Lessons from the Portuguese Political-Economic Transition to the Euro (1986-1999)

by

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Abstract: We show the Portuguese transition to the euro, in the framework of political-economics, by constructing a bivariate confidence index, based upon Rocha de Sousa (1998, 1999a,b, 2001). Besides we try to understand if the euro functioned as an instrument of politico-economic integration. The article has the following structure: section 1 shows the process of monetary European construction, section two illustrates the need for budget consolidation before the euro, section three illustrates the notion of monetary credibility and the construction of a bivariate politico-economic index, section four illustrates the role of ECB and of the SECB, section 5 assesses the study of euro impact on Portugal and, section 6 evaluates EMU after 10 years based upon EC (2008) and, finnally, section 7 concludes.

Key-words: Credibility, Euro, Europe, ECB, European Integration, EMU, Pair Minister of Finance / Governor, Portugal.

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1. Introduction: The birth of the Euro

> "*Jean Monnet's dream that European integration would eliminate conflict may have been a delusion. France and other countries do not share Germany's fixation on sound money -- or its hegemonic vision. A European central bank would be unresponsive to local unemployment, while political union would remove competitive pressures within Europe for structural reform, prompting protectionism and conflict with the United States. A Europe of 300 million people and an independent military might be a force for world peace, but war is also a distinct possibility."*- Feldstein (1997b).

The Euro is the common currency adopted initially on 1 January 1999, by 11 countries who had already signed the Maastricht treaty. On January 2001 Greece joined the euro, afterwards Malta, Cyprus (2004) and Slovenia (2007) joined, summing up 15 countries out of 27 current European Union members.

This article pretends to address some of the following questions:

-How did the euro arise?

-What are its causes and consequences?

-What can we expect in a global tri-polar euro, yen and dollar world?

Greenspan (2008: 11-14), the longest tenure chairman of the Fed, starts his memories by recognizing that what surprised him most was the successful EMU construction and the global success of the Euro. How was this process possible?

Do notice as we can see by the quote of Feldstein above (1997a,b) that, this highly considered American economist, expected a failure of the EMU construction, and that eventually this process might cause a war within Europe.

The process of European construction began in the aftermath of the Second World War, when Monnet and Schuman proposed the joint creation of the High Authority for Carbon and Steel. This idea came to be implemented as European Coal and Steel Community (ECSC) by the Treaty of Paris in 1952. One of the explicit goals of the treaty was to end with the reasons who led to the military conflict.

In 1957 the creation of the European Economic Community (EEC) come to give strength to this idea, as the Treaty of Rome defined a Customs Union and a set of common policies. The Treaty of Rome (1958), in its 157 article, paragraph 1, illustrated the following idea: "each Member-State will deal its exchange rate policy as a question of common interest.".

The genesis of the euro thus is complex and goes far a back as all the process of European construction. For a detailed history of European construction see Olivi (1998), for a more recent one Eichengreen (2007) and for the political process of Euro construction - see Quatremer and Klau (1999).

The Werner Plan for the establishment of a common currency dates from the early 70's. After the European Council of the Hague, it was established the goal of a European Monetary Unification (EMU), from which the Luxembourg Prime Minister of that time, Pierre Werner, received a clear mandate to evaluate and proceed the development of the issue. The Werner Report was approved by the Council in March 1971. It previewed three phases of implementation till 1980. Nevertheless, the Plan became unattainable due to the first and second oil shocks (1973 and 1979) and with the aggravation of the dêbacle of fixed exchange rate Bretton Woods system.

With the collapse of the Bretton Woods fixed exchange rate system, it was created on 1972 the Monetary Snake, in which it was established a range of fluctuation bands within a tunnel (van Ypperselle and Kouene, 1985). From here it was born on 1979 the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS).

The ERM of EMS fixed a central parity of the different European currencies against the European Currency Unit (ECU). The different weight of the European currencies in the ECU basket was given by the weight of the country's trade related to the total European trade. EMS had initially two bands, a large band of more or less six percent around the central parity, and a narrow band of more or less 2,5%. The adherents' countries first joined the large band and then should join the narrow band in order to have access to the EMU.

Nevertheless from September 1992 till August 1993, the ERM of EMS entered into a major crisis. The northern currencies and the pound were forced out of the system. To avoid the collapse of the system, an extraordinary ECOFIN's meeting decided by the enlargement of the bands for more or less 15%. Obviously, this measure solved the problem, because it turned the system into one of managed float, which in practice was one of almost pure float (a currency could oscillate between 30%). This was opposed with the initial goals of European monetary construction which were of freezing (or fixing) the exchange rate currencies in the pre-euro period – see Buiter, Corsetti and Pesenti (1998).

The Treaty of the European Union, was negotiated on 1991, and was negotiated with the goal of deepening EEC, and thus the organization become to be known as European Union (EU), thus seeking to attain explicitly European Monetary Union (EMU), and not just a monetary but also an economic union - the idea was one market, one currency. The Maastricht criteria, 3% for the public deficit related to the GDP, 60% for the public debt, the inflation rate should not exceed the average of the three lowest plus 1,5%; and the interest rates should not exceed the average of the lowest three plus 2%, these criteria emerged as a precondition for the euro.

2. The Growth and Stability Pact and the need for pre-Euro Financial Consolidation

The Stability and Growth Pact (SGP) emerged by German imposition due to the fear of the lack of budgetary discipline by essentially Latin countries. The Stability and Growth Pact is composed by three documents that tend to regulate the preventive and effective procedures in the case of the emergence of a excessive budget deficit.

Accordingly to Duisenberg (1997), the late first President of the ECB, the SGP would have two functions: prevention, in order to prevent the emergence of excessive deficits, and dissuasion, what to do in the case of existence of a excessive deficit.

The general rule would be that a country cannot ever exceed the 3% ceiling of its GDP. In the long run this country should aim at nil deficit or, if possible, a budget surplus. The emergence of an excessive budget deficit would trigger the following procedure: Firstly, there would have to have a non-remunerated deposit in the ECB proportional to the amount of the excess bias over 3% (and with a ceiling amount of 0,5% of GDP); Secondly, if the situation was not corrected, that is the deficit returned to a value below 3%, then the non-interest deposit would be turned in a effective fine, that would eventually be redistributed to all the Eurozone countries (except, obviously, for the defaulting country).

We might wonder why the need for the rigor of budget disciplines for the European Member states? The economic literature and central bankers have come to show a link of causation between excessive budget spending and inflation. It has been shown that in countries where budget discipline isn't imposed as a rule for economic policy, inflation tends to spur. This is so, because government spending, without corresponding tax increases, leads, for the same supply, to an aggregate demand expansion, which would yield inevitably in price increases and thus inflation.

The role of prices in a market economy complies with a three-fold function, as Friedman and Friedman (1980) state: 1) index of scarcity, a good is expensive if it is rare and cheap if it is abundant; 2) has a role of income redistribution; 3) has a role of incentive mechanisms for the economic agents to act consequently.

Due to German aversion to inflation, quite clear in the monetary restraint the Bundesbank has always showed, and which resulted from the fact that in the aftermath of the First World War, due to the war effort, the prices rose from 1 in 1922 to ten thousand billion in final November 1923. Friedman (1992: 170) tells us more: "*during the German hyper-inflation after First World War the rate of money increase was of an average of more than 300% per month.*" For the case of Hungary in the aftermath of the Second World War, the same author tells us that the growth rate of money was of more than 12 000% a month, and that prices rose by 20 000% in a full year. In this case money lost all their value and functions, so that it was needed to adopt alternative money, namely cigars. This was due to the fact that cigars would keep its value (as long as they weren't smoked) and also allowed to tabulate their goods and served as a mean of exchange.

The SGP come also to impose limits to the use of budgetary policy. There is nevertheless which allows countries to attain a budget deficit greater than 3%, only in the case of having of a slump at least of 1,25% for a given period of time.

3. Money Credibility: its need and definition; The Escudo in the transition

The credibility of economic policy is one of the most defended concepts by economists. Brunetti, Kisunko and Weder (1998) proposed a new measurement approach based on firm level surveys and an indicator of the "credibility of rules". Using a survey of micro-data for 73 countries and 3800 firms, standard cross-country growth and investment analysis indicates that low credibility of rules is associated with lower rates of investment and growth.

Demerstzis and Hallet (2007) study the effect of central bank transparency in theory and practice, namely its impact on inflation and the output gap, using a small analytical model for an imperfect transparent central bank. Their main conclusion is that the average magnitudes of their model's variables (inflation and outup gap) aren't affected by imperfect transparency (using a meausure by Eijffinger and Geraats) but only variability (variance) is in fact affected by it.

Economic policy credibility, can be defined, as a bias between what is announced by a specific economic agent (namely the State or CB), and what in reality happens - see Blinder (2000) and Cukierman (1992), and, also, Blinder (1998) defines simple rules for monetary policy. Cukierman (1992) defines central bank's credibility starting from a composite index, in which the potential duration of the governor's mandate duration is accounted. Cecchetti and Krause (2002) analyse central bank structure, policy efficiency and macroeconomic performance, in terms of empirical performance. Herrendorf (1999), Herrendorf et al. (2003) analyses the role of independent monetary policy.

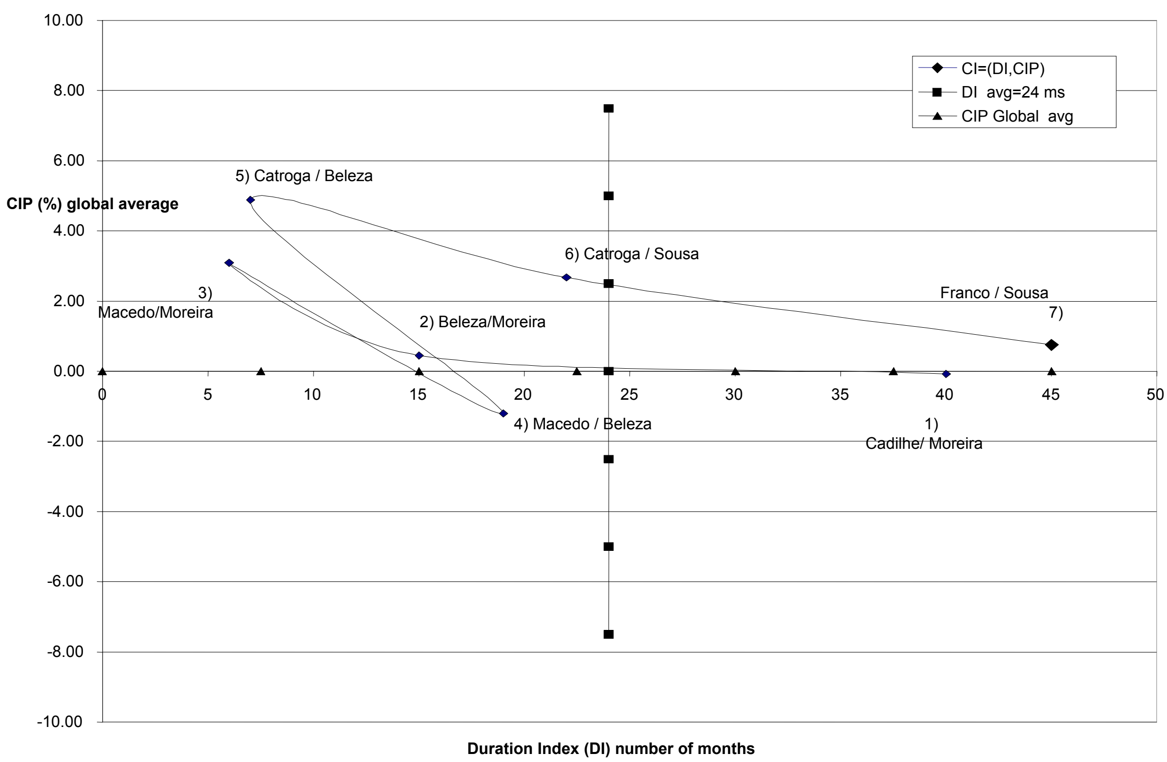
Starting from these previous ideas I defined one of the credibility's index coordinate by the duration of the mandate's pair Minister of Finance/Governor - this pair was first analysed by Braga de Macedo (1997), but this time it is done in terms of effective duration facing potential duration of the pair: 48 months/2 = 24 months, under the hypothesis that the minister of finance renovation would take place at the middle of the central banker's governor term. There are some other studies about political cycles, e.g. Alesina et al. (1997) is a good survey. Lijphart (2007: ch. 13) presents a political appreciation of the credibility of central banks. He bases himself on the studies by

Cukierman, and constructs a table where he averages the different approaches and does it for the period 1945-1996 - see his table 13.1 (Lijphart 2007: 221).

Do notice that recent Portuguese political government transition has been analysed in general, among others, by Costa Lobo (2005).

Torres (1996: ch.3) stressed the importance of political accountability and also tried to define the role of political economy for EMU. Other authors, e.g. Braga de Macedo (1996) defined Portuguese transition as a matter of "Selling stability at home, earning credibility abroad", or Giordano and Persaud (1998; ch. 5) tackle the same issue, independence of central banks and illustrate for the case of Bundesbank. Giovannini (1995) sums up a lot of the problematic of the transition: the need for fixing exchange rates (the background Giovannini 1995:7-95), the need for an independent European Central Bank Giovannini(1995: 127-144), an finally to look after transition Giovannini (1995: 315-366).

Figure 1- Global Bivariate Confidence Index (CI) for the pair Min / Gov



In a study I proposed a bivariate credibility index for the Portuguese economy, namely for the pair Minister of Finance/ Governor - see Rocha de Sousa (1999a,b, 2001). The index had two components, one of them being the duration of the mandate's pair (compared to the expected average duration for the pair), and the other being the deviation from covered interest parity (of the Escudo facing DEM, peseta and dollar). Figure 1 presents a simplified graphic of the bivariate credibility given by the different the pairs MF/Governor of the politico-economic Portuguese transition of the escudo to the euro. The first coordinate (DI) is the duration index in months of effective the mandate of the pairs, the second coordinate (CIP- deviation from covered interest parity) is a measure of market efficiency of the former Portuguese currency facing other currencies for the respective pairs. Clearly the evolution shows that Portuguese integration started with a credible pair (point 1 - Cadilhe / Moreira (MF/G)), and from pairs 2 (Beleza/Moreira (MF/G)) to 6 (Catroga/Sousa (MF/G)) there was a high turnover (or turbulence), but at the end on the verge of monetary union there was the most credible pair in the transition - point 7 (Franco/Sousa (MF/G)). This final pair 7 had the highest duration during this transition and also had a good performance in terms of market efficiency, and was with this pair that Portugal joined the fore-front of the euro on 1 January 1999. The geometric locus of biggest credibility is the horizontal line (with the triangles), because reflects more efficiency facing other currencies, and must be the farthest to the right from the vertical line (with the small squares) which indicates an average expected duration of the turnover MF/Governor of 24 months. Points to the right to the vertical line do reflect higher credibility, than the hypothetical vertical 24 months line.

4. ECB, SECB; the risks and benefits of adopting a common currency

The European Central Bank (ECB) is the keeper of European price stability, because in his mandate and rules has a statement that says exactly the price stability is his prime goal, and whose interpretation means an yearly inflation for euro-zone below 2% - see Issing et al. (2001). De Grauwe (1992) presents the theoretical costs and benefits of adopting a common currency, based upon Robert Mundell's Optimum Currency Areas (OCAs) approach - see Mundell (1961) and also McKinnon (1963).

This posture and goal are a clear heritage from the already quoted Bundesbank anti-inflationary stance.

The euro adoption hasn't come at zero cost. The countries which adopted the euro, abdicated from their monetary and exchange rate policy, and become highly constrained in the budget policy stance by the SGP, as we saw on section 2. There might emerge problems, namely due to asymmetrical shocks, that is if a country or a region is more severely affected by a slump than the rest of the euro zone. A typical example of an asymmetrical shock was when Finland suffered a severe slump due to the fall of the Berlin Wall, which led to the implosion of the former Soviet Union, which was his main trade partner. For Portugal the end of the Multi-fiber Arrangement (MFA) led to a severe slump on the textile industry in Northern Portugal. What to do in these worst case scenarios?

The monetary policy of the ECB won't be changed just because a country entered in a slump, whilst others stay with a normal expansionary phase, and thus most keep the majority of votes for a tight monetary policy in the governing ECB council. Besides budget policy can't be changed, unless some prerequisites are met and a formal authorization is given to exceed the binding constraint of the 3% deficit as percentage of the GDP.

The best solution would be if prices were flexible to let the recession take place, let the prices fall and the markets adjust through price. The problem in the European case is that by historical experience prices have had only one way, and that's been the steep increase.

The adjustment could also pass through quantities and in a more concrete way by the adjustment of the European labour market. If there was perfect workers' mobility, in the slump area there would be emigration from these areas to the other areas where there would be workers' shortages. This process would go on till unemployment would be eliminated. But, nevertheless during this process there is a terrible "but" of this voting with the feet solution and that constraint is the language barrier. Whilst on the US one can migrate freely, as the language is common, in Europe as is known the language barrier is strong: for instance if there is a slump in the Alentejo region (Centre/South Portugal) in order for worker to migrate, for instance for Germany, they would have to learn a new language. Additionally the housing market in Europe is much more rigid than the US one, factor which in fact reinforces again the inter-state mobility between Americans than among Europeans.

There is also an additional solution which has taken place in the US most times: a federal budget, which transfers money from expansionary areas to slump areas. The problem is that at an European level the Federal budget is limited to 1,26% of the EU GDP, and with further enlargements the competition for funds, namely with poorer states, did increase the competition for these incomes.

5. Portugal and the study of Euro's impact assessment

Cavaco Silva (1997) presented a widespread audience book about EMU and its consequences for Portugal. Loureiro (1999) tries to bridge the gap between the existent economic literature and macroeconomics of EMU in Portuguese. Recent economic histories of Portugal are Mateus (1998) and Silva Lopes (2004).

Blanchard (2007: 1) sums up Portuguese transition within the euro as a difficult process: "*In the second half of the 1990s, the prospect of entry in the euro led to an output boom and large current account deficits in Portugal. Since then, the boom has turned into a slump. Current account deficits are still large, and so are budget deficits. This paper reviews the facts, the likely adjustment in the absence of major policy changes, and examines policy options.*"

The Portuguese Ministry of Finance ordered to the academy a study of the impact of the euro in the Portuguese economy - See Barbosa et al. (1998). The study was quite extensive and their conclusions were rather optimistic. We will stress only a few of them, namely the ones we find more appealing.

The study scrutinizes the Portuguese exposition to the exterior, and thus infers the occurrence of asymmetrical shocks - Barbosa et al. (1998: 145). Afterwards it analyses the possibility of instruments and adjustment mechanisms to fight these shocks.

As it is well known the degree of openness of the Portuguese economy increased substantially since the Portuguese adhesion to the EEC in January 1986. As the exposition to the exterior increases, thus the vulnerability to external shocks of the Portuguese economy increases. But the authors advance with the hypothesis that with a deeper integration of EMU the disynchrony of the cycles will tend to lower. Nevertheless, the volatility of the Portuguese GDP was higher than the EU average, but nevertheless the Portuguese GDP does tend to follow the European cycle - Barbosa et al. (1998: 154).

Besides the authors tried to infer if the exchange rate policy had before EMU a stabilizing role, with the aim of further assessing if it was in fact a considerable loss of an economic policy instrument. These authors did decompose these effects between neutral and non-neutral effects on the GDP and the real exchange rate. For the case of effects in relative production (from 1970 to 1989) the non-neutral shocks explain almost 96% of total effect, and in the case of the real exchange rate, the dominant shocks were the neutral ones with a weight of 90% of the total effect - Barbosa et al. (1998: 173).

Summing up, the shocks in the past that had shown more explanatory power for real production are the ones who have less explanatory power for the real exchange rate, and thus the authors' state (Barbosa et al. 1998:173): "in the past, the real exchange rate didn't play a significant role as a stabilizing instrument facing the main macroeconomics shocks". Besides the authors refer a major fact which has been established in the Portuguese economic literature, that nominal exchange rate was used as instrument to fight the inflation differential facing the exterior and not as a true instrument to fight maladjustments or current macroeconomic imbalances.

We might recall that Portuguese inflation's evolution was remarkable, decaying from two digits values before the 90's and afterwards to single digits values - this is an irrevocable credibility gain. How to face desynchronized inflation emergence in Portugal facing different Eurozone inflation evolution.

This might arise from more restrictive budget policy stance, not just from de jure but from a real rationalization of government spending.

Silva Lopes defended in the recent past (SEDES conference in 2001) that there is a further adjustment mechanism: the real wage mechanism. The so quoted study Barbosa et al.(1998: chap.5) devotes this section to the study of this kind of adjustment.

Besides Barbosa et al. (1998) quantified budget policy through a prospective scenario analysis. There was clearly a trade-off between budget policy effort stance and the evolution of the Portuguese debt - there must have had a "*mutual compatibility between these two variables*". To attain these twofold objectives we must have a primary budget surplus in the long run. They had also recommended a higher budget effort in the short run on order not to exceed the 3% constraint. Given the initial weight of public debt, the probability of exceeding the 3% ceiling would be higher as higher the initial debt weight.

They also previewed for the credit and capital market, due to the euro introduction, a deepening of liquidity, essentially through the mergers of various stock markets, which in fact caused efficiency gains.

The authors also quantified the impact of interest rate reductions derived from euro-zone integration in Portugal. The results obtained come from a previous general equilibrium model of endogenous growth, already used before by Gaspar and Pereira (1995).

Their scenario analysis concludes that for the Portuguese transition the best solution is the one which assures a reduction of 50 basis points from real Portuguese rates facing the EU. In this cases they previewed a real gross domestic product of 3,3%, 3,3% and 2,9% after adhesion to the euro.

Their sectorial analysis, based upon the CAE (classification of economic activities), tried to evaluate the euro impact due to more opening of the Portuguese economy. The biggest chunk of labour activity, for primary and secondary sectors in the national structure, had low outward exposure. The highest outward exposure sectors had the highest unit labour costs.

As for the banking sector, one of the most directly affected by the euro introduction, the banks had to take into account the loss of exchange rate operations revenues between the 12 of the Eurozone. The quoted study given by the EUBF (European Union Banking Federation), which tells us that more than 60% of the direct costs of euro introduction have to do with the introduction of new coins and notes, and the respective processing and other payment systems. Around 20% of the costs are related to credit concession and were highly related with direct attendance to the public. The remaining 20% were inputted to the loss of exchange rate operations.

For the national banking system Barbosa et al. (1998: 37) estimated that direct costs were, for a yearly evolution from 1997 to 2001, between 2,2% and 2,7% of the cashflow, and of 6,2% to 10,7% of net results.

6. EMU @10

The Report EMU@10 prepared by the EC scrutinizes the evolution of the euro for its 10 first years. It summarizes their main findings by the following issues (EC, 2008, Part I: 9-147):

1) *Macroeconomic performance*: the report scrutinizes all 11 entrants macro performance since 1999.

2) *Business cycle synchronization*: it increased within euro-area and thus justified more inter-twined approach that the Euro came to represent. The volatility of output within euro-area diminished, even though it also diminished among US, Japan and the rest of the world – but the decrease within euro-area was more accentuated. This is very important as more synchronization decreases the probability of adverse asymmetrical shocks.

3) *The adjustment experience*; in this chapter the report describes in detail all the pre-requisites the 11 entrants in the Euro area had to comply with.

4) *Macroeconomic policies and the policy mix*: It describes the need for coordination between fiscal policy (namely the SGP) and the role of ECB's monetary policy.

5) *Reforms of social systems and labour and product markets*: The ageing of European population put a stress on the sustainability of pensions and welfare states. Some countries were more sensible and approved more easily reforms (postponing labour market exiting – like retirement requirements) which will yield forward looking solutions which might be sustainable. A more inclusive approach, namely including immigrants from other (yet) non-EU or non-Euro area countries, might renewal fertility

rates and bring upon a more young and sustainable population. The product markets also become more integrated, common policies, competition and regulatory policies became tighter and stringent reinforcing the role of innovation and spurring the role of R&D in the Lisbon Strategy framework (approved upon from 2000's Portuguese presidency of the EU Council.)

6) *Financial market integration*: The integration of European stock market trying to compete with NYSE and Nasdaq became successful. European banking regulations were (re)defined and enlarged. Nevertheless the report already pointed to the housing bubble mania that was emerging and thus created the biggest slump in recent times, namely since the 9/11 times. Alesina and Giavazzi (2006: ch9, 109) pointed already to conflicts of interest raising in the financial markets, between principals and agents (as micro theory of moral hazard and adverse selection scrutinize). They also pointed to the divergence of CEO's executive payments in good and bad times, and also that the governor of the Central Bank of Italy was the second highest on the pay-roll of Central Banks, while former Wim Duisemberg's ECB's President was only sixth (Alesina and Giavazzi, 2006: ch. 9, 113 and 117).

7) *Catching-up within the euro-area*: This chapter is of tantamount evidence because it evaluates the trajectory of development of the former cohesion four: Portugal, Spain, Ireland and Greece. Ireland was the most successful, surpassing at 2008 the 100 average GDP per capita of EU, Greece had some "troubles" but also managed to converge. We are left at large with the Iberian duo: the success of Spain and the laggard dismal Portugal. The report clearly states that Portugal failed in its mission, when compared to Spain. Some reasons are advanced: i) the entry rate of the Escudo and Peseta versus the euro, ii) the lack of reforms in the economy; iii) the lack of financial prudence in the fiscal policy. Regarding the first justification of the Portuguese dismal record (after the euro accession), one must state that Portugal entered with a fixed parity which was only 15% devaluated facing market fundamentals, while Spain did it on 30% devaluation of the Peseta facing the euro. This might emerge as striking, but it entailed a loss of competitiveness which is major due to the fact that Spain's is Portuguese main export market. Besides, the lack of reforms, Portugal had to face the end of Multi-fiber arrangement (as we referred previously) which created an asymmetric shock at the textile and apparel North of Portugal. This was quite damaging as Portugal entered to face competition on an (un)equal footing with China (heavily governmental subsidized

and huge scale effects) and with India (both of which had severely cuted labour costs). The lack of financial prudence obliged Portugal to enter for two times on an Excessive Deficit Procedure (EDP). Nevertheless, on the first time (still alone managed to recover), on the second time, fortunately, it would be accompanied by Italy and especially France and even more by Germany, which eased up the pressure on this performance.

8) *Trends in the international role of the euro*; it shows the euro has inevitably come to be the second leading world currency. Its' weakest points are in Latin America and Asia, but has steadily increased its role as unit of account, store of value and income valuation.

9) *The evolution of economic governance*. The ECB and the euro have come to represent Europe. It's needed a more deepened integration at the political level. The Convention and the Treaty of Lisbon have aimed at these objectives.

The report also points goals and challenges forward to the EMU (EC 2008, Part II: 149-242): "*1) A changing landscape; 2) Promoting growth and employment; 3) Ensuring efficient adjustment and stabilization; 4) Quality and sustainability of public finances; 5) Enlarging the euro area; 6) Managing the euro-area's growing international role; 7) Exploiting policy synergies and the benefits from coordination.*"

Besides the report also leads (EC 2008, Part III: 243-294) to: "1) The role of domestic agenda; 2) Enhancing the global role of the euro area; 3) More effective governance."

7. Conclusion: Lessons from Portuguese accession to the Euro

With this paper we have shown that the transition to the euro is a credibility process, hard, long, pain-staking. On section 3 we constructed a bivariate credibility index with two coordinates, duration of the pair (MF/GV-Minister of Finance/Governor of the Central Bank) and a market measure performance (CIP - deviations from Covered Interest Parity) which shows some turbulence in the Portuguese accession to the euro.

We might withdraw some lessons from Portugal for future entrants into the Euro-area:

i) Credibility comes at hard cost: it is hardly gained (1986-1999) but easily lost (2000-2009) – process or lesson which I'll call **hysteresis in credibility accession.**

ii) Financial prudence must be sustainable in order not to conflict with cooperative European rules (namely SGP) - Lesson which I call **cooperative European public expenditure prudence**.

iii) The role of the Lisbon Strategy and namely the role of innovation and human capital is pressing – Portugal invested heavily more on physical infra-structures than human capital (education and professional experience). As opposed to this, Ireland since the 70's was already putting a stake on education. This lesson I call: **"Persons first, roads afterwards"**.

iv) The design of public policies must also be inter-twined with private incentives. While farmers were being (heavily) subsidized not to produce some cash-crops, some alternatives should have been thought of. Lesson: **Coordination of private and public incentives**.

v) The exposure of Portuguese economy outwards increased (namely due to the end of the Multi-fiber arrangements), as the degree of openness increased a requalification of labour-skills should have been thought at. This lesson I call: **Opening rapidly, convening faster, restructuring even faster**.

vi) The reduction of risk premia, the decrease of interest rates, even though this started well before the current international crisis, should have been taken into account to foster FDI and attract steadily more investment. Lesson: **FDI is not granted**.

vii) Even the euro comes at some cost, once it is signed it is irreversible due to the credibility pre-condition; so final lesson: - **There Is No Alternative! TINA**.

We might sum up the Portuguese transition process to and from the euro as: 1986-1999- from illusion to credibility, and 2000-2009, from credibility to delusion.

The main task of politics, in order to avoid a trajectory from illusion to delusion, is to wisely advocate sustainable policies which further sustain credible governments and happy people. We are in a severe slump, which hasn't been seen from ages, accountability, proximity and legitimacy in the politico-economy sphere are in fact needed – Braga de Macedo (2008) and Mateus (2008, 2009) discuss this more at length. Eichengreen and Baldwin (2008) propose a reform of the World Financial system.

Schumpeter wisely orchestrated the role of creative destruction from a crisis. Nevertheless, the euro has shown that is a good "cushion" for the world crisis. In fact, Iceland, one of the leading countries in terms of HDI (human development index) entered into bankruptcy, because it leveraged too much its growth on financial sector and was out of the Euro. Even though we might counsel euro's TINA, we might take advantage of the crisis in order to reinforce the role of the euro. The role of private gains instability should not exceed the role of public stability. And that's why we have here the euro to stand for.

8. Appendix: The data sources

The data sources were compiled from Braga de Macedo and Torres (1989) and from my Msc Thesis and subsequent work Rocha de Sousa (1998, 1999a,b, 2001).

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