History of Convergence: Lessons from Accession
The Portuguese Disinflation Experience

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By the time of the accession to the European Community (EC) (1986), Portugal enjoyed both significantly low levels of per capita GDP and significant macroeconomic disequilibria. This situation created a great challenge for the economic policy in the years following the accession with the need to reconcile potential conflicting objectives, namely a reduction of the gap in terms of per capita income (real convergence) and a gradual convergence of inflation rate with the EC average (nominal convergence). From the beginning it was recognised by the Portuguese authorities that the best way to achieve both aims was to adopt policies oriented towards macroeconomic stability, which provide the best possible framework for sustainable economic growth and development. In early 1990s the goal of nominal stability was reinforced in the context of the objective to participate in the Economic and Monetary Union from the onset.

Since EC accession the global economic situation changed significantly. A rapid catching-up has taken place, inflation was brought down to levels broadly compatible with price stability, and the budget deficit was reduced to below the 3 per cent reference value of the Maastricht Treaty. Progress achieved in nominal convergence allowed Portugal to become one of the eleven founding members of the euro area. Throughout the adjustment and convergence process important difficulties had to be faced, and important lessons can be drawn from the Portuguese experience.

A disinflation process is usually associated with huge losses in terms of output and employment. Indeed, the idea that there is no medium to long-run trade-off between inflation and growth and that a stable macroeconomic framework is necessary for sustainable economic growth became a consensus among economists. However, the existence of a short-run trade-off between output and inflation often receives a lot of attention, in the particular in the political debate. The Portuguese experience shows that this short-run trade off does not necessary emerge provided the right conditions exist. A credible monetary policy strategy and real-wage flexibility seemed to have played a role in moderating the costs of disinflation.

The monetary policy strategy adopted, which proved very effective in steering inflation expectations, was a key feature in moderating the costs of disinflation in Portugal. The Portuguese disinflation strategy was based on a non-accommodating exchange rate policy. The choice of the exchange rate as a monetary policy intermediate target seems particularly advisable in case of small open economies. Due to the openness of the economy there is a close link between the external and internal value of the currency and import prices tend to play a determinant role in the inflation behaviour. In this context, controlling the exchange rate is crucial to the achievement of price stability. Thus, in case of small open economies there is a structural reason for stabilising the exchange rate.

Portugal is a typical case of a small open economy. In fact, the degree of openness of the Portuguese economy is very high (for example, in the beginning of the

1990s the average sum of total imports and exports vis-à-vis GDP was 46 per cent while the share of imports in domestic demand was 47 per cent). Since 1977, a crawling-peg depreciation regime of the escudo effective exchange rate was in place. The inflation differential between Portugal and its main trading partners was fully compensated by the escudo depreciation in order to preserve the competitiveness of Portuguese exporters. After accession to the EC the monthly depreciation of the escudo was progressively cut down to rates below the inflation differential. In October 1990, the crawling-peg was abandoned and the goal of the exchange rate policy gradually moved towards "stability of the escudo". Between November 1990 and April 1992, the exchange rate of the escudo floated within a limited range, which was not announced. On April 6, 1992, the escudo joined the Exchange Rate Mechanism (ERM) of the European Monetary System. A few months later, during the Summer, the escudo was caught by the severe turbulence that affected the ERM and which continued until the Summer of 1993, culminating with the widening of the ERM fluctuation bands in August 1993. Banco de Portugal did not exploit the increase room for manoeuvre provided by the enlargement of the ERM bands and re-affirmed its commitment to exchange rate stability. In this context, the behaviour of the escudo was characterised by growing stability. This strategy proved successful in anchoring inflation expectations and in moderating the costs of disinflation. For the candidate countries to the EU the choice of the monetary policy strategy is likely to become very important.

Given that the disinflation strategy was based on a non-accommodating exchange rate policy, potential costs would be expected in a deteriorating performance of the external sector, which would translate into increasing unemployment and a decline of output (see the case of Mexico and Argentina). However, this was not the case and rapid economic growth and a broadly stable current account balance accompanied declining inflation. The favourable performance of the external sector during this period suggests that an equilibrium real appreciation of the Portuguese escudo was taken place associated with an enormous inflow of foreign funds related to the financial integration and to the Community structural funds. The impact of these capital inflows on investment reinforced the catching-up process. Foreign assistance will certainly be of crucial importance to the candidate countries.

Another important factor in moderating the costs of disinflation was the relatively flexibility of the Portuguese labour market. Real wage flexibility has acted as a partial substitute for employment/unemployment, thereby providing a smoothing mechanism of the adjustment process. Indeed, the capacity to undertake relative wage and price adjustments is one of the pre conditions for a sustainable pegged exchange rate.