Banco de Portugal
EUROSYSTEM

Living with the Euro: The Portuguese Experience

Pedro Duarte Neves

Conference on European Economic Integration | The Euro's Contribution to Economic Stability in CESEE

16-17 November 2009

Main stylised features

From boom to recession …

From adjustment with slow recovery,
to the recent world crisis…

Regime change and incentives

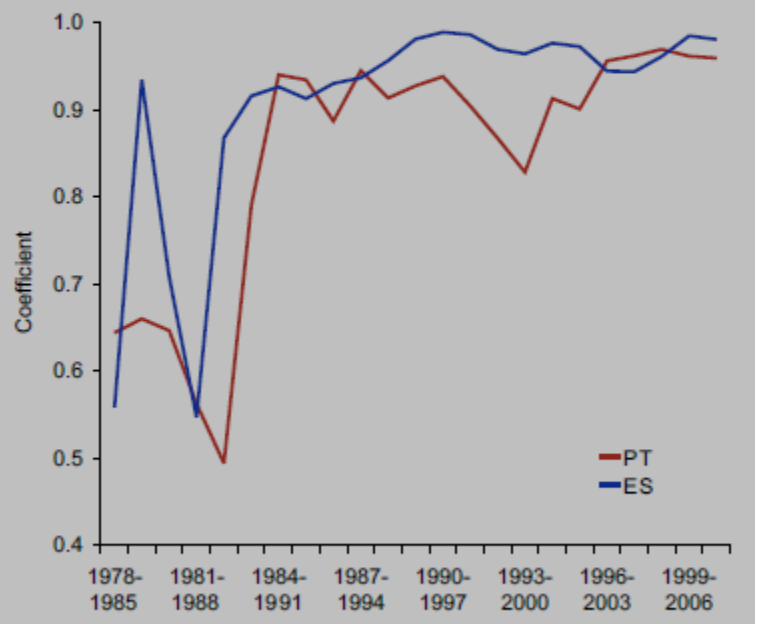
Main stylised features

- Strong synchronisation of economic cycles
- Real convergence vs. real divergence
- Cyclical sensivity of real wages
- Substancial increase in the indebtedness of the private sector
- Gap between domestic demand and domestic supply translated in current account deficits
- Deep changes in the structure and success of the exporting sector
- Regular increase in public revenue and public expenditure, and pro-cyclical fiscal policy
- Inflation and ULC convergence

Main stylised features

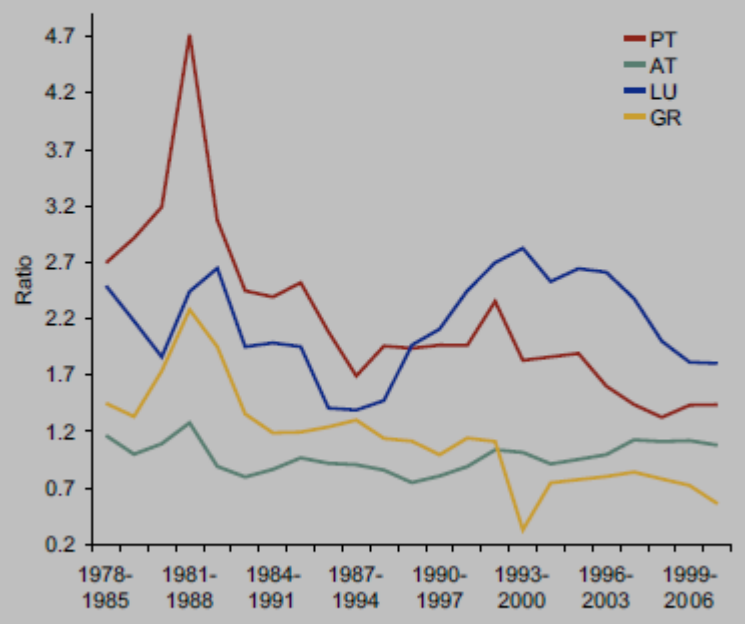
Strong synchronisation of economic cycles

BETWEEN THE PORTUGUESE AND SPANISH BUSINESS CYCLES AND THE EURO AREA BUSINESS CYCLE (8-YEAR ROLLING-WINDOWS; 1978-2007)



Sources: European Commission (AMECO) and Banco de Portugal.

VOLATILITY OF PORTUGUESE AND SPANISH BUSINESS CYCLES *VIS-À-VIS* THE EURO AREA'S BUSINESS CYCLE VOLATILITY (EIGHT-YEAR ROLLING-WINDOWS; 1978-2007)



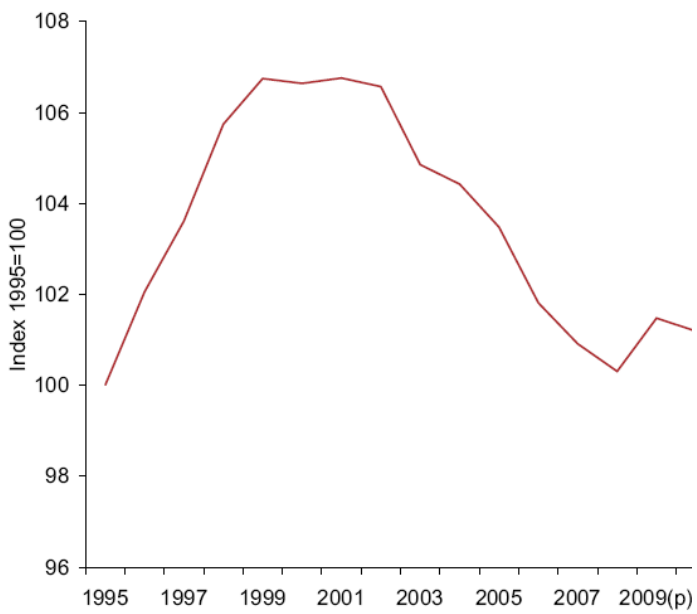
Sources: European Commission (AMECO) and Banco de Portugal.

Main stylised features

Real convergence vs. Real divergence

GROSS DOMESTIC PRODUCT

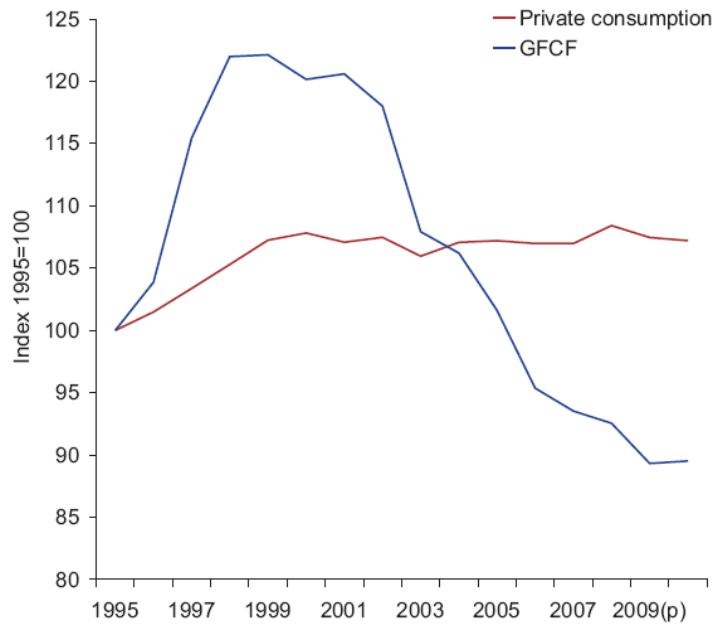
Cumulative growth differential *vis-à-vis* the euro area



Sources: ECB, Eurostat, *INE* and Banco de Portugal.
Note: (p) - projected.

GDP COMPONENTS

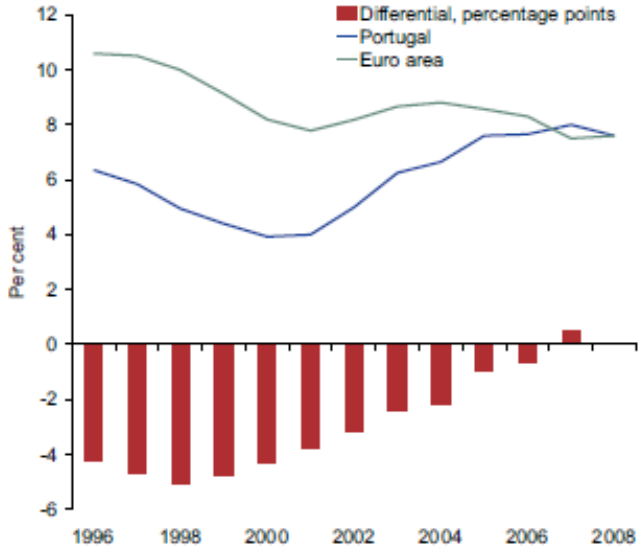
Cumulative growth differential *vis-à-vis* the euro area



Sources: ECB, Eurostat, *INE* and Banco de Portugal.
Note: (p) - projected.

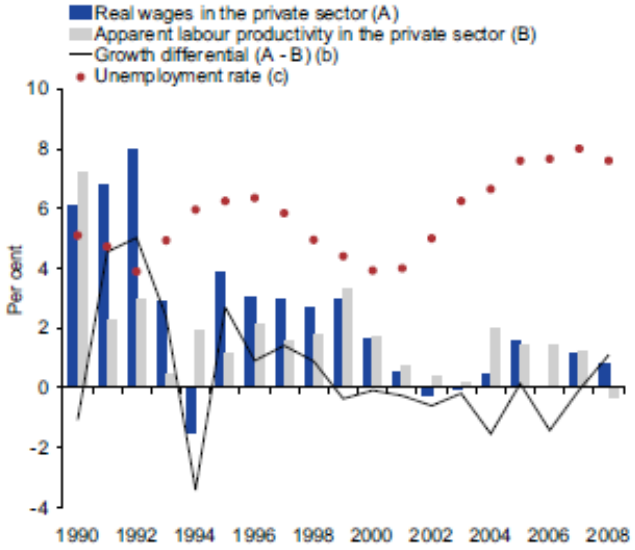
Main stylised features
Cyclical sensivity of real wages

UNEMPLOYMENT RATE IN PORTUGAL AND IN EURO AREA [a]



Sources: Eurostat, *INE* and Banco de Portugal.
Note: (a) The unemployment rate series was constructed according to the methodology described in Castro, G. L. and Esteves, P. S. (2004), "Quarterly series for the Portuguese economy: 1977-2003", Banco de Portugal, *Economic Bulletin-June*.

CHANGE IN REAL WAGES AND IN APPARENT LABOUR PRODUCTIVITY – PRIVATE SECTOR [a]

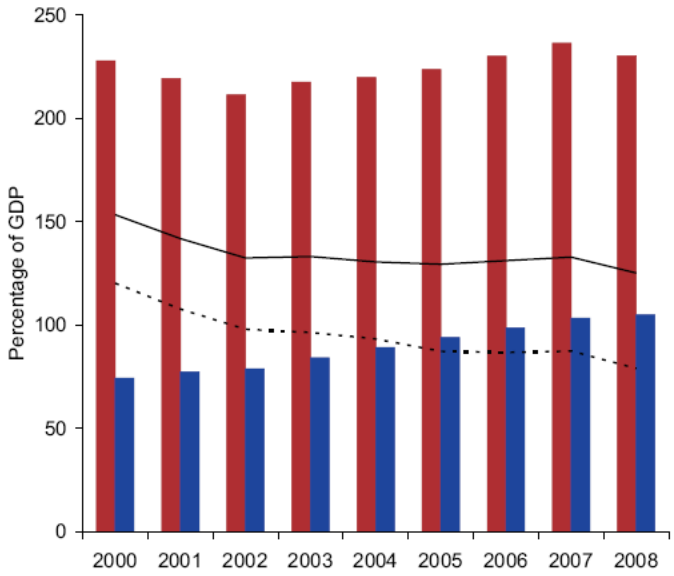


Sources: *INE* and Banco de Portugal.
Notes: (a) The real wages are obtained using the private consumption deflator. (b) In percentage points. A positive (negative) value means that real wages grew more (less) than productivity. (c) The unemployment rate series was constructed according to the methodology described in Castro, G. L. and Esteves, P. S. (2004), "Quarterly series for the Portuguese economy: 1977-2003", Banco de Portugal, *Economic Bulletin-June*.

Main stylised features:

Substancial increase in the indebtedness of the private sector

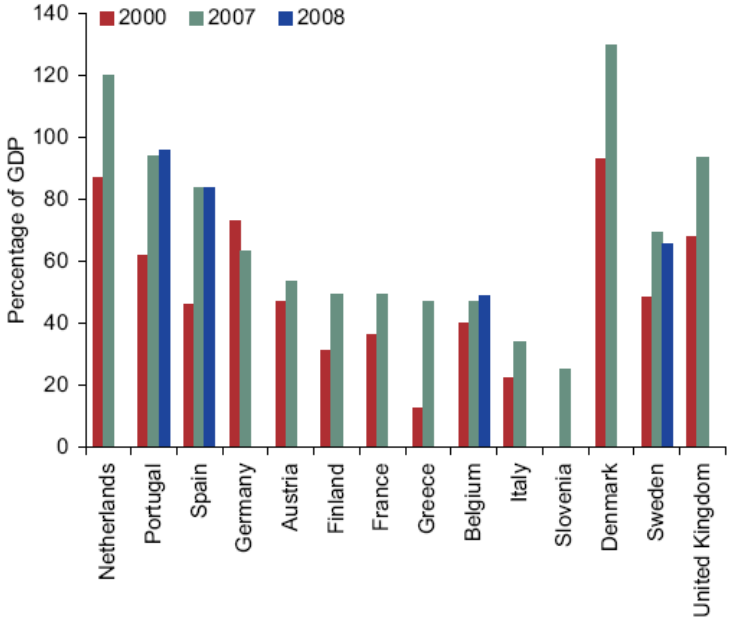
INDIVIDUALS' FINANCIAL ASSETS AND LIABILITIES



Sources: *INE* and Banco de Portugal.

- Total financial assets
- Total financial liabilities
- Net financial wealth
- Net financial wealth excluding insurance technical reserves and other receivables/payables

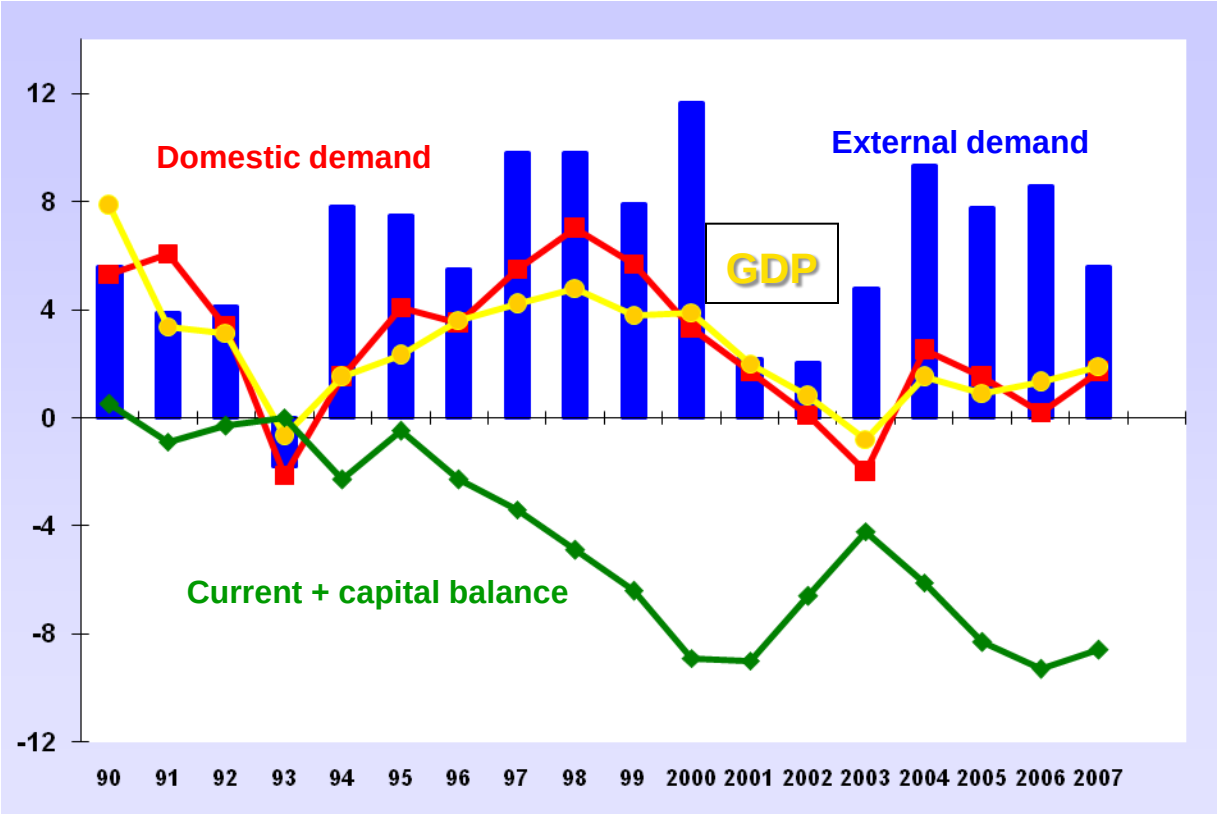
INDIVIDUALS' FINANCIAL DEBT



Sources: Eurostat and Banco de Portugal.
Note: Consolidated accounts (except for United Kingdom, non-consolidated).

Main stylised features:

Gap between domestic demand and demand supply translated in current account deficits



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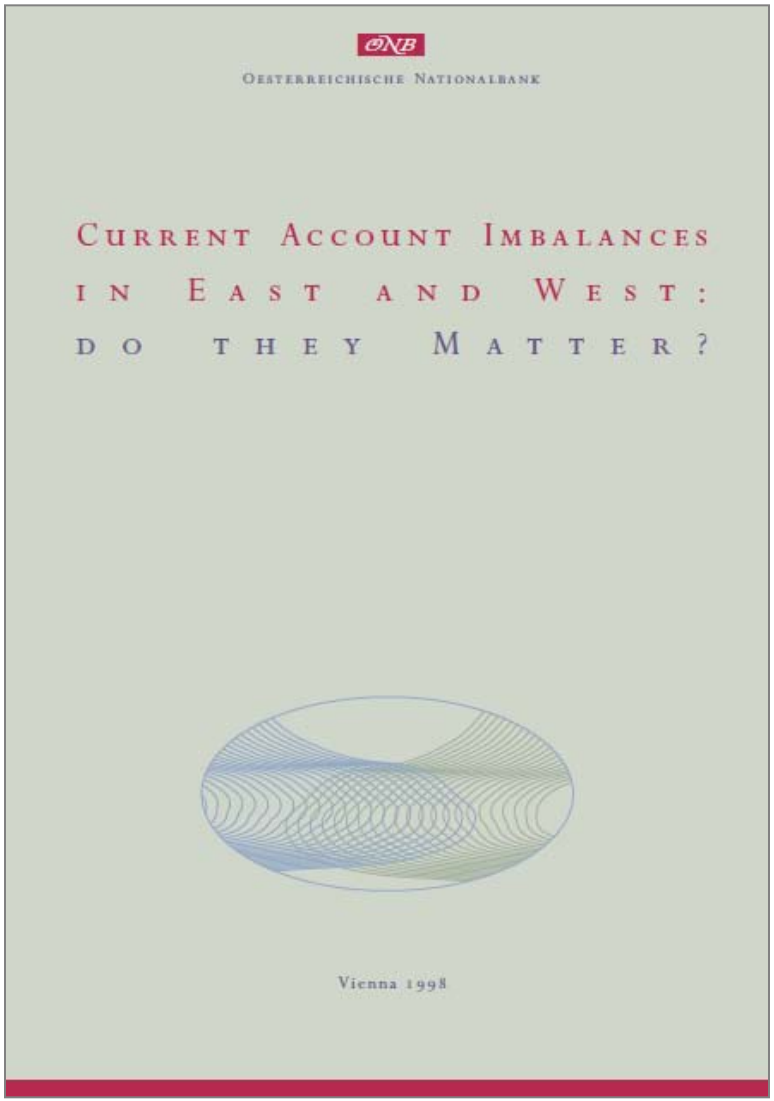

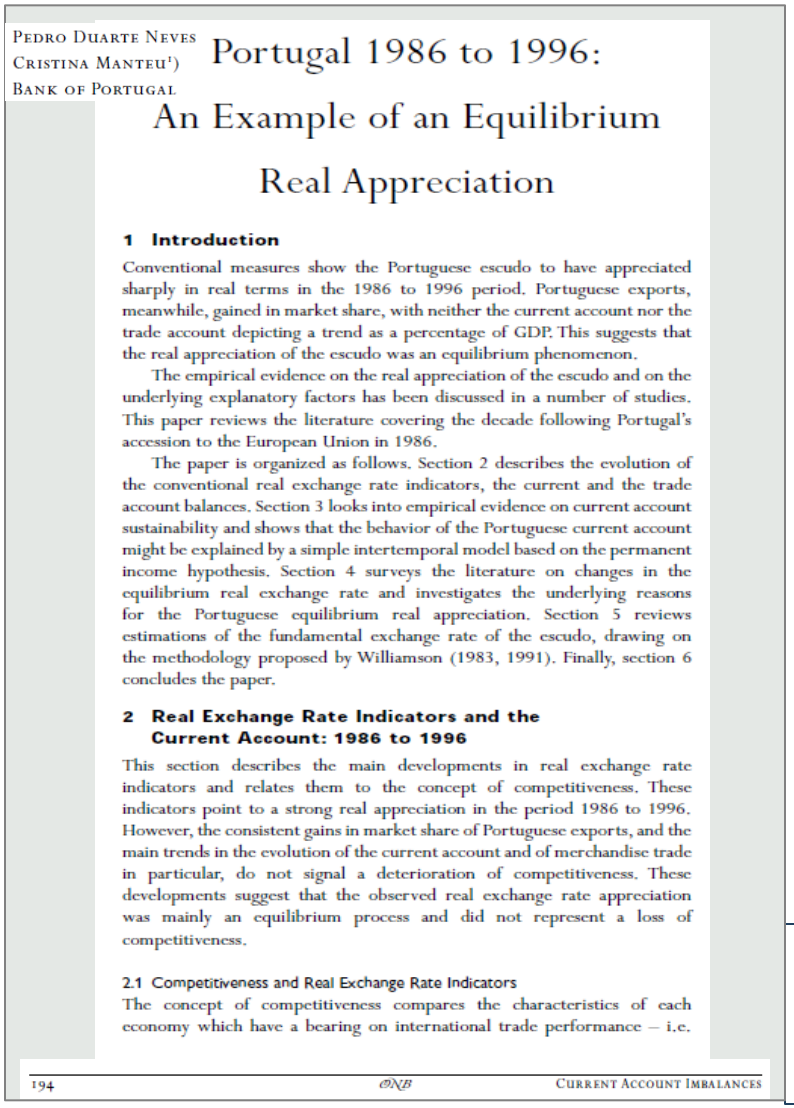

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Portugal 1986 to 1996: An Example of an Equilibrium Real Appreciation

1 Introduction

Conventional measures show the Portuguese escudo to have appreciated sharply in real terms in the 1986 to 1996 period. Portuguese exports, meanwhile, gained in market share, with neither the current account nor the trade account depicting a trend as a percentage of GDP. This suggests that the real appreciation of the escudo was an equilibrium phenomenon.

The empirical evidence on the real appreciation of the escudo and on the underlying explanatory factors has been discussed in a number of studies. This paper reviews the literature covering the decade following Portugal's accession to the European Union in 1986.

The paper is organized as follows. Section 2 describes the evolution of the conventional real exchange rate indicators, the current and the trade account balances. Section 3 looks into empirical evidence on current account sustainability and shows that the behavior of the Portuguese current account might be explained by a simple intertemporal model based on the permanent income hypothesis. Section 4 surveys the literature on changes in the equilibrium real exchange rate and investigates the underlying reasons for the Portuguese equilibrium real appreciation. Section 5 reviews estimations of the fundamental exchange rate of the escudo, drawing on the methodology proposed by Williamson (1983, 1991). Finally, section 6 concludes the paper.

2 Real Exchange Rate Indicators and the Current Account: 1986 to 1996

This section describes the main developments in real exchange rate indicators and relates them to the concept of competitiveness. These indicators point to a strong real appreciation in the period 1986 to 1996. However, the consistent gains in market share of Portuguese exports, and the main trends in the evolution of the current account and of merchandise trade in particular, do not signal a deterioration of competitiveness. These developments suggest that the observed real exchange rate appreciation was mainly an equilibrium process and did not represent a loss of competitiveness.

2.1 Competitiveness and Real Exchange Rate Indicators

The concept of competitiveness compares the characteristics of each economy which have a bearing on international trade performance – i.e.

194 ONB Current Account Imbalances

Main stylised features:

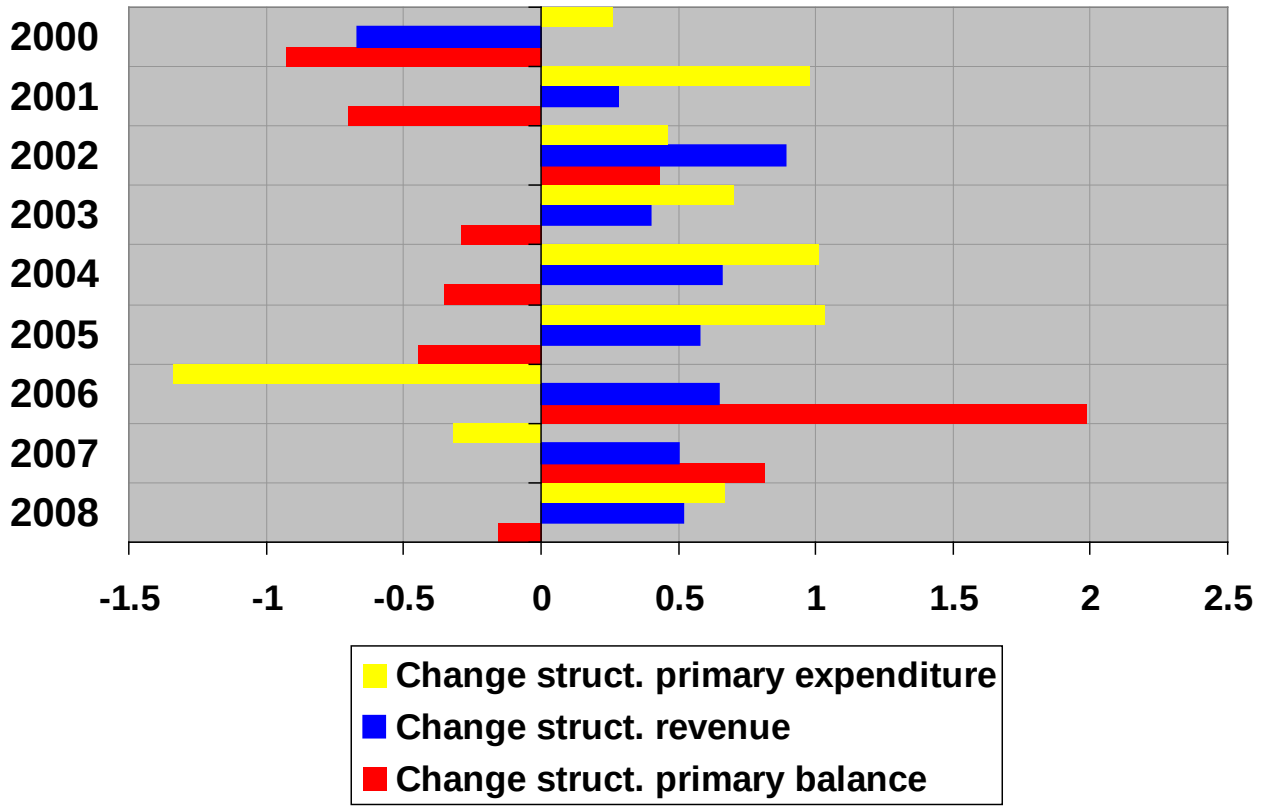
Deep changes in the structure and performance of the exporting sector

- Strong increase in trade openness;
- Strong gains of export market shares from 1987 to 1996, strong losses from 1997 to 2006;
- Movement towards exports of medium-high and high technology goods;
- Increase in intra-industry trade;
- Increasing importance of vertical specialization;
- Evidence of important activity within exporting firms in terms of product and destination switching

Main stylised features:

- Regular increase in public revenue and public expenditure
- Pro-cyclical fiscal policy

Change of primary deficits, revenues and expenditures, cyclically adjusted and excluding temporary measures (as a % of GDP)



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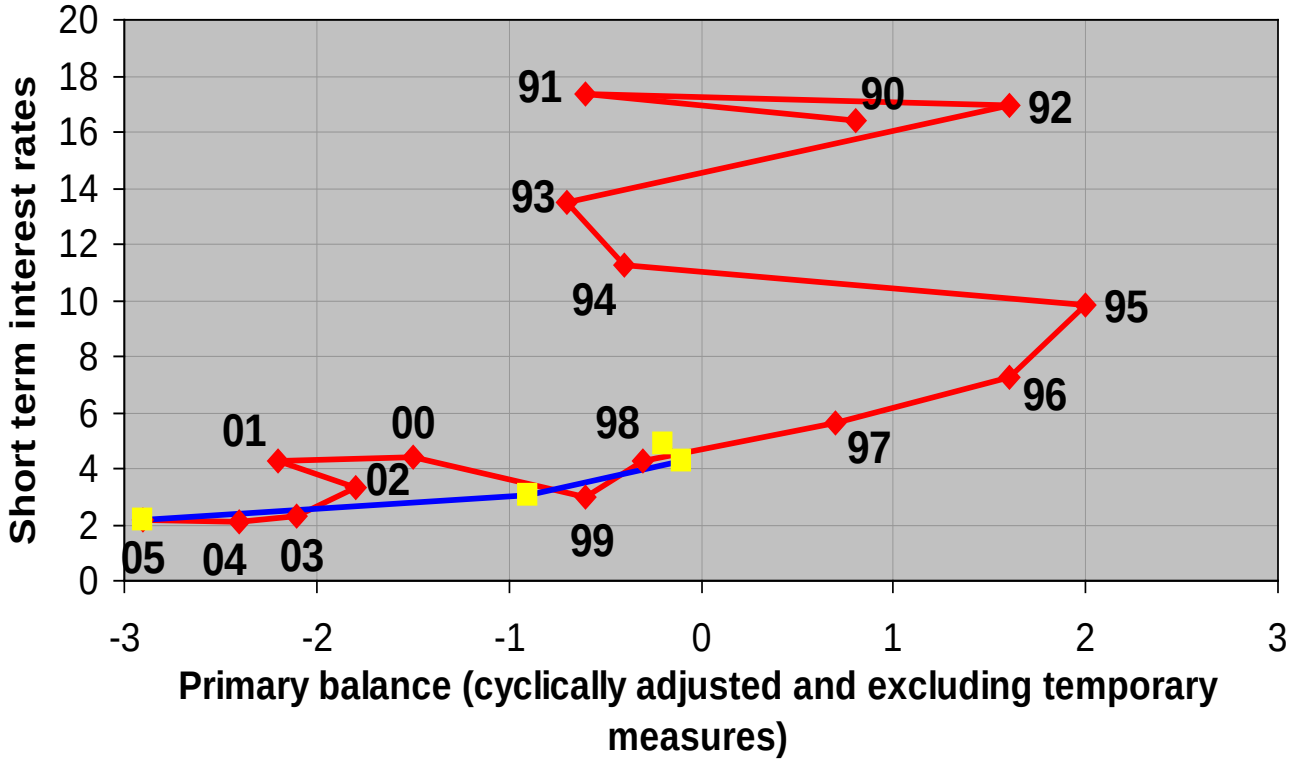
Before the introduction of the euro and until 2005: pro-cyclical (this behaviour exacerbated expectations concerning trend growth during the late 90s and contributed to the sharp reversion of expectations in the early 00s)

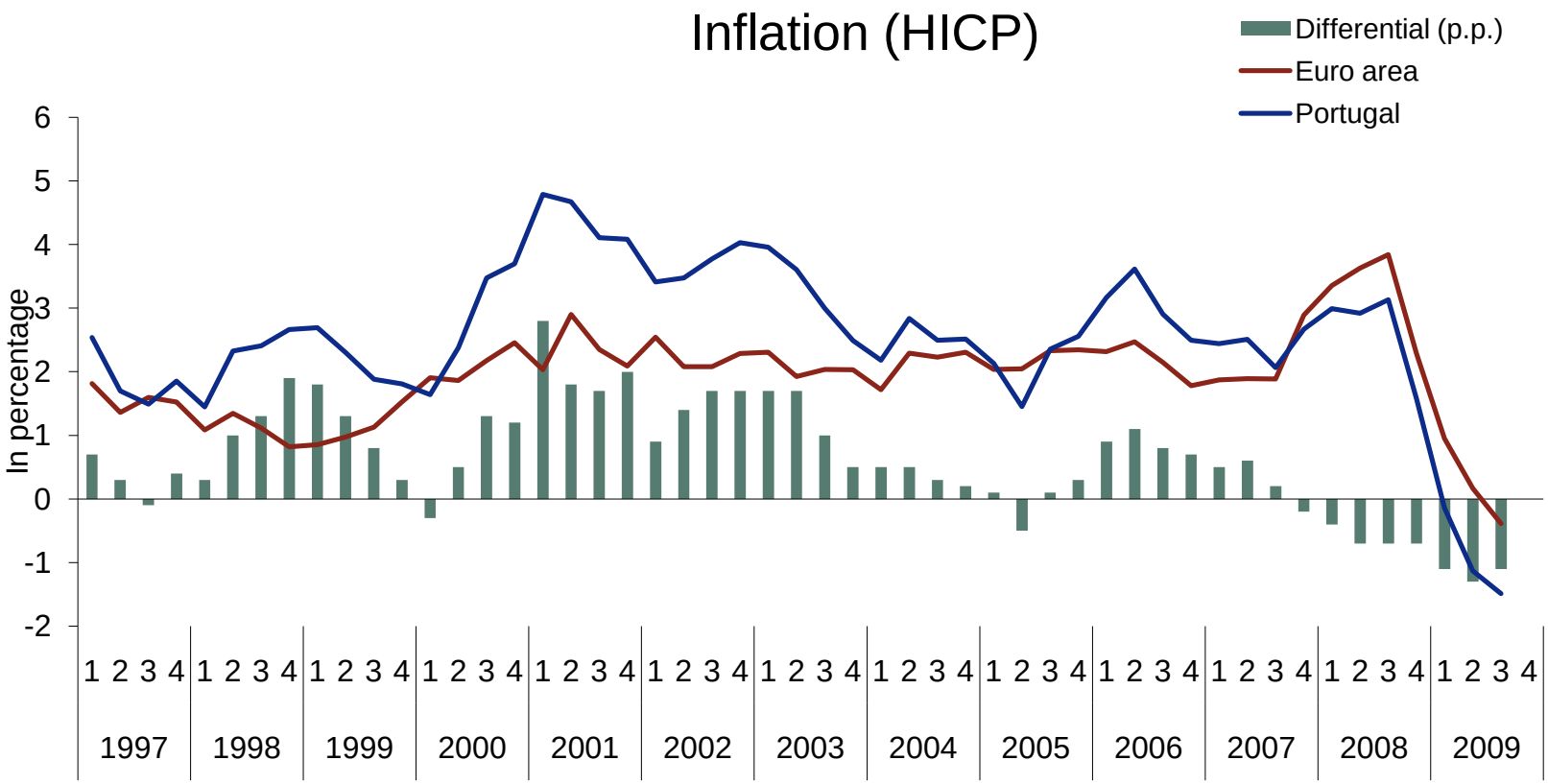


Main stylised features:

Nominal convergence

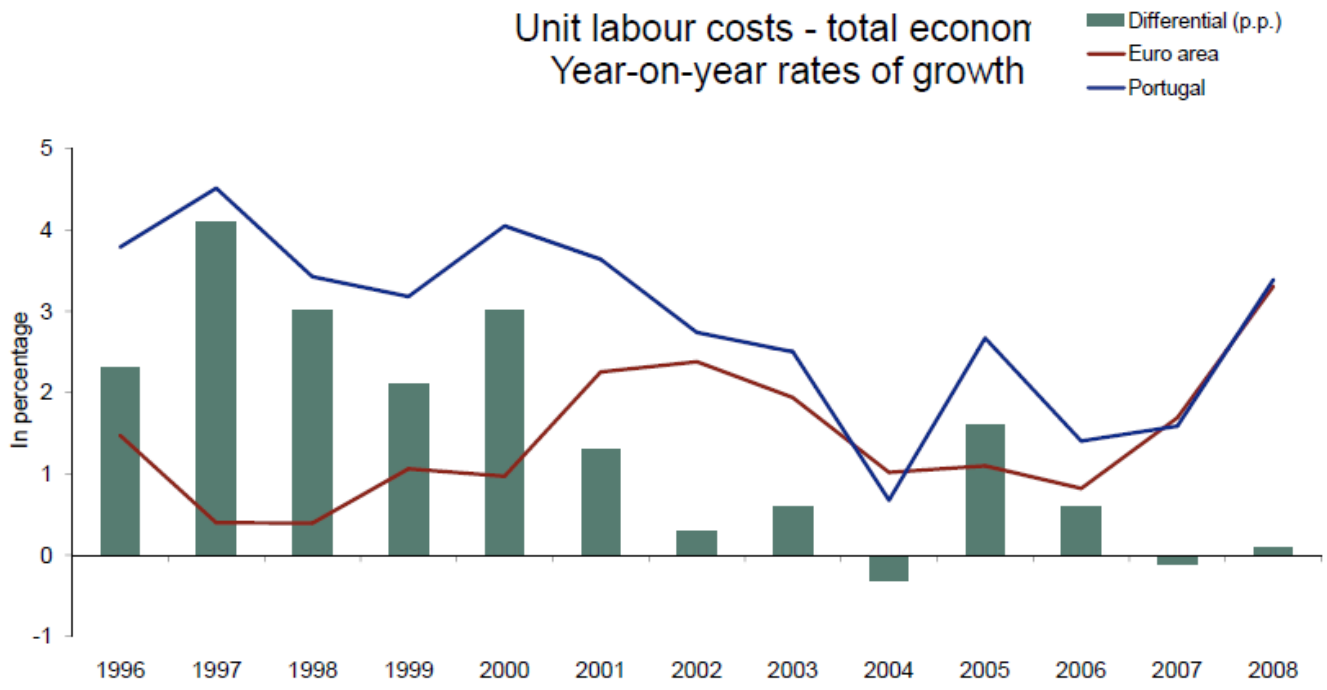
- Inflation convergence;
- ULC growth convergence.

Inflation convergence



Source: Eurostat.

UCL growth approached the euro area dynamics around 2002/03



Sources: ECB, INE and Banco de Portugal.

From boom…

- The boom was relatively short
- The interest rate channel played a major role
- No bubble emerged in the property market
- Fiscal policy was pro-cyclical

To recession…

- The role of shocks
- The role of expectations:

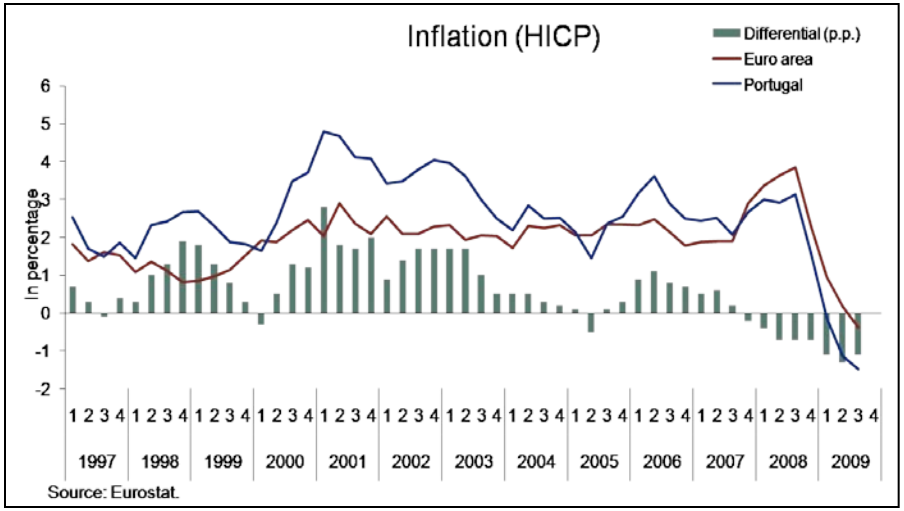
  the emergence of the 2001 budget crisis

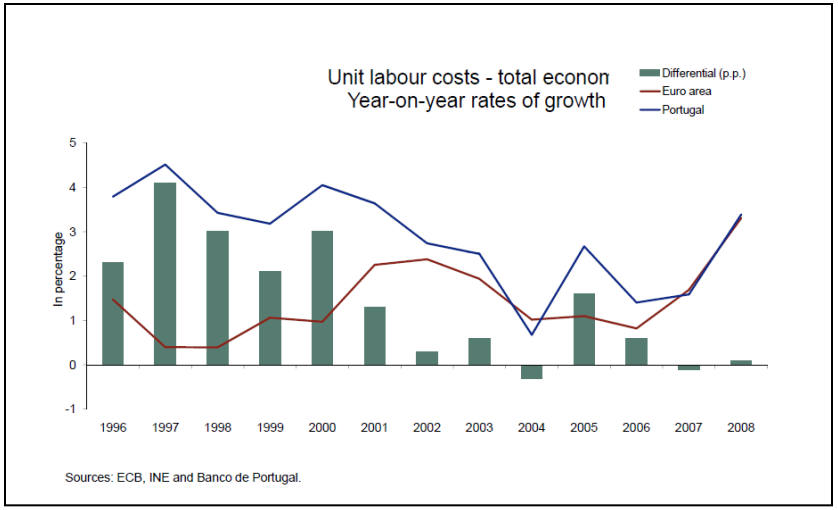
From adjustment with slow recovery…

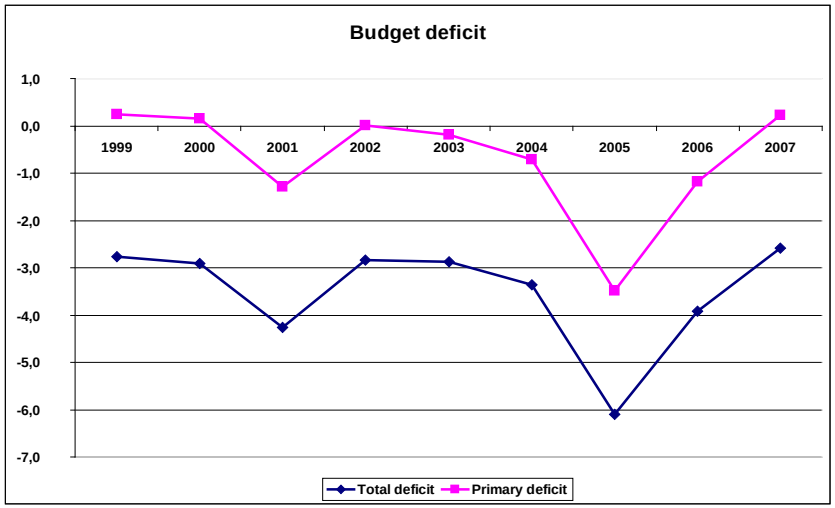
- Fiscal consolidation
- ULC growth at the euro area figures
- Inflation convergence
- External deficit structural adjustment

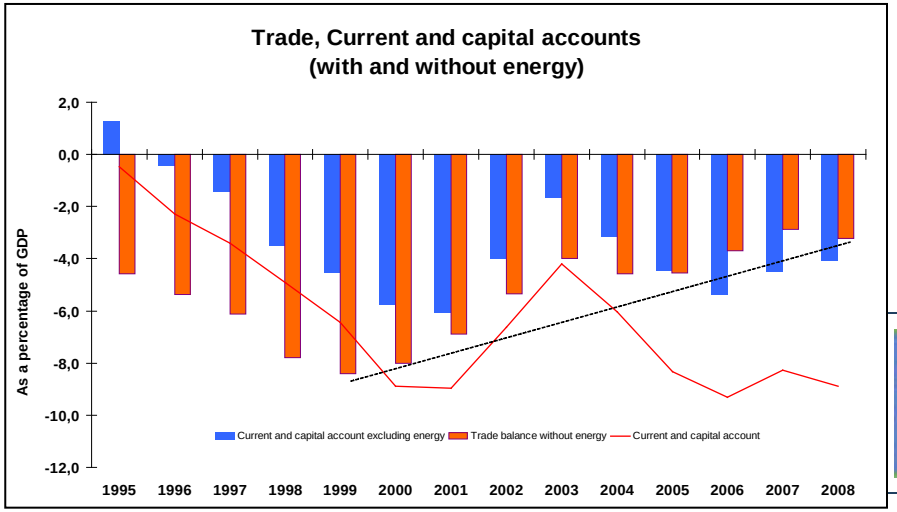
To the recent world crisis…

Portuguese economy: from boom to adjustment









Regime change and incentives

- Lower and less volatile inflation and interest rates
- Fiscal position
- Change in comparative advantages

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