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Portugal's participation in EMU at the initial stage now looks certain

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Introduction

On the 25th March the Commission and the European Monetary Institute published their separate reports on progress towards meeting the convergence criteria for Economic and Monetary Union. In addition, the Commission published its Recommendation on which Member States had qualified to participate in the Single Currency on 1st January 1999. Its assessment was that eleven countries met the criteria: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Denmark and the UK had met the criteria, but had exercised their right to "opt out" for the time being.

This Recommendation now has to be confirmed by the Council of Economic and Finance Ministers (ECOFIN); by the European Parliament; and, for final decision, by the European Council of Heads of State and Government on 2nd May.

*

Portuguese economic policy in recent years has been largely shaped by the need to meet the convergence criteria and join Economic and Monetary Union. Despite initial scepticism about Portugal's prospects, the economy has responded well, and participation in 1999 now looks certain.

An important characteristic of policy over recent years has been the broad consensus on the main economic issues between the two leading political parties, the centre-right Social Democratic Party (PSD) and the centre-left Socialist Party (PS). Most notably, both parties have been strongly in favour of joining the Single Currency at the first opportunity.

While some EU governments have met strong opposition to austerity programmes, popular protest has remained subdued in Portugal. One of the reasons may be that the country's flexible labour market has kept unemployment below the EU average, despite a rise to over 7% in recent years. Both the Portuguese Communist Party (PCP) and the right-wing Popular Party (PP) opposed the Maastricht Treaty. This opposition has nevertheless had little impact on public policy.

Compliance with the criteria

Under the Maastricht Treaty, EU Member States' participation in the third stage of EMU is conditional on their complying with four basic nominal convergence criteria. These nominal criteria have been met, as outlined in Table 1.

Table 1: Convergence criteria for Portugal

	Inflation	Long-term interest rates	Budget deficit (% of GDP)	Public debt (% of GDP)
1993	6.5	11.2	6.1	63.1
1994	5.2	10.5	6.0	63.8
1995	4.1	11.5	5.7	65.9
1996	2.9	8.6	3.2	65.0
1997	1.9	6.4	2.5	62.0
Feb 97-Jan 98 (ref. period)	**1.8**	**6.2**	**2.5**	**62.0**
1998 (forecast)	2.2	-	2.2	60.0

Source: Commission and EMI reports, March 1998

Portugal will therefore meet *à la lettre* the inflation, interest rate and deficit criteria. The ratio of government debt to GDP, is not far from the 60% reference level in 1997 and since 1995 it has been approaching the reference value at a satisfactory pace. Moreover, it is forecasted that the reference level will be reached in 1998.

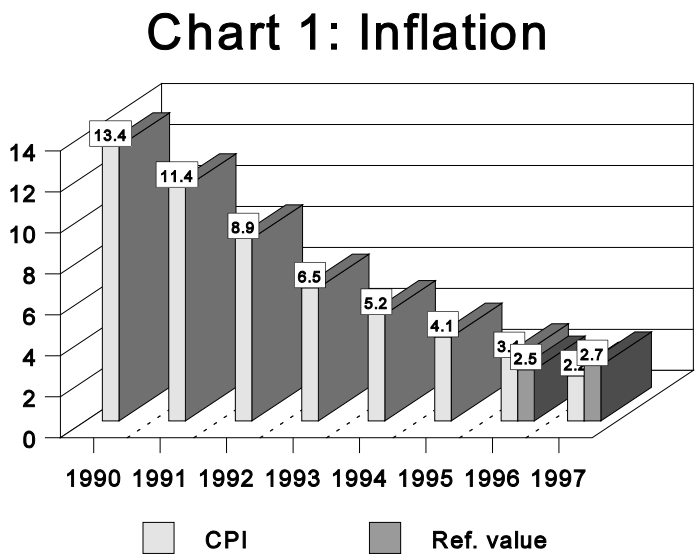
a) Inflation

Consumer price inflation in Portugal , as measured on the basis of the Consumer Price Index, has followed a downward trend since the early 1990s, with the rate falling steadily from above 13% at the start of the decade. This experience of disinflation reflects a number of important policy choices. Monetary policy has been geared increasingly towards the reduction of inflation rates, first through a unilateral link to a basket of ERM currencies, and then, from spring 1992 onwards, through membership of the ERM. This general orientation has been supported by adjustments in fiscal policy, reforms designed to enhance product market competition and labour market reforms. In addition, the macroeconomic environment has contributed to containing upward pressure on prices. In particular, in the context of weak GDP growth in 1993-94, a negative output gap emerged. In the subsequent recovery, the output gap has been reduced gradually.

Against this background, upward pressures on compensation per employee have been restrained although increases have still been considerable. Growth in unit labour costs has decelerated markedly over the 1990s. Import price developments have underpinned the disinflationary process during most of the period under review.

Over the reference period from February 1997 to January 1998 the average rate of Harmonised Index of Consumer Prices inflation in Portugal was 1.8%, i.e. well below the reference value of 2.7%. This was also the case in 1997 as a whole. In 1996 average HICP inflation was 2.9%

Most forecasts of inflation suggest a rate of somewhat above 2% for 1998 and 1999. Risks for price stability over this period are associated with a narrowing of the output gap and accelerating unit labour costs.



Source: National data and European Commission
Note: 1996 and 1997 data are referred to HCPI inflation adopted by the European Council in October 1995 which set out a step-by-step approach for harmonising the CPI in the Member States.

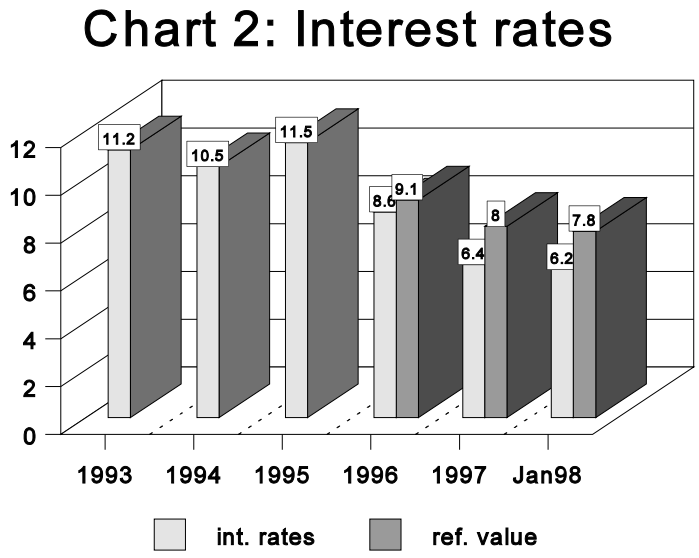
Summarizing, the inflation rate in Portugal has been decreasing gradually until 1997 when it was below the reference value.

b) Long-term interest rates

Long-term interest rates have been on a broadly declining trend since the early 1990s. A broad trend towards the convergence of Portuguese long-term interest rates with those prevailing in the EU countries with the lowest bond yields has also been observed for most of the period since the early 1990s. Since mid-1995 this process of convergence has accelerated and the differential has now been virtually eliminated. The main factor underlying this trend was the significant narrowing of the inflation differential. In addition, the relative stability of the Portuguese escudo's exchange rate and the improvement in the country's fiscal position also played a role.

These underlying developments were seen by markets as improving the prospects for participation in Stage Three of EMU - an element which may in turn have played an independent role in accelerating the narrowing of yield differentials, both directly and by further improving the prospects for price and exchange rate stability.

Over the reference period from February 1997 to January 1998 long-term interest rates in Portugal were 6.2% on average, and thus stood below the reference value for the interest rate criterion of 7.8% set on the basis of the three best-performing Member States in terms of price stability. This was also the case for 1997 as a whole, as well as for 1996. Long-term interest rates have been below the reference value since November 1996.



Source: EMI, Eurostat

Note: Jan 1998 data are the figures of the reference period from February 1997 to January 1998

Summarizing, above all since 1995, long-term interest rates have been declining to below the reference value in 1996 and 1997.

c) Budget deficit as a % of GDP

Following the recession in 1993 and the slow recovery of the economy up to 1995, Portugal's government deficit reached 6.1% of GDP in 1993 and declined only slightly to 5.7% of GDP in 1995. The government deficit was brought down to 3,2% of GDP in 1996, due to the gradually improving economic conditions and the consolidation measures adopted since 1994.

Growth in government expenditure slowed down in 1996 and spending on government investment, the public wage bill and subsidies to enterprises remained restrained. Interest

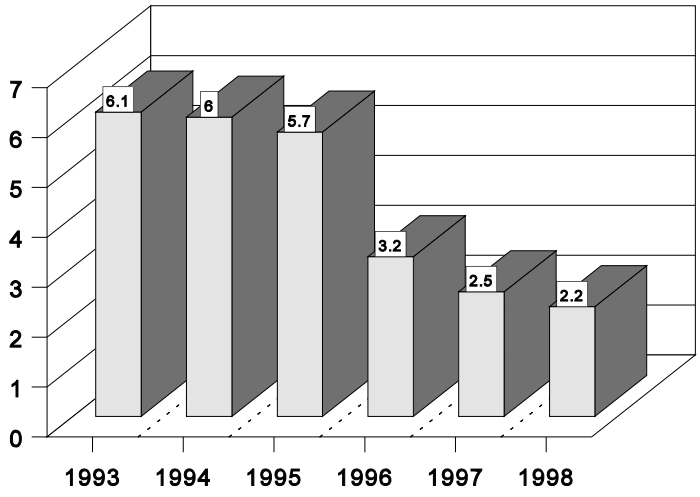
payments fell sharply in 1996, due to falling interest rates and improved debt management. The most important contribution to the marked reduction of the government deficit came, however, from a noticeable improvement in the efficiency of the collection of taxes.

A discretionary tightening already took place in 1994 and 1995 but there was only a small reduction in the actual deficit due to the worsening economic conditions during those years. The substantial reduction in the government deficit which took place in 1996 was mainly brought about by an additional budgetary retrenchment, even though improving cyclical conditions also contributed to this result. Since 1996 government investment expenditure has been larger than the government deficit.

In 1997, the government deficit fell more than initially expected to 2.5% of GDP. The further improvement in the 1997 deficit resulted mainly from economic growth and relied less on further structural consolidation. The measures included in the 1997 budget were similar to those implemented over the previous years: better debt management to bring down interest payments, control of current primary expenditure and further increases in tax receipts and social security contributions due to improved tax collection methods.

For 1998, the deficit is forecast by the Commission services to fall further to 2.2% of GDP. Tax revenues and social security contributions are expected to remain buoyant, due to the improved efficiency of the tax administration and the social security system, while interest payments are expected to be reduced further and government investment will remain restrained.

Chart 3: Budget deficits



Source: European Commission
Note: 1998 data are the Commission forecasts

The Portuguese convergence programme of March 1997 projects a further gradual reduction of the government deficit to 1,5% of GDP by the year 2000, in a context of continuously buoyant economic growth. Two thirds of the projected deficit reduction would come from further

reductions in interest payments, while the rest would be generated by the limitation of current primary expenditure. The programme sets an explicit limit for current primary expenditure and aims for a re-orientation of government expenditure towards increased spending on social security, education and investment.

To sum up, the government deficit in Portugal has been reduced substantially and continuously since 1993 and in 1997 it fell below the reference value. In view of the sustained buoyancy of economic growth and the further decline in interest payments, the government deficit is expected to continue to decrease further in 1998.

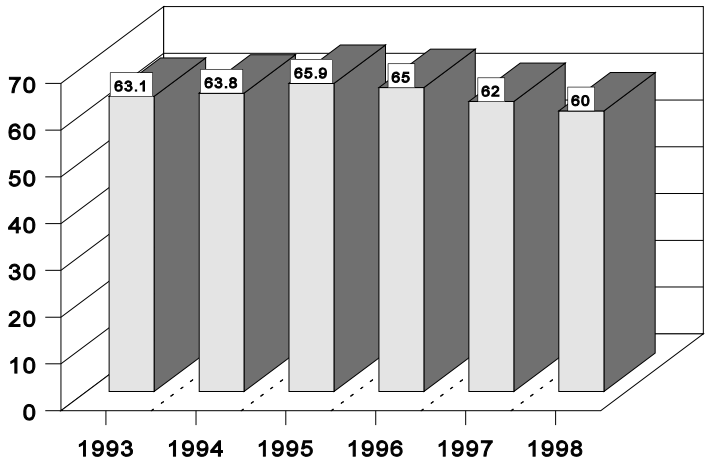
d) Public debt as a % of GDP

Following its sharp increase to 63.1% of GDP in 1993, the government debt ratio continued to drift upwards in 1994 and 1995, before starting to decline in 1996, when it fell for the first time to 65.0% of GDP. The debt ratio fell further by 3,0 percentage points to 62.0% of GDP in 1997, due to the combined impact of the lower government deficit, higher GDP growth and the use of substantial privatisation receipts to redeem government debt.

Part of the receipts from the privatisation of public enterprises in the telecommunications and electricity sector carried out in 1997 was used to redeem government debt for an amount of almost 4% of GDP in the same year.

For 1998, the Commission services forecast the government debt to fall further to 60% of GDP. The Portuguese government plans to realise around 2% of GDP of privatisation receipts in 1998, a large part of which will be used to further redeem the government debt.

Chart 4: Public debt



Source: European Commission
Note: 1998 data are the Commission forecasts

Portugal is currently running a primary budget surplus of 1.9% of GDP. The analysis of debt trends contained in the Commission's March 1998 report shows the overall level of debt falling below the 60% reference level in 1998.

Table 2: Sustainability of Portuguese debt trends

Government debt ratio in 1997 (% GDP)	Change in debt ratio 1996-7 (%GDP)	Actual primary balance in 1997 (%GDP) (1)	Debt stabilising primary balance in 1997 (%GDP) (2)	Debt stability gap* in 1997 (%GDP) (3)=(2)-(1)	Years to bring debt ratio below 60% of GDP**	Year when debt ration falls below 60% of GDP**
62.0	-3.0	1.9	0.8	-1.1	1	1998

Source: European Commission
**A negative sign means that the actual primary balance is sufficiently large to bring down the debt ratio in 1997.*
***The calculations have been made as follows: Spring economic forecasts for the debt ratio until 1999 and projections thereafter, fixing interest rates on government debt at a level of 6%, inflation rates at 2% and keeping real GDP growth rates and primary balances constant at the levels forecast in 1999.*

The EMI report draws attention to the increase in the Portuguese "elderly dependency ratio" (i.e. the population aged 65 and over as a percentage of the population aged 15-64) during the early decades of the next century. This will rise from 20.9% in 2000 to 33.5% in 2030, and constitutes a further element of public debt in the form of pension obligations.

The EMI report also draws attention to certain features in the structure of Portuguese public debt. The proportion currently denominated in Portuguese escudos, rather than foreign currencies, is 81,2% of the total. Its average maturity, moreover, has been of 3.5 years. Short-term debt (below a year) is 33%, medium-term debt (1-5 years) is 38% and long-term debt (over 5 years) is 29%.

As a conclusion, the government debt ratio has been declining since 1995 and exceeded the 60% of GDP reference value by only a small amount in 1997. The government debt ratio is expected to equal 60.0% of GDP in 1998 and then to fall below the reference value.

e) Normal ERM fluctuation margins

The Portuguese Escudo has been participating in the ERM since 6 April 1992, i.e. for considerably longer than two years prior to the examination.

As mentioned above, Portuguese monetary policy has been geared towards the achievement of price stability, from spring 1992 onwards within the context of the ERM.

Focusing on the reference period from March 1996 to February 1998, the currency, benefiting from sizable short-term interest rate differentials vis-à-vis most partner currencies, has normally

traded close to its central rates against other ERM currencies. On occasion the Portuguese escudo traded outside a range close to its central rates vis-à-vis various partner currencies. The maximum upward and downward deviations from central rates, were 3.5% and -2.3% respectively, abstracting from the autonomus upward trend of the Irish pound. The episodes in which such deviations occurred were temporary, the degree of exchange rate volatility vis-à-vis the Deutsche Mark was low and short-term interest rate differentials against those EU countries with the lowest short-term interest rates were contiguously narrowing. During the reference period Portugal did not devalue its currency's bilateral central rate against any other Member State's currency.

Table 3: Exchange rate stability
(1 March 1996-27 February 1998)

Membership of the Exchange Rate Mechanism (ERM) Membership since Devaluation of bilateral central rate on country's own initiative	Yes 6 April 1992 No	
Maximum upward (+) and downward (-) deviations from central rates in the ERM grid (%)of the Portuguese escudo against		
Belgian franc	2.8	-1.4
Danish krone	2.8	0.0
Deutsche Mark	2.9	-1.1
Spanish peseta	1.7	-2.3
French franc	3.5	0.0
Irish pound	3.0	-9.3
Italian lira	3.0	-0.7
Dutch guilder	2.5	-1.7
Austrian guilder	2.9	-1.1
Finnish markka	1.2	-1.4

Source: European Commission and EMI calculations

Summarizing, the escudo has been stable in the ERM and close to the central rates against the other Member States' currencies, except the Irish pound.

f) Independence of the Bank of Portugal

The Commission and the EMI, in their reports, analyse the compatibility of the national legislation of each Member State, including its central national bank statutes, with the Treaty and the ESCB Statute.

The statute of the Banco de Portugal was amended to meet Treaty and Statute requirements for Stage Three, following a consultation with the EMI, as follows.

♦ Article 105 of the Constitution was adapted by means of the Constitutional Law No.1/97

of 20 September 1997. The new article now states that the Bank is the national central bank of Portugal and performs its functions in accordance with the law and with the international norms binding upon the Portuguese State. This reference to "international norms" intends to cover in particular the Treaty and the Statute.

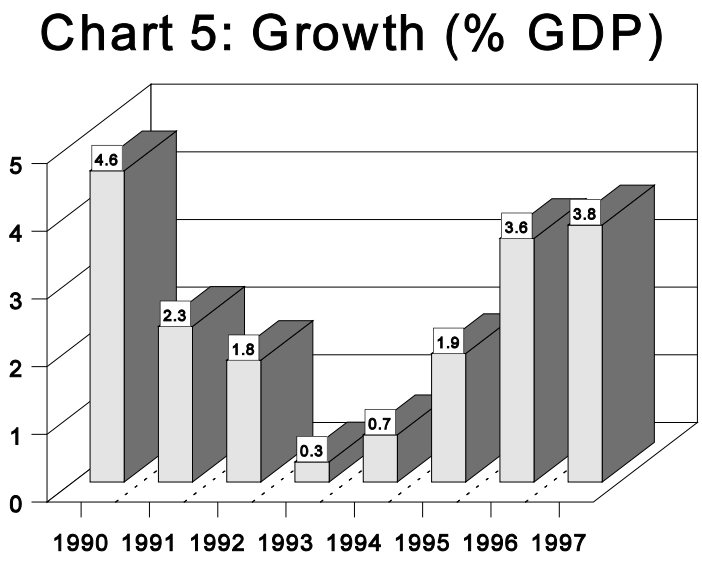
- The Organic Law of the Banco de Portugal of 30 October 1990 as amended was changed with Law No. 5/98 of 31 January 1998 (the new law).

All provisions of the new law regarding independence have entered into force already, while the other provisions will come into force when Portugal adopts the euro.

With the adoption and the entry into force of the Constitutional Law No. 1/97 and the new law, the Commission and the EMI consider that the statute of the Banco de Portugal is compatible with Treaty and Statute requirements for Stage Three.

g) Growth and unemployment

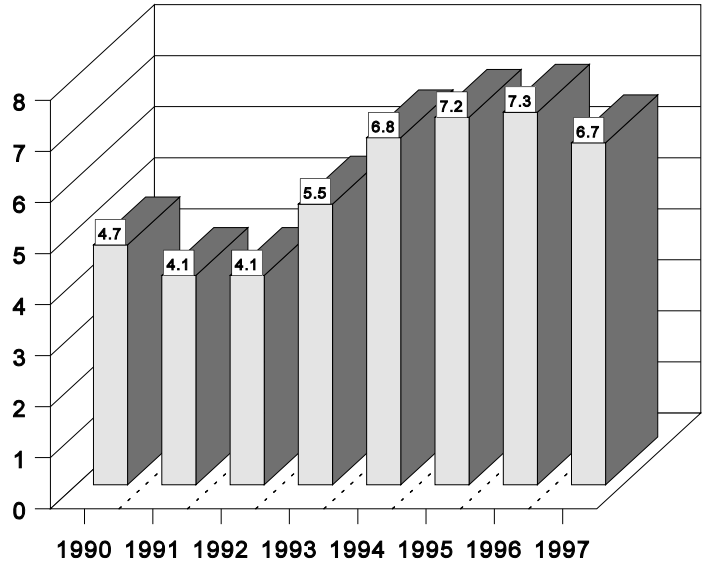
Portugal's economy has improved significantly in the recent past. The economy began a new business cycle with strong growth based on exports and investment.



Source: European Commission

If we look at the growth trend we can see that the GDP decreased continuously until 1993 where it reached the lowest figure of the decade. Since then it started an upward trend until now with growth rates over 3.5% in 1996 and 1997.

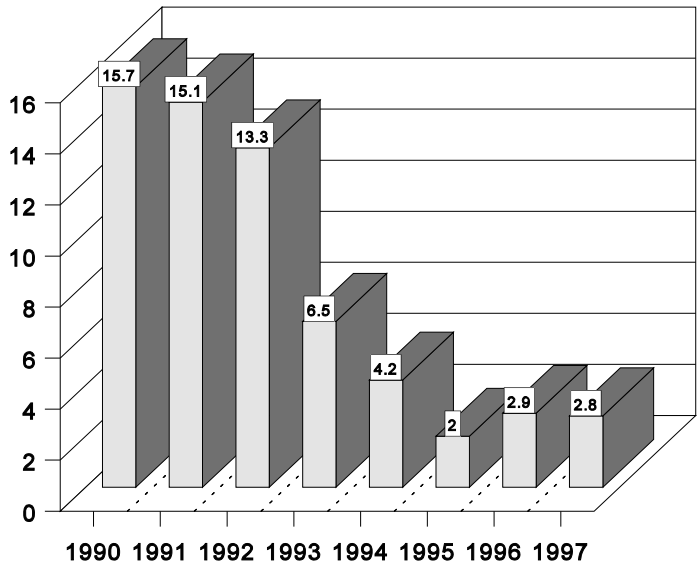
Chart 6: Unemployment (% GDP)



Source: National data

Unemployment has been growing since 1992 until 1996, to start decreasing in 1997. This recent downward trend is the result of the sustained economic growth but there is also a substantial rise in the number of people seeking work. According to the OECD, there is good reason to be optimistic over the ability of the Portuguese labour market to adapt to the new monetary regime. The OECD, moreover, welcomes the strategic social pact signed by the social partners and the government which, in exchange for wage moderation undertook to implement a vast panoply of reforms targeted at taxation, social security, employment services, education training, work contracts and competition on the product markets. The most important objective of this plan is to raise the level of teaching and qualifications in Portugal to the OECD average.

Chart 7: Unit Labour Costs (% GDP)



Source: National data

Unit labour costs decreased during the 1990-95 period, increasing only moderately in 1996 and 1997. The "policy mix" implemented in Portugal in the context of EMU, monetary policy oriented towards price stability and fiscal policy restricting the public deficit, has brought about a decrease in interest rates, as a result of lower inflation and budget deficit. This reduction, together with wage moderation, has promoted economic growth and a moderate fall in unemployment.

h) Current account balance

In Portugal there was a current account deficit of more than 2% of GDP in 1997. Rapidly rising import growth due to a domestically led recovery explains most of the current account deterioration. Portugal is, however, experiencing high productivity growth in the exposed sector, compensating for unit labour cost increases in the overall economy. Furthermore, inflows of foreign direct investment remain strong in Portugal, indicating that the current account deficit is sustainable at least for the foreseeable period.

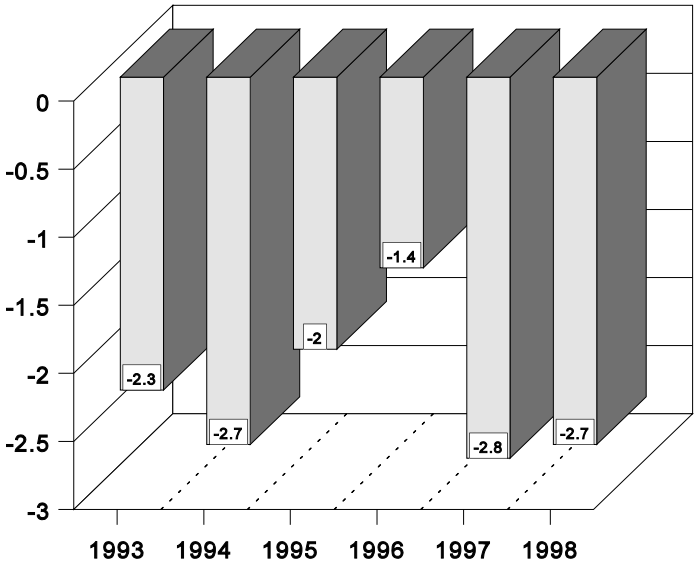


Chart 8: Current Account balance (- = deficit)

Source: European Commission
Note: 1998 data is the Commission forecast

i) EC Cohesion and Structural Funds

Receipts from the European Community structural funds have played a significant role in enabling Portugal to meet the convergence criteria. The expected GDP by the end of CSF 1994/1999 programming period will be 3% higher than it would have been without these transfers. The investment rate over the GDP is expected to be 31.5%, instead of 29% without these transfers.

Political Background

i) The Government

Portugal's political stability was consolidated by the victory of Socialist Jorge Sampaio in the presidential elections of January 1996, which gave Portugal a Government and a presidency of the same colour for the first time since democracy was restored in 1974.

The Socialist Government is, however, only half socialist in the party political sense, in that only 9 out of the 17 Cabinet Ministers are Socialist Party members. The others are independent specialists, experts in their fields. By naming Antonio de Sousa Franco, an independent respected for his technical rigour, as Finance Minister, Prime Minister Guterres has shown his determination to keep spending in check.

ii) The Social Democratic Party

The centre right Social Democrats (PSD), the main opposition party, is slowly regaining confidence after its general election defeat in October 1995, which ended 14 years in Government. PSD leader Fernando Nogueira resigned after Cavaco Silva lost the presidential elections, which immersed the party in crisis. Marcelo Rebelo de Sousa, a liberal intellectual who did not serve under Cavaco Silva, was elected as the party's leader at a special Congress in March 1996.

The leadership crisis has blunted the PSD's opposition to the Government, and Guterres has made the PSD's role more difficult by adopting almost identical economic policies. The Socialist's commitment to liberalization, privatization and fiscal restraint amounts to a

continuation of Cavaco Silva's main policies. The PSD also shares the Government's goal of ensuring Portugal a place among the first group of countries to adopt a Single European currency.

iii) The Popular Party

The PP's populist message of defending national interests against the austere policies "dictated by the Treaty on European Union" was well received by the electorate in the 1995 General Election, when the Party increased its seats from 5 to 15. Manuel Monteiro, its 37 year old leader, has challenged the PSD's domination of the right, and has for long argued in favour of a national referendum on Maastricht.

iv) The Communist Party

On the left, the hard-line Communist Party is exerting pressure on the Government, partly to secure something in return for its support of Sampaio in the presidential election. The Communists are strongly anti-EU and attack spending cuts made in the name of meeting the EMU convergence criteria.

v) The political situation

The minority Socialist Party (PS) government's relations with the main opposition party, the centre-right Social Democratic Party (PSD), are said to be tense, and the threat of an early general election will mark the rest of the current legislature, which formally ends in October 1999. The PS government falls justs four seats short of an absolute majority, and has already suffered a number of parliamentary defeats against the combined vote of all three opposition parties. Most commentators expect a general election in 1998.

The PS government, in fact, does not seem averse to an early election. Recent opinion polls suggest a recovery in support for the PS, to about 37% of the vote, compared with 31% for the PSD (with 16% of the electorate undecided). This still leaves the PS below the 43,8% level it registered at the last general election, but the margin between the two leading parties, which has been running at around 6-7% in the third quarter, can be expected to increase again in the government's favour as a result of the favourable economic cycle and Portugal's inclusion in Stage Three of Economic and Monetary Union (EMU) in 1999.

Apart from budgetary matters, the political debate has been centred on two forthcoming referenda, one on the creation of a regional administrative structure, and the other on the EU.

The first referendum will propose the division of continental Portugal into eight regions. These will be purely administrative in nature, and will have no legislative or fiscal powers (unlike their Spanish neighbours). They will be responsible for economic planning in their regions, the management of most public services, and the channelling of investment incentives and subsidies.

The second proposed referendum will be on the Amsterdam Treaty. (No referendum was held on Maastricht because the constitution did not allow it) The two main parties will support a "Yes" vote and the two minor parties a "No" vote.

vi) Public opinion

Opinion polls favour a comfortable victory in favour of integration. The referendum on Amsterdam is more an exercise in popular democracy than the settlement of a burning political issue. Public opinion also favours Portuguese participation in the Single Currency, though a substantial minority are worried about the consequences. The Spring 1997 "Eurobarometer" found 46% in support, 30% against, with the rest undecided.

In general, the Portuguese people support Prime Minister Guterres in his belief that:

> *"We want Portugal at the political centre of Europe where the decisions are made, not out on the edge where they have to be obeyed".*[1]

Conclusion

Over the reference period Portugal has achieved a rate of inflation of 1.8%, which is well below the reference value stipulated by the Treaty. Looking ahead, there are no signs of immediate upward pressure on inflation; forecasts project inflation to stand somewhat above 2% in 1998 and 1999. Over the same period the level of long-term interest rates was 6.2%, i.e. below the reference value.

In 1997 Portugal achieved a fiscal deficit ratio of 2.5%, i.e. below the reference value, and the outlook is for a decrease to 2.2% in 1998.

The debt-to-GDP ratio is just above the 60% reference value. After reaching a peak in 1995 the ratio declined by 3.9 percentage points to stand at 62.0% in 1997. Regarding the sustainability of fiscal developments, the outlook is for a decrease in the debt ratio to 60.0% of GDP in 1998, i.e. a level equal to the reference value.

In view of these developments concerning budget deficit and public debt, the Commission considers that the excessive deficit situation has been corrected and that an excessive deficit no longer exists in Portugal. The Commission is therefore recommending to the Council the abrogation of the decision on the existence of an excessive deficit for Portugal.

The Portuguese escudo has been participating in the ERM for considerably longer than two years. Over the reference period it remained broadly stable, generally close to its unchanged central parities.

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[1] *Financial Times, 12/7/1996*

With the adoption and the entry into force of Constitutional Law No. 1/97 and Law No. 5/98 of 31 January 1998, the Commission and the EMI consider that the statute of the Banco de Portugal is compatible with Treaty and Statute requirements for Stage Three.

The reports of the Commission and the EMI show that Portugal fulfils all the convergence criteria. Hence, the Commission considers that a high degree of sustainable convergence has been reached in Portugal and recommends to the Council that Portugal fulfils the necessary conditions for the adoption of a single currency.