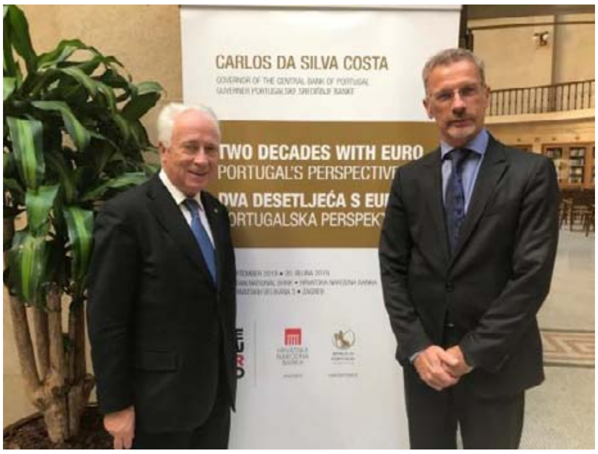
Intervenção do Governador, Carlos da Silva Costa, no Banco Central da Croácia (apenas em inglês)

Two decades with the euro: Portugal's perspective

Lecture by Governor Carlos da Silva Costa on the occasion of his visit to Hrvatska Narodna Banka, Zagreb [1]



1. Introductory remarks

Good morning.

I would like to thank Governor Boris Vujčić for his kind invitation to visit the Croatian National Bank and for the opportunity to share **the Portuguese experience with the euro** with you **and the steps that led to its adoption in 1999**.

First of all I would like to express my satisfaction with Croatia's intention to join ERM II and the Banking Union by mid-2020, as well as to **congratulate the Croatian authorities on the remarkable progress the country has made since it became part of the European Union**.

As one of the eleven founding members of the euro area**, Portugal's preparation for the introduction of the single currency took place in a very different context** from the one in which Croatia will adopt the euro.

On the one hand, because, at the time, the process involved the **simultaneous assessment of all the European Union (EU) countries and the launch of a completely new currency.** In particular, it required**:**

- **(i)** A decision on **which of all those countries fulfilled the necessary conditions**;

- **(ii)** The creation of **multiple EU-wide preparatory work-streams and coordination networks** at the level of central banks and public administrations among others, so as to ensure a smooth and balanced transition;
- **(iii)** The **launch of the euro** and the subsequent **physical introduction of previously non-existent notes and coins**.

On the other hand, because the European regulatory framework and institutional architecture have significantly evolved since then, notably following the responses to the financial crisis and the establishment of the Banking Union.

However**, despite all the differences in the framework conditions and starting points**, I am convinced that **the Portuguese experience with the Exchange Rate Mechanism (ERM) of the European Monetary System and with the euro and the lessons that can be drawn from that experience may provide a useful point of reference for Croatia**.

In order to give you a more complete picture, allow me to highlight **some key developments and regime changes experienced by the Portuguese economy over the last four decades**, starting with a few words on the period before accession to the European Economic Community (EEC), in January 1986.

2. Before EEC accession

In the late 1970s and early 1980s the Portuguese economy was characterised by severe macroeconomic imbalances, significant market distortions, a large public sector and poor economic performance. The root cause of the macroeconomic imbalances was essentially excessive domestic demand growth in relation to the productive capacity of the economy, leading to external debt accumulation.

To overcome its Balance of Payments difficulties, Portugal had to negotiate two IMF programmes, in 1977-1978 and in 1983. The implementation of both packages was very successful in attaining their targets.

In a context of monetary sovereignty, the imbalances translated into currency depreciation, international reserves depletion and high and rising inflation rates (annual inflation was 21.4%, on average, for the period 1978-1985, reaching almost 30% in 1984). The policy prescription at the time consisted of interest rate increases, credit growth ceilings, capital controls and the devaluation of the national currency, the escudo, to contain domestic demand and restore export competitiveness. With this aim, **a crawling-peg regime was introduced** in August 1977, a few months before the first IMF stabilisation package.

As a result of the adjustment strategy followed, the real value of wages, pensions and savings declined sharply and wealth was transferred from creditors to debtors. **Money illusion blurred the perception of the adjustment costs and of the fundamentally unbalanced burden-sharing.**

The 1983 programme brought the current account back into balance and put inflation and the general government deficit on a declining path. However, **in 1985, the year preceding Portugal's accession to the EEC, inflation still ran at around 20%** (14 percentage points above the Community average), **the general government deficit exceeded 8% of GDP** and **GDP per capita was about 50% of the Community average**, reflecting the country's low productivity levels.

3. From EEC accession to adoption of the euro

Accession to the European Economic Community in January 1986 was a critical regime change for the Portuguese economy. It posed many difficult challenges but it also provided many key opportunities. Increased trade and financial integration, and later on the commitment to becoming a founding member of the monetary union, **provided a critical "stick and carrot" for Portugal to follow a path based on the prevalence of market mechanisms and on the pursuit of macroeconomic stability**.

1986-early 1992: from EEC Accession to ERM participation

From EEC accession up to early 1992, economic policy was driven by the need to implement the Single Market programme and the acquis communautaire.

The performance of the Portuguese economy improved significantly and a rapid catching-up process started (GDP per capita grew 5.8%, on average in the period 1986-1991). However, signs of an increasingly overheated economy were also becoming apparent and domestic production was limited by capacity constraints and a tight labour market. An increasingly unbalanced policy-mix exacerbated excess demand.

Disinflation became a major goal of economic policy and the Portuguese authorities progressively adopted a monetary policy strategy based on **exchange rate stability as an intermediate target to reach the final goal of price stability**. The exchange rate policy became progressively less accommodative, aiming at breaking the vicious circle of inflation-devaluation without jeopardising the sustainability of external accounts.

From 1986 onward, the escudo's monthly depreciation rate was successively cut down and in October 1990 the crawling-peg regime was abandoned. In addition, the reference basket against which the escudo was measured was changed to a basket of five currencies of the ERM. **The aim of the exchange rate regime shift was two-fold**:

- The authorities wanted to **introduce some short-term unpredictability in the exchange rate** of the escudo in order to discourage (short-term) capital inflows;
- The new regime should **prepare the country for future participation in the ERM** (seen as a useful framework to pursue the disinflation process and to foster macroeconomic stability).

Early 1992-1998: ERM membership

From the signature of the Maastricht Treaty in February 1992 onwards, **ensuring compliance with the convergence criteria established for participation in the third stage of Economic and Monetary Union (EMU) became the immediate priority** of economic policy in Portugal. **One of the first steps in that direction was participation in the ERM**.

The escudo joined the ERM in April 1992, with a fluctuation band of ±6.0% [2] – then called the 'wide band'. ERM membership underlined the Portuguese authorities' commitment to the pursuit of a non-accommodative exchange rate policy, and was expected to have a favourable impact on inflation expectations. **Membership was also necessary to ensure that the country would be a candidate for adopting the single currency from the start.**

Immediately after joining the ERM, the escudo became the strongest currency in the parity grid, and reached the ceiling against the weakest currency in the system, which at the time was the British pound. **However, the first year of ERM participation was not an easy one** and Banco de Portugal had to be very active to keep the escudo within the band.

In the summer of 1992 the escudo was caught in the turmoil which affected the ERM and ultimately led to the widening of the fluctuation bands to ±15.0% in August 1993. Massive interventions had to be carried out, as well as other measures, in defence of the national currency. The escudo was subject to more than one realignment of the central parity and it depreciated significantly.

It was clear that **the ERM regime was not compatible with the degree of openness of the economies participating in the internal market and the existence of autonomous monetary policies.** It was this inconsistency that led to the 1992-1993 currency crisis, with direct implications for intra-European trade flows. This has clearly shown in practice that the existence of an internal market without a single currency necessarily represents an unstable equilibrium. **The need for a single currency became more evident than ever.**

After the enlargement of the ERM fluctuation margins there was increased stability in the run-up to the EMU. Despite deteriorating domestic conditions, the Portuguese authorities did not exploit the increased room for manoeuvre provided by the enlarged bands, so that official interest rates were adjusted in a manner consistent with the maintenance of exchange rate stability. **During the period of ERM membership, inflation declined steadily and the differential against the European Union average was virtually eliminated.**

In fact, **since the mid-1990s, the prospect of EMU participation fostered the rapid convergence of interest rates to the levels prevailing in Germany** (the anchor country in the ERM). Prospective EMU Member States – especially those with worse track-records in terms of macroeconomic stability – initially benefited from a **virtuous circle between nominal convergence and the prospect of EMU participation**:

- On the one hand, **in the so-called "converging" countries, policy efforts towards fiscal consolidation coupled with lower inflation increased the likelihood of EMU participation** (as these countries became closer to fulfilling the Maastricht criteria);
- On the other hand, **a higher probability of joining EMU facilitated exchange rate stability, interest rate convergence** (declining risk premia) **and the improvement of the budget balance** (lower interest payments on public debt).

The magnitudes involved were impressive: from 1993 to 1998 nominal long-term interest rates in Portugal declined substantially, with the 10-year interest rate spread against the German bonds narrowing from around 5 p.p. to about 0.3 p.p.

The sizeable interest rate cuts were interpreted by the Portuguese economic agents as largely irreversible, associated with a new macroeconomic regime characterised by price stability. Thus, the reduction of interest rates translated into a significant slowdown in the liquidity constraints experienced by households and corporations, providing a strong boost to domestic demand growth. In addition, **participation in the euro area has admittedly brought about an expansionary effect on domestic demand through a more favourable economic outlook,** which led economic agents to increase consumption and investment.

After European integration, Portugal also experienced rapid real convergence, with the relative position of the Portuguese income per capita rising rapidly vis-à-vis average European levels. In 1998, GDP per capita had increased to around 70 per cent of the EU average.

Table 1 - The Portuguese economy in 1978-1998: Some key figures

	Average 1978-1985	Average 1986-1991	Average 1992-1998
Inflation (1)	21.4	11.7	4.9
GDP growth	3.0	5.7	2.7
GDP per capita growth	2.2	5.8	2.4
Budget balance (% GDP)	-6.6	-5.5	-5.2
Current and capital account (% GDP)	-5.3	0.6	-2.0
Nominal effective exchange rate (2)	245.3	115.3	104.1
Real effective exchange rate (ULC) (2)	83.9	86.1	101.2

Sources: Banco de Portugal, National Statistics Institute, Eurostat

(1) Consumer Price Index, annual average rate of change

(2) 1999=100

4. Two decades with the euro

The introduction of the euro

Following significant progress in nominal convergence and the alignment of national legislation with the EU Treaty and the Statute of the European System of Central Banks, **Portugal was in a position to become one of the eleven founding members of the euro area**. The EU Council decision of 2 May 1998 confirmed that Portugal fulfilled all the necessary conditions for the adoption of the single currency.

The euro was introduced on 1 January 1999 in foreign exchange and financial currency operations and for the vast majority of retail operations. However, its **physical introduction only took place on 1 January 2002 and at the end of February 2002 euro banknotes and coins became the only legal tender** in the euro area.

In Portugal, the physical replacement of the escudo with euro banknotes and coins took place normally and gradually, following extensive preparatory work carried out by Banco de Portugal and other entities. In September 2001 euro banknotes and coins were distributed to credit institutions and, in December, to large companies and retailers. Finally, from 17 December**, starter kits worth 10 euro were sold to the public** at the counters of both Banco de Portugal and credit institutions, containing a mix of all euro coin denominations, so that Portuguese citizens could become familiar with the new currency.

One additional feature was that Portugal introduced a legal requirement for the dual display of prices around the cash changeover (as was also the case in Austria and Greece). Dual display allowed for an easier comparison of prices in the two denominations, thereby **reducing the information processing costs for consumers**.

The conversion of national currencies into euro gave rise to some fears over its effect on prices among the general public of the participating countries. Portugal was no exception.

It is clear that **consumer prices were not immune to the conversion** of national currencies into euro. Yet, **it is impossible to make a precise assessment of its effect** on inflation because **several other factors simultaneously affected price developments in 2002**. In the case of Portugal, for instance, there was a rise in the standard value added tax (VAT) rate from 17% to 19%, as from June.

However, **Banco de Portugal's estimates suggest that in the first quarter of 2002 the overall impact of the conversion process on the year-on-year change in the Consumer Price Index was around 0.2 p.p. and around 0.5 p.p. in the case of services prices [3].** As in other countries, the analysis also confirmed **signs of price increases caused by the changeover in some specific products, mostly regarding frequently bought goods and services that were usually paid in cash,** hence leaving consumers with the feeling that inflation was high due to the introduction of the euro. As regards **mandatory dual display of prices**, research published by the ECB showed that it had a **dampening effect on the evolution of some prices [4]**.

The euro has provided businesses and households with an important set of tangible and visible benefits: lower transaction costs; more transparent and competitive markets and increased trade; greater certainty in saving and investment decisions; easier price comparison; simpler shopping and travel within Europe; easier access to other markets and new business opportunities.

Naturally, **the euro has also brought new requirements in regard to the behaviour of economic agents,** namely because the exchange rate mechanism to compensate for differences in Member States ceased to be available.

The overall success of the Portuguese experience in the convergence period hides important policy fragilities, particularly in the fiscal domain. In fact, a countercyclical fiscal policy would have helped to contain the risks associated with the expansion of domestic demand stemming from monetary easing and interest rate declines. And a macroprudential policy would have provided awareness of the build-up of systemic risk. However, **macroprudential policy was simply not part of the standard toolbox and the mostly pro-cyclical fiscal policy that was followed contributed to rising imbalances in the economy in the early years of EMU, making the subsequent adjustment more painful.** Let me say a few words on this.

Before 2008 – the accumulation of macroeconomic imbalances

The significant degree of monetary easing in the run-up to EMU provided a huge stimulus to domestic demand. As the "new world" of low interest rates and abundant financing seemed to offer a free lunch to the "converging" countries, **several imbalances started to build-up i**n those countries, taking different shapes:

- In countries such as **Portugal or Greece**, fiscal imbalances became a major problem – even if the size of the problem was substantially different. In both countries, savings arising from lower interest rates and boom-related windfall revenues were used to finance expansionary expenditure policies;
- In countries such as **Spain or Ireland**, fiscal policies were more prudent. Still, imbalances built-up, mainly taking the form of a real estate bubble;
- In **Ireland,** an oversized financial sector developed in tandem with the real estate bubble (a similar phenomenon also occurred in non-euro EU countries, the most prominent case being Iceland).

In Portugal, from the mid-1990s to 2007, the very substantial easing of liquidity constraints – arising both from the interest rate decline and access to a huge wholesale market for funding – **led to booming private sector credit and a fall in households' savings rates.** From 1995 to 2007, private sector debt almost doubled as a percentage of GDP (averaging 187.2% of GDP during this period), while households' savings rates almost halved.

The increase in indebtedness was mainly used to finance consumption and low-return investments, mostly in the non-tradable sector. As a result, imports expanded and **large current account deficits materialised**, **without a corresponding increase in the economy's growth potential.** From 1995 to 2007, the current and capital account moved from near balance to an 8.6% of GDP deficit.

The public sector also benefited from lower interest rates and easier access to credit. In addition, booming private expenditure pushed up tax revenue. All else being equal, this should have meant substantially improved overall and primary balances, as well as declining debt levels. **Prudent fiscal management should have led to the boom in private spending being partly offset, even if only by letting automatic stabilisers play their role**.

When interest rate convergence was complete and the initial impact of EMU on growth disappeared, the underlying unsustainable fiscal policies swiftly became apparent. Also, structural bottlenecks arising from a lack of competition and an outsized public sector an excessive weight of the public sector in the economy, contributed to an **overexpansion of the non-tradables sector, hampering competitiveness and aggravating external imbalances**.

It cannot be ignored that, **as a regime change, EMU had a major impact on the setting of expectations, the transmission channels as well as the equilibrium values of key economic variables.** This made it extremely difficult to assess developments in real time, causing very reasonable and competent people to disagree about the best explanation, and therefore to advocate different policy responses.

In hindsight, it is clear that the pro-cyclical fiscal policy, a less demanding regulatory context, the complacency of international financial markets and the non-existence of macroprudential policies contributed decisively to the accumulation of significant macroeconomic imbalances in the Portuguese economy from the mid-1990s.

After 2008 – the global crisis and the 2011 adjustment programme

The macroeconomic imbalances made the Portuguese economy extremely vulnerable to the international financial crisis that started in 2008 and its contagion effects. When the crisis hit, followed by a global recession, an expansionary fiscal policy was once again adopted, and this time it was particularly intense, despite the imbalances hitherto accumulated and the absence of fiscal space. In 2010, the budget deficit was above 11% of GDP and gross public debt was around 100% of GDP.

At the same time, **in the banking sector, the accumulation of non-performing loans resulting from the volume and quality of credit granted in the decade 2000-2010 and the effects of the financial crisis weakened banks' balance sheets** increasing their vulnerability and the constraints faced by the Portuguese economy.

At EU level, the sovereign debt crisis in the euro area brought to the forefront the failures in EMU economic governance, and exposed the particular vulnerability of euro area Member States to changes in markets' sovereign risk perception. **The high and rising level of external indebtedness** (gross external debt represented 226.7% of GDP at the end of 2010)**, coupled with a weak performance of potential output, fuelled investors' concerns about Portugal's ability to pay back its debt.** Domestic banks and the government found it increasingly difficult to obtain external financing: banks had to turn to the Eurosystem, whereas public debt was increasingly placed in domestic banks.

This situation ultimately resulted in Portugal's inability to fund itself in the international financial markets in the first half of 2011, after the 10-year yields had nearly doubled those of the previous year, reaching over 9%. **Recourse to external official financing under a financial assistance programme became, once again, unavoidable**. The Economic and Financial Assistance Programme was agreed in May 2011 between the Portuguese authorities, the EU and the IMF and expired on 30 June 2014.

Remarkable progress has been achieved during and after the 2011-2014 adjustment programme:

- The budget deficit significantly declined and public debt was put on a downward trend;
- Private sector deleveraging is ongoing; and
- The banking sector is more robust, with a stronger liquidity position, higher solvency ratios and improved asset quality.

The Portuguese adjustment programme has widely been regarded as a success story. In my view, this success was due to **three factors**:

- **Programme ownership**. Portugal was committed to the programme's implementation, its urgency was understood and accepted by the general public and there was a constructive dialogue with social partners;
- **The speed and intensity of the response from the tradable sector**, in particular exports, was key to the rapid rebalancing of the external accounts and mitigation of the impact of lower domestic demand on the non-tradable sector;
- **The preservation of confidence in the banking sector**, as evidenced by the behaviour of deposits, was crucial to preventing the economy from collapsing with a credit crunch and avoiding the imposition of capital controls.

However, notwithstanding the undisputed progress made, several vulnerabilities and important challenges still remain. **Although the level of indebtedness in the Portuguese economy and asset quality on credit institutions' balance sheets have evolved favourably, there is no room for complacency**. It is imperative to ensure budgetary discipline and continue the deleveraging process of the private sector and the strengthening of the banking sector.

Reducing the high levels of indebtedness, in parallel with creating conditions that allow investment to increase (both in quantity and in quality), is essential for improving the Portuguese economy's current situation. **The experience of the past 40 years teaches us that the initial impact from an assistance programme will only be sustainable if there are structural changes that foster higher potential growth.**

A long-lasting improvement in the economic welfare of the Portuguese depends crucially on the **maintenance of a sustainable macroeconomic framework that provides suitable incentives for economic agents and on following a reform agenda** that supports long-term sustainable growth.

Table 2 - The Portuguese economy in 1995-2018: Some key figures

	Average 1995-2007	Average 2008-2010	Average 2011-2014	Average 2015-2018
GDP growth	2.4	-0.3	-1.5	2.2
GDP per capita growth	2.0	-0.4	-1.1	2.5
Current and capital account (% GDP)	-6.3	-9.6	0.1	1.2
Budget Balance (% GDP)	-4.3	-8.2	-6.3	-2.4
Government debt (% GDP)	62.4	87.5	126.8	128.3
Private sector debt (% GDP) (1)	187.2	253.2	258.9	216.3
Gross External debt (% GDP) (2)	156.2	218.3	229.8	212.6
Potential GDP growth	2.1	-0.2	-0.6	1.2
GFCF (% GDP) (3)				
Tradables	9.8	9.9	8.0	8.1
Non-tradables	15.2	11.6	8.0	7.4
Loan-to-deposits ratio	112.3	152.6	117.8	93.2
Real exchange rate (ULC) (4)	103.2	106.7	104.2	101.9

Sources: Banco de Portugal, National Statistics Institute, Eurostat

(1) Non-financial private sector

(2) In the first column, average corresponds to the period 1999-2007

(3) Nominal. In the last column average corresponds to 2015-2016 due to data unavailability for 2017-2018

(4) 1999=100

5. Exchange rate regime: the euro and potential growth

The introduction of the euro has eliminated the uncertainty associated with exchange rate fluctuations. In fact, one of the biggest advantages of the single currency is that it neutralises the "external factor" thereby contributing to increased stability. Yet, at the same time**, it eliminates the possibility of recourse to the exchange rate instrument to manage competitiveness problems** even when they result from internal factors.

In fact, prior to the introduction of the euro, whenever the economic side "failed", the exchange rate instrument allowed (directly) competitiveness to be restored and (indirectly) a real depreciation of public and private debt through the inflation that resulted from currency devaluation. **With the single currency and the single monetary policy it is no longer possible to use currency devaluation to offset productivity differentials or real appreciations resulting from inflation differences and to restore the competitiveness and employment of a given economy.** It is also no longer possible to resort to financial repression through debt devaluation, with the consequent transfer of wealth from creditors to debtors, in particular to the public sector. Excessive leverage requires financial adjustment by debtors, so that creditors are not penalised.

The euro also eliminates the anaesthetising effect of the exchange rate. In fact, with the loss of the exchange rate "crutch", price and wage deviations have an impact on the unemployment rate and productivity deviations accelerate the perception of the structural weaknesses of the economy and the need for reform. Therefore, the single currency makes the need for adequate policies, sound public finances and financial discipline of private actors more visible. **It requires institutions and policies that are fit for purpose in the new context**.

This means that, although exchange rate stability or a **single currency are important for generating favourable conditions for optimising economic growth, they are not the determining factors**. Those factors are the **quality of the policies and institutions and the way resources are allocated between the tradable and the non-tradable sectors** of the economy. **And they are not intrinsic to the exchange rate regime**.

In Portugal, the history of the past 25 years teaches us that **imbalances were caused by the combination of excessive indebtedness and weak potential growth**.It also teaches us that **easy access to credit coupled with insufficient quality of institutions and policies have constrained potential growth.**

As I have already stressed above, the prospect of adopting the euro translated into increased access to capital from the mid-1990s. However, resulting **capital inflows were misallocated, leading to macroeconomic imbalances**. The banking system channelled foreign funds to domestic residents, leading to a strong increase in consumption and investment and a consequent deterioration in the current account,without a corresponding expansion of the economy's growth potential. Indeed, **the investment surge financed through the credit expansion was mainly channelled towards non-tradable sectors, hampering productivity and potential GDP growth**. On average, in the period 1995-2007, Gross Fixed Capital Formation in the non-tradable sector represented more than 60% of total GFCF, amounting to 15.2% of GDP.

In my opinion, **the real challenge Portugal is currently confronted with is that of generating and maintaining high levels of employment and productivity** to ensure a lasting trajectory of growth and convergence with its EU partners.

Starting from a very low base, Portugal experienced a **long period of real convergence, from 1960 to the mid-1990s**, with a clear upward trend in Portuguese GDP per capita as a percentage of the EU15. By contrast, **evidence points to no progress in real convergence of the Portuguese economy over the last 25 years**, associated with ongoing unfavourable developments in relative Total Factor Productivity in a context where the contribution of the capital stock – which supported real convergence in the previous period – declined significantly.

The resumption of the convergence process of the Portuguese economy is a complex and demanding task, namely in view of the challenges posed by demographic trends and rapid technological change. A lasting trajectory of growth and convergence towards our European partners **depends on our ability**:

- To promote **efficient resource allocation**, namely through sustained maximisation of investment returns, and reallocation towards the tradable sector;
- To reach **higher levels** of productivity;
- To generate and maintain **high levels of employment**; and
- To ensure that the **combination of capital and labour generates an output that is desired and valued by the market**.

6. Lessons and challenges

Let me now turn to **some major lessons that I believe can be drawn from Portugal's participation in the EMU, as well as some challenges for countries in a monetary union**.

First of all, we can speculate as to **how it was possible that high current account deficits persisted for several years in Portugal and in a number of other euro area countries without financial markets questioning these countries' ability to repay their increasing debts**.

In fact, for a number of years, **the dominant view in academic and policy circles, as well as in financial markets, was what we might call the "benign view**". According to this view, current account imbalances were the expected result of deeper integration among countries with different levels of economic development and, in a monetary union, **a current account deficit reflecting the financial balance of the private sector would be no cause for concern**. Credit risk monitoring would ensure adequate risk-pricing, and there would be no aggregate (and thus policy-relevant) macroeconomic imbalance.

However, **the assumptions underlying the benign approach turned out to be highly unrealistic and misleading from a policy perspective**. With the benefit of hindsight, it is clear that a more "prudent view" was warranted. Over-optimistic expectations about future growth prospects and short-sightedness, weak domestic institutions and real and financial frictions should have made a strong case for policy intervention aimed at mitigating the boom-bust pattern of monetary integration.

The buffers that would have resulted from lower public debt and stronger capital in the banking sector would have put the converging economies on a much sounder footing to face the financial storm. Also, a more ambitious and consistent approach to structural reform would have left these economies better equipped to face the challenges of globalisation and ageing.

In a monetary union, the problem is not the potential lack of foreign exchange reserves to address balance of payments imbalances but the sustainability of debt of the various sectors of the economy. The question arises over the financial capacity of each sector to service and roll over debt, and to respond to new financing needs. The same reasoning applies to Member States themselves, within a framework where there is no bail-out mechanism.

The biggest challenge for a country that enters a monetary union is the sustainability of policies. Policy authorities need to closely monitor economic developments, to read the signs and to stand ready to "sail against the wind". This means that economic policies have to be more restrictive when there is a need to contain excessive credit growth and the indebtedness of the private sector is mounting. **Policy-makers must not fall into the temptation of drifting along with the current because access to funding is easier and cheaper and the available volumes are higher. Above all, it is important that policy-makers are not dazzled by the initial advantages of the single currency**. If accompanied by a complacent attitude, these advantages can become a trap and a risk to economic sustainability.

7. Concluding remarks

In short, the balance of the Portuguese experience with the euro is very positive and has represented a key regime change. The euro promoted a move towards a regime characterised by structurally lower and less volatile interest and inflation rates and led to important structural changes in the Portuguese economy.

For the EU as a whole, the creation of the single currency 20 years ago was a pivotal moment in the history of European integration. Since then, we have come a long way but there is still a long way to go. In recent years, in response to the difficulties arising from the financial crisis, there have been profound changes in the EMU rules and architecture aimed at making it more balanced and more resilient to shocks. However, **EMU still has significant weaknesses and remains incomplete in some key areas, such as the Banking Union and the Capital Markets Union.**

The EMU results from a sharing of sovereignty between Member States. Its construction is based on permanent negotiation and approximation of different starting positions, safeguarding national cultures and identities while guaranteeing a sense of belonging and a "group identity". **This implies an institutional framework with a great capacity to understand and manage differences and to facilitate the interaction between the interest of the whole and the specific of the parts, in order to ensure that the former is greater than the sum of the latter. EMU also requires mutual trust, where responsibility and solidarity go hand in hand**.

It is therefore important that **Member States continue to work together in a committed way to complete the journey that started in 1999** so that European citizens can fully profit from the benefits of their common currency.

The prospect of Croatia entering ERM II and subsequently adopting the euro is undoubtedly a very welcome development in this collective endeavour.

Thank you.

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[1] As prepared for delivery

[2] The ECU central rate was set at about 1.4% below the market rate prevailing at the time.

[3] Santos, D., R. Evangelista, T. Nascimento and C. Coimbra (2002), "Analysis on the impact of the conversion of escudos into euro", Banco de Portugal, Economic Bulletin, September 2002.

[4] Michael Ehrmann, "Rational inattention, inflation developments and perceptions after the euro cash changeover" ECB Working Paper Series, 588, February 2006.