Office Memorandum

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Note 5

DEC 18 1980

JR

TO : The Managing Director

DATE: December 18, 1980

FROM : Brian Rose BR

SUBJECT : Portugal--EFF

I have informed Mr. Mentré--in response to his question at lunch today--that the projected amount of an EFF with Portugal would be about SDR 1 billion over three years. Up to now we have talked in terms of 600 per cent of the old quota (SDR 1,032 million); 450 per cent of the new quota would amount to SDR 1,161 million.

cc: SED

EUR

cc: SED

Office Memorandum

CONFIDENTIAL

TO : Managing Director
Deputy Managing Director

DATE: December 12, 1980

FROM : Alan A. Tait AT

SUBJECT : Portugal: Technical Assistance: Back-to-Office Report

Following a request from the Portuguese authorities for further technical assistance to help in the introduction of a value-added tax (VAT), Mr. Thanos Catsambas (economist, FAD) visited Lisbon November 27-December 11 and Mr. Tait (Assistant Director, FAD) joined him for the second week of the visit.

Mr. Catsambas worked with the economists on the VAT Committee and with members of the National Institute of Statistics, with the Grupo de Estudes Bàsicos da Economica Industrial (GEBEI), and with the Central Department of Planning. A methodology was agreed on the use of the input-output table and the Household Budget Inquiry to assess the incidence and distributive effects of the substitution of various existing sales taxes by a value-added tax. Mr. Catsambas prepared a paper, A Proposed Methodology for the Distribution of the Burden from Excise Taxes Among Income Groups in Portugal, which was left with the authorities.

In the second week we concentrated on discussing some of the broad options and negotiating positions (vis à vis the EEC) for the Portuguese VAT Committee. The most important of these concern the use of the zero rate, publicly provided services, the treatment of farmers and transport. On the basis of these discussions we prepared estimates of the probable VAT base showing that, accepting all the regulations of EEC, VAT Sixth Directive, the implied rate of VAT to replace those present sales taxes which are in contradiction to the EEC Directives, would be about 8.5 per cent. If food and water were zero rated the required VAT rate increases to about 16 per cent. The derivation of these statistics and the assumptions behind them were agreed with the Portuguese statisticians and economists before the tables were presented to the VAT Committee; the estimates therefore represented an agreed position.

In discussions with Professor X. de Basto, Chairman of the VAT Committee, and with Dr. Oehen Goncalves, Director of Planning and Studies, it was agreed that before any further economic studies could be undertaken the committee in consultation with the EEC needed to define the legal position of the tax base. Dr. Goncalves expressed his appreciation of the Fund technical assistance and anticipated that, perhaps in a year's time when the new input-output table would be ready as would the 1980/81 Family Household Budget Survey, the authorities might ask again for technical assistance in this area.

The authorities are proceeding with their intention (recommended by the IMF in July 1980) to produce a document on the VAT for public discussion early in 1981. They also intend training some 40 tax administrators about the elements of VAT and after that (by June 1981) they anticipate that the IMF technical assistance on VAT tax administration discussed earlier, would be appropriate.

cc: Mr. Goode
Mr. Beveridge
Mr. Khalid
EUR
ETR
INST
LEG
RES
Mr. Mohammed
Mr. Watson

Mr. Rose

Office Memorandum

TO : Mr. Dannemann

DATE: December 9, 1980

FROM : T. Ter-Minassian T-M.

SUBJECT : Portugal--Bureau of Statistics Assistance

During the recent staff visit to Portugal, the head of the Research Department of the Bank of Portugal indicated that the work of Mr. Sundgren on the general statistics had been quite useful and wondered whether another visit (by Mr. Sundgren or another staff member of the Bureau of Statistics) could be arranged to cover more thoroughly the areas (like labor statistics) that Mr. Sundgren had only touched on cursorily because of time limitations, and to follow up on the implementation of his recommendations. You may want to give consideration to this matter at your earliest convenience.

cc: Mr. Rose

Mrs. Ter-Minassian December 2, 1980

Brian Rose

Portugal

On December 16 the Managing Director wishes to be briefed on the status of our relations with the so-called "difficult countries" which I think involves Portugal. Your back-to-office report will probably give me sufficient information for this purpose though I may want to put a few additional questions to you. But could you please also provide me with the ratios referred to in the memorandum from the Managing Director to Mr. Palmer of November 21, as I would like to have this available for the Managing Director in any event. Please get in touch with me before any work is done on this as there are a couple of the ratios on which I have particular views.

Office Memorandum

To: The Managing Director
The Deputy Managing Director

December 8, 1980

From: T. Ter-Minassian T.T-M.

Subject: Portugal - 48-Hour Report

At the request of the Portuguese authorities, a staff team consisting of Messrs. Aghevli (ETR), Dhonte (ETR), Kopits (EUR), Roe (IBRD), Miss Jones (EUR, Secretary), and myself visited Lisbon in the periods November 16-24 and December 2-5 for informal discussions on a possible use of Fund resources under the Extended Fund Facility.

The sudden death in a plane accident of the Portuguese Prime Minister, Dr. Sa Carneiro on December 4 has opened a period of serious political uncertainty in the country. There is no heir apparent and the ruling center right coalition (Aliança Democratica) runs a danger of splitting in the future, especially following the re-election of the incumbent President Eanes. The Minister of Finance, Dr. Cavaco e Silva, who has been a strong proponent of a program with the Fund, which he views as providing needed support for a sustainable medium-term development effort, may decide not to participate in the next Cabinet, if he feels he will not enjoy the same degree of political support as from the late Prime Minister. The timing of further contacts is, therefore, uncertain.

The discussions focused on the short-run outlook and policies and on the medium-term program currently in preparation. We left with the authorities memoranda summing up our views on both, as well as technical notes on the position of the public enterprises, the management of external debt, and the proposed four-year public investment program.

Economic performance in 1980 has been quite good. Growth is estimated at about 4.5 per cent; inflation has decelerated sharply, to less than 17 per cent on average for the year, compared with about 24 per cent in 1979; and the non-oil current balance has continued to improve on the strength of the performance of exports, receipts from tourism, and emigrants' remittances. The current deficit is estimated at about US$700 million (less than 3 per cent of GDP). For the first time in several years the budget deficit will not exceed significantly the initially projected amount (equivalent to about 10 per cent of GDP). The authorities' efforts to reduce tax evasion have produced very good results, with revenue estimated to rise by 38 per cent. A beginning has been made at containing the growth of public consumption.

There are, however, areas of weakness which, if uncorrected, could seriously jeopardize future performance. A major one is represented by the financial position of public enterprises, especially in the transport sector. Political pressures and the desire to moderate the recorded rate of inflation have led the authorities to freeze public transport prices since September

1979 and to authorize price increases in other public enterprises which are clearly inadequate to cover cost increases. In addition, subsidies were frozen at the 1979 level. These developments have led the enterprises to increase resort to credit from abroad sharply. External debt has risen by over US$1.5 billion (of which about US$1 billion was in short-term liabilities) in the first three quarters of the year. This inflow of capital, together with a rapid growth of credit to the private sector, has led to a sharp increase (around 36 per cent) in liquidity in the economy.

The prospects for 1981 are, of course, influenced by uncertainties with respect to the development of world trade and of the oil price. On the assumption of an average price of oil of $40 per barrel and of a 3 per cent growth in world trade, the Portuguese representatives project a current account deficit equivalent to US$1.1-1.2 billion (4-4.3 per cent of GDP). GDP growth is expected to decelerate slightly (to around 4 per cent) and the rate of inflation to remain around 17 per cent, even assuming moderation in wage settlements. The 1981 budget has not yet been presented to Parliament but the Minister of Finance gave the mission details of the version just approved by the Cabinet. It provides for a decline in subsidies, near constancy of public consumption in real terms, and the maintenance of a sustained growth of tax revenue from a relatively high base. Nevertheless, the deficit is expected to remain constant in per cent of GDP, as a result of a sharp increase in interest payments and in public investment. No details were yet available on the prospects for its financing; it is fairly clear, however, that, unless the share of nonmonetary financing increases significantly, the increase in bank credit to the public sector will continue to pre-empt a sizable share of the maximum increase in domestic credit which is consistent with a substantial slowdown in the growth of liquidity.

The mission emphasized to the authorities the need to maintain a relatively high level of real interest rates, to ensure a further decline in velocity. It advised against any significant reduction in lending interest rates at the present time (a move which is strongly sought by various pressure groups), especially in the light of the recent trend in international capital markets. On exchange rate policy, it suggested that decisions about a further reduction in the monthly rate of effective depreciation of the escudo be postponed until there is clearer evidence of moderation in wage settlements.

Preparations for the medium-term program are proceeding at a slower pace than desirable. A macroeconomic framework calling for maintenance of a sustained rate of growth, led by investment, and for a gradual reduction in inflation to around 10 per cent by 1984 is expected to be officially presented at the beginning of next year. Meanwhile, work is proceeding on the selection of a list of investment projects by the public administration and the public enterprises to be undertaken over the period 1981-84. The staff team emphasized that the investment program of the public enterprises should be complemented by an appropriately articulated financing plan, defining the relative roles of self-financing, budgetary transfers and resort to domestic and external credit, as well as the policy measures necessary to strengthen their financial position. In collaboration with the IBRD staff, we also provided comments on the content of the investment plan and made suggestions for the improvement of coordination among the agencies responsible for formulation and implementation. We found the cooperation of the IBRD staff especially valuable in this respect.

cc: Mr. Habermeier
Mr. Hood
Mr. Finch
Mr. Mohammed
Mr. Nicoletopoulos
Mr. Van Houtven
Mr. Watson

INTERNATIONAL MONETARY FUND

Portugal--Use of Fund Resources

Minutes of Meeting No. 1
Held at the Bank of Portugal
November 17, 1980

Present:

Portuguese Representatives	Fund Representatives
Dr. J. A. Girão	Mrs. T. Ter-Minassian
Dra. T. Cardoso	Mr. B. Aghevli
Dr. M. Beleza	Mr. P. Dhonte
	Mr. G. Kopits
	Mr. A. Roe

Economic Developments in 1980 and Prospects for 1981

An assessment of the economic developments in 1980 and of the prospects for 1981 were provided by the Portuguese authorities (mainly Dr. Girão). It was stressed that this assessment should be viewed as tentative because it was largely based on preliminary information available for the first semester of 1980.

1. Developments in 1980

a. Aggregate demand

Gross domestic product is estimated to increase by 4.6 per cent, somewhat higher than previously estimated; the increase for 1979 was also revised upward to 4.8 per cent. Private consumption is estimated to increase by about 3.5 per cent and public consumption by about 2.5 per cent (based on Bank of Portugal deflator). Consumption increased rapidly during the first semester, partly reflecting an increase in pensions and adjustments in income tax brackets, but it is expected to decelerate in the second semester because of slower increases in wages and large deceleration in remittances (to about 23 per cent).

Investment (fixed capital formation) is likely to increase by about 7 per cent, surpassing the initial target of 6 per cent. The increase in investment was mainly a result of increased construction. Demand for housing rose because of the increasingly tighter situation in the rental market and improved incentives and credit facilities for own home purchases.

There are some signs of shortages, such as in cement, but the evidence on investment for the latter part of the year is rather sketchy. Nonresidential investment increased rapidly during the first semester but it may slow during the second. The evidence on the profit situation of various sectors is too ambiguous to conclude anything.

b. Balance of payments

The following estimates for the trade account in 1980 were provided based on the figures for the first semester.

	Per cent increase
Import volume	8
Import prices, including oil 1/	26
Oil prices, including refined 2/	65
Oil prices, crude	87
Excluding oil	20
Export volume	10
Export prices 1/3/	18
	In millions of US$
Current account deficit	600-750

1/ In U.S. dollars; prices in escudos are higher by about 2 percentage points, reflecting the depreciation of the escudo.
2/ About 35 per cent in the first half of 1980 compared with the first half of 1979.
3/ About 27 per cent in the first half of 1980.

The large increase in imports reflects some stock accumulation, resulting from prolonged expansion in the economy and the low level of stocks in 1979; the income elasticity over the longer term is about 1.2, compared with the implied value of 1.6 for 1980. There are some indications that export growth may be slowing, largely because of protectionist measures in foreign markets, particularly for textiles, furniture, wool, and cork.

c. Monetary developments

Narrow money is expected to increase by 20 per cent in 1980, and broad money by 30 per cent. The rapid expansion of broad money is largely a result of the increase in migrant deposits which increased by 62 per cent. To the extent that migrant deposits are largely demand determined, this increase does not create excess demand pressures. The increase in liquidity, excluding migrant deposits, is 25 per cent, which is not too excessive. Credit to public enterprises has increased relatively slowly (16 per cent by August) but this does not represent a tight credit position for these enterprises because they have had easy access to foreign credit.

A major concern regarding the financial system is the situation of excess liquidity of the commercial banks, resulting from the rapid expansion of reserve money combined with tight credit ceilings. The banks are put in a difficult position as they are forced to pay relatively high rates on time deposits without being able to extend additional credit. Consequently, although deposit rates are not out of line in terms of parity with foreign rates or domestic inflation, they are imposing a loss on banks. The Government has attempted to partially alleviate the situation through the interbank bond market, but the rate of interest paid on government bonds is relatively low.

d. <u>Prices and wages</u>

CPI rose by only 0.1 per cent in September and 1.0 per cent in October. The deceleration in inflation was largely a result of higher supplies of some food items (comprising 15 per cent of total weight in CPI); higher subsidies on food items and on services; the failure to fully reflect in domestic oil prices the increase in the price of imported oil; and changing expectations as regards the permissible increases in wages and prices, leading to lower profit margins and higher productivity in many public and private enterprises. While most prices are not strictly controlled, increases in prices of major items must be declared and reviewed by the Government.

<u>Dr. Girão</u> agreed with the staff that although this system may prove effective in controlling inflation in the short run, it is important that longer-term financial policies are designed so as to be consistent with price and external objectives; otherwise, excess demand pressures would be reflected in higher domestic inflation and in a deterioration of the external position. Given the current large increases in external prices and in liquidity, the present price performance may be viewed as somewhat artificial.

Nominal wages rose by about 21 per cent during the first semester, but they may slow in the second semester; the minimum wage was raised by 20 per cent in September.

Productivity rose by 3 per cent, slightly below the increase in real wages. It was pointed out that the increase in prices of nonfood products was broadly in line with cost developments suggesting that there had not been much of a profit squeeze, at least in the private sector.

2. Prospects for 1981

a. Aggregate demand

GDP is expected to grow by about 5.0 per cent. The composition of aggregate demand is expected to change in 1981. Private consumption is expected to increase by 4.0 per cent, and public consumption by 2.0 per cent. Investment is expected to increase faster, but there is some uncertainty about stock accumulation. The following tentative projections are made:

	Per cent increase
Gross investment	8
Fixed capital formation	10
Housing	(7-8)
Private nonresidential	(10)
Public	(8)
Of which: administrative	(6)

Private nonresidential investment is expected to accelerate due to increased confidence, partly resulting from recent measures providing compensations to the previous owners of the nationalized enterprises in the form of bonds which can be utilized for capital participation in certain public enterprises or as collateral for certain types of loans for investment purposes; the details of this scheme are currently being worked out. Higher investments are also expected in tourist industries, which are operating at capacity, and in the export sector, which is likely to modernize in anticipation of Portugal's membership in EEC and the expected growth in markets for export commodities in the longer term. Direct foreign investment is expected to increase rapidly to perhaps twice the present level, which is relatively small.

The staff pointed out that the planned increase in investment requires a greater savings effort to ensure that the burden of foreign borrowing would not become excessive. The Portuguese authorities responded that they were also concerned about this point, particularly since the increase in savings ratio observed in recent years is not likely to continue as this ratio reaches its long-term value of 0.22 in 1981. Measures are being considered to increase public savings through more tax effort. The authorities are also considering policies to promote private financial savings by providing a more diversified array of financial instruments as well as higher remuneration for holding these instruments. Some of the schemes under consideration are the introduction of different types of savings deposits. While some of these schemes existed previously, they were never utilized since they were not competitive with time deposits. The Government is also considering the placement of longer-term bonds. Efforts are being made to encourage the private issues of bonds but it is difficult to promote the issuance of such bonds because of the relatively low lending rates of the commercial banks.

The authorities are concerned that while the above measures may broaden the scope for holding financial savings in different forms, they are not likely to increase overall savings substantially.

b. Balance of payments

The following tentative forecasts are provided for the trade account in 1981.

	Per cent increase
Import volume	5.5
Import prices 1/	13
Agriculture (weight .9)	(6)
Nonagriculture (weight .72)	(10)
Oil (weight .19)	(20)
Export volume	7
Export prices 1/	11
	In millions of US$
Current account deficit	900-1,000

1/ In U.S. dollars; prices in escudos are expected to be higher by about 4 per cent, reflecting the depreciation of the escudo.

The rate of depreciation of the escudo is expected to be reduced to 0.3 per cent per month and the external terms of trade to deteriorate by 2.0 per cent. Migrant remittances are expected to be about $3.2 billion.

c. Monetary developments

A rough monetary program has been drawn by the Bank of Portugal. The program is based on the following assumptions:

An inflation target of 15 per cent (GDP deflator);
A growth target of 5.1;
An income elasticity of 0.9 for narrow money;
A value of 0.11 for the ratio of time deposits (excluding migrant deposits) to income (same value as in 1980);
A value of 0.5 for the ratio of migrant deposits to remittances.

These assumptions lead to an increase of 17 per cent in narrow money and 23 per cent in broad money. Claims on Government are expected to increase by about Esc 120 billion and net foreign assets to decline by Esc 25 billion (about US$0.5 billion). The staff questioned the latter assumption in the light of the likely developments of the balance of payments on current and capital account. Credit to productive sector is calculated, as the residual item, to be about Esc 220 billion (21 per cent); this credit is regarded as somewhat tight.

The staff indicated that the program was consistent with its own estimates of demand for money (M2), which provide an income elasticity of about 1.6 (i.e., 1.6 x 5.1 + 15 = 23). However, it was not possible to estimate the demand for money (M2) excluding migrant deposits because of data limitations.

d. Prices and wages

The target inflation is set at about 16 per cent for CPI and 15 per cent for GDP deflator. This target is broadly in line with the increase in foreign prices (13 per cent) and the expected depreciation of about 4 per cent. Some upward adjustment would be made in the prices of energy products and the services provided by the public enterprises.

In terms of cost developments, nominal wage increases are expected to be maintained at about 18-19 per cent, while productivity is expected to increase by about 4 per cent. The Government will continue to monitor wages directly in the public sector and indirectly in the private sector through price controls as this has proved an effective means of control in the past.

INTERNATIONAL MONETARY FUND

Portugal--Use of Fund Resources

Minutes of Meeting No. 2
Held at the Bank of Portugal
November 19, 1980

Portuguese Representatives

Dr. Christine de Souza, Director General, D.C.P.
Dr. Ferreira d'Amaral, Head of Global Modelling, D.C.P.
Dr. Carlos Alcobia, Head of Public Enterprise Section, D.C.P.
Representatives of Bank of Portugal

Fund Representatives

Mrs. T. Ter-Minassian
Mr. B. Aghevli
Mr. P. Dhonte
Mr. G. Kopits
Mr. A. Roe

The Medium-Term Framework and Public Investment Program

1. Macro-framework assumptions

Dr. Ferreira d'Amaral outlined the main assumptions behind the macro projection to 1984. These included:

(a) International inflation rate including oil of 10 per cent.

(b) Oil price increase averaging 15 per cent.

(These two assumptions together give a term of trade deterioration of 2 1/2 per cent per annum until 1984. 1984 trade deficit is very sensitive to this assumption.)

(c) Sustained increase in agricultural production of 4 per cent per annum. This will ensure a stagnation of agricultural imports after 1984. He discussed the pricing and investment policies underlying this projection but was unable to be very specific.

(d) Structural changes have been incorporated for modelling purposes in relation to four industries, namely steel, cement, pulp and paper, and petrochemicals. The major change was the reduction in the import coefficients in the input-output table in relation to inputs coming from these industries. In addition, the changes affect export growth rates from the steel and petrochemical industries.

(e) The Moncorvo project is incorporated in the plan only insofar as demand for investment goods is concerned. No supply changes are anticipated in the 1981-84 period.

(f) The overall import elasticity emerges from these assumptions. It is falling and is expected to be below unity by 1990 (though the formal modelling is only taken to 1984). In response to a question, it was made clear that domestic supply rigidities are not considered as a possible cause of higher imports than are implied by the fixed coefficients.

(g) Migrants' remittances grew in line with international inflation.

2. Macro-framework: issues

In the discussion a number of additional points emerged, namely:

(a) In spite of the preamble to the plan document, the projection to 1984 implies near constancy of the wage-profit ratio.

(b) The relatively ambitious growth of private investment (9 per cent per annum) is not directly integrated with the assumed performance of exports in the predominantly private sector industries. However, the export growth assumptions are available on a sectoral basis and can be made available to us.

(c) There is no data on the sectoral composition of private investment. Even historical data does not make this available because of the inadequate coverage of the industrial surveys.

(d) The public investment total in the macro forecast is related only vaguely to the project list.

(e) The employment growth rate derived from the projection (2 per cent per annum) is probably optimistic. It assumes no fall in agricultural employment (now 30 per cent of total employment) or in textile employment. There was a vague reference to an alternative to IIIS geared to employment generation.

3. Planning organization

Dr. Christine de Souza briefly described the organizational arrangements underlying the 1981-84 project list. The planning units in the line ministries receive the tentative lists from their respective ministries. In some cases, these units merely acted as a post-box, passing on proposals to D.C.P. In other cases, a feedback/discussion process was also originated. In general, the feedback stage did not work well and D.C.P. has been forced to take more initiative in this area. In public enterprises the position was somewhat easier because of the more specific nature of their proposals. However, financing plans have not generally been made available. A political decision on the 1981 proposals in public administration will be made in the next few weeks. Political decision on the 1981-84 program will certainly be made before the program is published, probably in May/June 1981.

4. The investment list

This has four main components and a number of subcomponents, namely:

(a) Public Administration investments. These are stated in rather nonspecific terms. At the moment, the proposals are vastly in excess of what is physically and financially feasible (e.g., an overall expansion of investment of 8 per cent will be allowed in 1981 as compared to proposals amounting to 38 per cent).

(b) Investments in Industrial Public Enterprises. This list is subdivided according to those where (i) decisions have been made by the enterprises and (ii) investments where decisions are still pending. These two components are not watertight and negative decisions under (ii) might cause rethinking about some item of (i) (e.g., PVC and VCM). In both categories, some technical work leading to an absolute commitment to go ahead remains to be done. List (b) is characterized by the fact that D.C.P. has accepted it as a good basis for a program.

(c) Investments in transport enterprises. In aggregate terms the cost of these investments is vastly excessive relative to what economic and financial considerations can justify. D.C.P. is revising the list in collaboration with the enterprises (results in two weeks or less).

(d) Investments enterprises with some state participation, e.g., Sorefame.

In general the D.C.P. are well aware of the need for further work along the lines which the mission itself had identified. Future version of the program should include:

(i) the presentation of a global financing plan consistent with the investment program;

(ii) a classification of projects which better reveal their various different statuses;

(iii) a slimmed down program for public administration; and

(iv) a slimmed down transport sector program.

5. Coverage

The investment list excludes local authority programs although these are implicitly included in the macro-investment total.

Projects in Azores, Madeira are not included in line with the noninclusion of the islands in Portuguese national accounts (though they do get into balance of payments data).

Investments by Brisa are shown under Public Enterprises under the subheading of Infrastructure. It was agreed to meet again on Monday, November 24 at 10 a.m. in D.C.P. Revised documents relating to transport sector investments would be made available to us before that meeting. These were subsequently provided to us.

INTERNATIONAL MONETARY FUND

Portugal--Use of Fund Resources

Minutes of Meeting No. 3
Held at the Ministry of Transport and Communications
November 19 and 24, and December 4, 1980

Portuguese Representatives	Fund Representatives
Dr. Ferreira de Lemos	Mr. G. Kopits Mr. A. Roe

Solution of CP's situation

Under the terms of a decree law proposal worked out by the Ministry of Finance and the Ministry of Transport and Communications in the last week of November, the infrastructure of CP will be taken over by the Government and placed under the financial responsibility of the General Directorate of Transport (integrating replacement investment into PIDDAC), while leaving operational maintenance thereof with CP. Under this arrangement, in exchange for the infrastructure valued at Esc 14.2 billion as of December 31, 1979, the Government will credit CP with Esc 6.1 billion (the remaining Esc 8.1 billion having been already paid for by the Government) which, along with Esc 4.7 billion in delayed subsidies for prior years, totals Esc 10.8 billion in short-term credits to offset an equivalent amount in short-term liabilities. This amount is to be followed by a credit of Esc 3.5 billion for interest due after January 1, 1980, raising total government credits to CP to Esc 14.3 billion.

As a second step, also envisaged under the arrangement, the remaining Esc 9.9 billion in short-term liabilities of CP will be disposed of as follows: Esc 4.6 billion to be consolidated into long-term liabilities with commercial banks; Esc 2.1 billion liquidated with capital transfers from the 1980 central government budget; Esc 2.2 billion with capital transfers from the 1981 budget; and Esc 1.0 billion will remain as CP's short-term liabilities. Thus, CP's equity after this operational will amount to Esc 5.0 billion, given Esc 0.7 billion equity as of December 31, 1979.

However, the second step is to be combined with a number of economic measures (currently under study by CP for submission to the Ministry of Transport) within an ASEF. The measures under consideration are in the following areas:

--reduction in CP's work force;
--five-year investment plan;
--annual government payments for maintenance of infrastructure on behalf of CP;
--CP rental payments to the Government for the use of the infrastructure to cover depreciation (about Esc 0.5 billion yearly) and a proportion of maintenance costs;
--discontinuation of uneconomic lines; and
--fare increases.

According to Dr. Ferreira, very recently the Minister of Transport urged the President of CP to speed up the preparation of proposed measures, as the decree law implementing step one as well as the ASEF will be held in abeyance until credible economic rationalization proposals are not forthcoming from CP. Yet, all in all, it appears unlikely that any progress in this regard will be made before early next year.

Overall transport policy

Reportedly, the Council of Ministers has given tentative approval to an integrated scheme of fare increases in the transport sector. The scheme involves a 27 per cent average increase in fares effective January 1, 1981, broken down as follows with the corresponding subsidy transfers:

--20 per cent on social passes for urban transport (CARRIS, METRO, STCP, TRANSTEJO), Esc 3.6 billion in transfers;
--up to 35 per cent on suburban transport (RN, CP), Esc 4.0 billion in transfers;
--0 per cent on air transport to the islands (TAP) Esc 1.0 billion in transfers; and
--up to 35 per cent on minor selected services Esc 1.2 billion in transfers.

Transfers total Esc 9.8 billion, or which Esc 8.2 billion is expected to come from the 1981 central government budget. In all other transport services (mainly intercity transport), public enterprises will be given autonomy to compete with private carriers, which implies an average fare increase of approximately 30 per cent for those services. Roughly 35 per cent of all such services provided by RN and 55 per cent of those provided by CP. On the other hand, for the country as a whole, RN covers about 45 per cent of passenger highway market while the remaining 55 per cent is left to 100 private carriers; RN provides all such services south of the Tejo River but only 10 per cent north of it.

However, in an unexpected move, on November 21 the Minister of Transport declared publicly that instead of the above increments, the Government will raise social passes by only 15 per cent and other fares by 20-25 per cent, resulting in an average increase of less than 20 per cent. Holding government subsidies at Esc 8.2 billion (implicitly approved in the 1981 budget proposal) would then mean that the enterprises' cash flow would drop from zero (including depreciation but after financial charges and subsidies) to a negative amount of about Esc 2 billion. Dr. Ferreira indicated that the actual decision between alternative fare increases will probably depend on the outcome of the presidential elections. If the incumbent wins, then the lower fare increase is likely to be adopted. Otherwise, the higher one will be adopted.

In broad terms, the inability of the CP of generating a positive cash flow (which would be exacerbated with an insufficient fare increase) coupled with the freeze on equity transfers from the 1981 budget at about Esc 6.5 billion, has direct implications for the investment level as well as the resort to domestic bank credit and external financing. In summary form (expressed in billions of escudos):

	1979	1980 Estimate	1981 MT proposal
PISEE investment	21	20	30
Capital transfer from budget	3	6	6
Self-financing	...	--	-2
Domestic bank credit	...	13	24
External credit	...	1	2

Dr. Ferreira indicated that the 1981 investment proposal is rather modest but further cuts will probably be needed to accommodate reasonable credit limits. Also, although in general, transport enterprises do not borrow abroad directly (except TAP), they do so indirectly by incurring short-term liabilities with respect to suppliers, forcing the latter to resort to foreign financing.

In closing, Dr. Ferreira promised to send to Washington consolidated accounts on transport enterprises that show their financing needs for 1981--on which his department is working at the present time.

INTERNATIONAL MONETARY FUND

Portugal--Use of Fund Resources

Minutes of Meeting No. 4
Held at the Bank of Portugal
November 19, 1980 at 4:00 p.m.

Present:

Portuguese Representatives	Fund Representatives
Dr. Girão	Mrs. T. Ter-Minassian
Dr. Gonçalves	Mr. B. Aghevli
Dr. Beleza	Mr. P. Dhonte
Dr. Mendoça Pinto	Mr. G. Kopits
	Mr. A. Roe

The meeting began with an explanation of an amendment (in the form of a supplementary budget) to the 1980 central government budget. According to Dr. Gonçalves, the supplementary budget involves additional appropriations and revenues broken down as follows:

	Billion Escudos	
Gross additional expenditure		12.9
Current		
Health services	2.9	
Civil servants' pensions	2.5	
Other	1.3	
Capital		
Repayment of Treasury decolonization loan	4.0	
Transfers to regional entities	1.2	
Reduction in current expenditure (other)		-3.4
Additional revenue forecast		9.5
Tax revenue (mainly transaction tax and motor vehicles tax arrears)	8.6	
Nontax revenue (from sale of aircraft and mint profit)	0.9	

Regarding effective tax revenues, Dr. Gonçalves indicated that total collections through August 1980 amounted to Esc 128 billion, compared to the annual forecast of Esc 192 billion (including additional revenue of Esc 8.6 billion). He listed a number of reasons that account for differences with last year's performance: abolition of the extraordinary tax; shift from specific to ad valorem tariffs on June 30; and amnesty on tax arrears (resulting in an estimated increase of Esc 3 billion) in June and July. Further, seasonal increases can be expected during the remainder of the year (September through December) from large collections in industrial tax (October), professional tax (October), and complementary tax (December).

In all, Dr. Gonçalves said that the Central Government is estimated to incur a current account deficit of Esc 48 billion (instead of Esc 42 billion estimated in September) and an overall deficit of Esc 135 billion or less (compared to the earlier estimate of Esc 126 billion).

Asked about recent trends in social security contributions, Dr. Gonçalves noted that such information is collected quarterly by the Social Security Institute. Similarly, there are quarterly reports on local government finances compiled by the Ministry of Internal Affairs. Unfortunately, these data are not forwarded to the Ministry of Finance. However, recently enacted legislation requires all autonomous entities and local governments to transmit such data to the Ministry of Finance.

In response to another question, Dr. Gonçalves discussed present earmarking of tax revenue. They consist principally of gasoline tax transfers for the Supply Fund; social security contributions for Social Security; and property tax; motor vehicles tax; and a fixed proportion of central government expenditure for local governments. The latter is essentially equivalent to the larger of two amounts: 18 per cent of expenditures on goods and services (interpreted by the Ministry of Finance as exclusive of wages and salaries but inclusive of interest payments) or 18 per cent of direct taxes. Payroll taxes, which until recently were earmarked for the Unemployment Fund, have been diverted to the government budget, from where transfers are made to the Fund according to need. Whereas the tax collections earmarked for local governments have not been altered, pending legislation envisages a transfer of expenditures on education and housing to local authorities.

Dr. Gonçalves estimated that the administrative public sector's domestic bank credit requirement for 1980 would be Esc 85 billion, obtained as follows:

	Billion Escudos
Saldo global	121
Redemption of public debt	2
Complementary periods, net	-5
Nonbank domestic borrowing	-12
New foreign borrowing	-18
Foreign borrowing of 1979, the proceeds of which were converted in 1980	-5
Cabora Baixa	1.6

Targets for 1981 have not yet been finalized. Interest payments were expected to jump from Esc 38.7 billion in 1980 to Esc 68.5 billion in 1981, assuming interest rates at the discount rate and Esc 3 billion for interest on compensation bonds. Subsidies to public enterprises would be cut from Esc 11 billion in 1980 to Esc 10.2 billion in 1981, while those for the supply fund would remain at Esc 13 billion. Changes in revenue sharing would have a "dramatic" impact. Capital expenditure, including equity transfers, was yet undecided and would be settled with an eye on the overall deficit, which was expected to exceed 9.5 as percentage of GDP's level of 1980. Projections of tax receipts were based on: price increase of 16 per cent; activity growth of 5 per cent; interest rates on time deposits to decline from 18 per cent to 17 per cent; 10 per cent surtax on complementary tax and 15 per cent surtax on inheritance tax to be maintained; elasticity of the transactions tax to be the same as in 1980--after correction for the Esc 1.5 billion extra collections in that year due to deferment of 1979 taxes and collection of arrears; exemption levels for direct taxes to be raised along with minimum wages, and the elasticity of that tax to be (conservatively) one (base growth of 20 per cent); updating of many fees; no further improvement in the collection of arrears, some further progress on the evasion of the transaction and complementary taxes.

Major pending questions concerned (1) the investment budget and (2) the wage awards.

INTERNATIONAL MONETARY FUND

Portugal--Use of Fund Resources

Minutes of Meeting No. 5
Held at the Ministry of Finance
November 20, 1980 at 10:30 a.m.

Present:

Portuguese Representatives	Fund Representatives
Mr. Dias, Secretary of State	Mrs. T. Ter-Minassian
	Mr. B. Aghevli
	Mr. P. Dhonte
	Mr. G. Kopits
	Mr. A. Roe

1. The Secretary of State indicated that a law has been drafted which will permit to redress the financial position of CP. The infrastructure of CP will be taken over by the Government, which will also correspondingly assume about Esc 15 billion of CP's medium- and long-term debt, so that CP will be left with liabilities of about Esc 14 billion, of which Esc 9-10 billion are short term. In addition, CP's remaining assets will be revalued so as to restore a positive capital position. CP is requesting equity increases of about Esc 4 billion over two-three years; a decision on this amount will await the finalization of its investment plan, which should be submitted within two weeks. The rate of fare increases was not yet settled; emphasis remained on productivity increases; the rate increase could be of 20-30 per cent, preferably in one shot.

2. On a more generalized level, the Secretary of State indicated that tariffs for public enterprises would be adjusted in line with increases in operating costs, while some pressure would be applied to stimulate productivity gains. Nominal subsidies have not increased in 1980 and will decline in 1981. Productivity will be fostered by a freeze on new hirings.

3. The Secretary of State indicated that the framework agreements with public enterprises embody quantified performance clauses. Moreover, quarterly reporting forms are being

finalized which will keep the Ministry posted on developments; in addition, provisions are being made for six-monthly audits by the Inspectors of Finance corps.

4. On the question of the diverture of companies, in which the Government has partial equity mainly indirectly through holdings of the banking system, the Secretary of State indicated that a law was being drafted which would permit about 200 of these firms to return to the private sector. The recently issued compensation bonds could be used in the purchase of these firms. It is expected that the process would begin in December and would also cover some of the enterprises controlled by IPE. An ad hoc arbitration committee will be set up to settle valuation problems.

5. On specific public enterprises, the Secretary of State indicated that Setenave's financial position would be strengthened by the sale of two surplus tankers and that the shipyard's activities would be reoriented to repair work and the construction of small vessels for domestic use. RN, CTN, CNN and to some extent the beer companies also were among the public enterprises targeted for financial restructuring in the near future.

INTERNATIONAL MONETARY FUND

Portugal--Use of Fund Resources

Minutes of Meeting No. 6
Held at the Ministry of Finance
November 20, 1980 at 12:00 noon

Portuguese Representatives	Fund Representatives
Dr. Figuereido Lopes, Secretary of State for Budget	Mrs. T. Ter-Minassian Mr. B. Aghevli Mr. P. Dhonte Mr. G. Kopits Mr. A. Roe

Dr. Figuereido Lopes discussed the division of responsibilities in the preparation of the forthcoming budget: he is in charge of expenditures, while the Minister and Undersecretary Carp (?) work together on revenue policy and forecasts. For the rest of the meeting he gave detailed account of recent developments and future plans concerning expenditure control, particularly in the area of personnel. In an effort to cut wasteful spending, the Government has assigned priority to the containment of payroll costs. In contrast to 1979, when 10,000 additional employees were hired, this year there have been only 600 employees, mainly specialists, hired by the Government. Dr. Figuereido noted, however, that this statistic hides the fact that recently there has been a sharp rise in employees hired under temporary contract (not paid out of wage appropriations) in verious government dependencies. The latter development is reflected in the employee health service data, which indicate that this year there have been 30,000 additional beneficiaries, of which 10,000 are local government employees and the remaining 20,000 employees include a large number of teachers. To close this loophole, a new law will be enacted requiring all temporary employees (even if hired for three months) to be remunerated from budgeted wages and salaries to qualify for health-related benefits.

In his presentation, Dr. Figuereido identified two issues: one he called budgetary and the other utilization of existing personnel. A number of budgetary measures are being proposed to Cabinet, some of which will have an impact only in three to four years. One measure is to rationalize the Government's personnel structure. Another measure consists of requiring all dependencies to prepare two wage budget proposals for the Ministry of Finance, one that contains all existing personnel and another that lists all vacancies as well (as of December 31, 1980); the resulting appropriations will be a combination of the two proposals with an effective freeze applied to the existing number of positions including vacancies. In addition, for the first time decentralized agencies (autonomous services and institutions) will have to submit lists of personnel for review to the Ministry of Finance.

As regards the second issue, Dr. Figuereido emphasized the need to promote fuller utilization of existing manpower. To this end, managers will be urged to identify priority activities within the context of the Medium-Term Plan. Also, greater use is expected to be made of interdepartmental mobility and early retirement schemes. Beyond the medium term, Dr. Figuereido outlined plans to maintain a permanent pool of formerly employed civil servants (including retornados from Africa) who would be provided professional training to re-enter public employment in a more productive capacity.

At a more general level, Dr. Figuereido discussed a number of ideas to modernize the expenditure process through improved management practices, definition of priorities, and application of cost-benefit techniques. As early as next year, there will be an attempt to replace the present approach of initiating the budget preparation by setting of global ceilings on outlays with a bottoms-up approach whereby the budget would be based on programs developed from within each agency. To support the new system, delegates from the central administration will no longer act merely as inspectors in charge of enforcing the budget law; they will be responsible to coordinate and negotiate budgetary requests from each agency. Another area where progress is expected next year involves the shift from the present duodecimal system of allocating disbursements for investment expenditures during the fiscal year, to a system that reflects the actual time path of expenditures.

Dr. Figuereido explained that his office has jurisdiction over the preparation of the budget of central administration but not over those of decentralized agencies. As a complement, the Inspector General of Finance has a number of functions (some of them still inactive): inspection of tax and customs administration; audit of public enterprises (new function); and audit of implementation of the budget, including the budgets of autonomous entities and local governments (still inactive). The Ministry of Internal Affairs is currently defining the new responsibilities (particularly in the areas of education and housing) of local governments and the attendant transfer of personnel from the central to local governments.

INTERNATIONAL MONETARY FUND

Portugal--Use of Fund Resources

Minutes of Meeting No. 7
Held at the Ministry of Finance
November 20, 1980 at 4:30 p.m.

Portuguese Representatives	Fund Representatives
Dr. S. Godinho, Secretary of State	Mrs. T. Ter-Minassian Mr. P. Dhonte Mr. G. Kopits

Dr. Godinho reported on the progress made by the Government in combatting tax evasion. He attributed the success of this effort largely to the coordination by the Tax Evasion Task Force with the Office of the Inspector General, the Computer Center, and the Ministry of Commerce. This effort has been concentrated principally on the transaction tax, complementary tax, and motor vehicle tax. The anti-evasion campaign includes a number of important administrative changes.

Specifically, responsibility for payment of the transaction tax has been shifted from the buyer to the seller (by October, collections of this tax exceeded by 40 per cent the level reached at the same time last year); complementary tax liabilities are now being processed centrally by computer; and the motor vehicle tax is now due upon delivery of the vehicle at the factory gate or at the point of import rather than later, as done previously. The two-month amnesty granted regarding arrears of the social security tax and transaction tax has also contributed to this year's extraordinary revenue growth.

In general, additional gains are expected in the future from more intensive computer applications, tax payments through commercial banks, assignment of taxpayer identification numbers, and taxpayer education. Efforts are also underway to make tax evasion a criminal offense and to induce prompt tax payments. According to Dr. Godinho the present five-year statute of limitation may be too short for enforcing tax compliance efficiently. Dr. Godinho indicated that he would appreciate any information from the Fund about the experience of other countries in combatting tax evasion.

In passing, he referred to the measurement of the fiscal cost of the investment incentives scheme (conducted by the Secretaries of State and Planning), introduction of the value-added tax, and eventual unification of several direct taxes into a global income tax (separately at the personal and corporate levels). Dr. Godinho explained that he has no direct involvement in these policy issues.

INTERNATIONAL MONETARY FUND

Portugal---Use of Fund Resources

Minutes of Meeting No. 8
held at the Bank of Portugal
on November 21, 1980

Portuguese Representatives	Fund Representatives
Dr. J. A. Girão	Mrs. T. Ter-Minassian
Dr. Mendes	Mr. B. Aghevli
	Mr. P. Dhonte
	Mr. G. Kopits
	Mr. A. Roe

The meeting discussed the discrepancies between the debt statistics from the Treasury as reported to IBRD and those from Bank of Portugal. For public enterprise debt, Dr. Mendes explained that the Treasury reporting is based on an annual survey of enterprises. Bank of Portugal data, on the other hand, is based on the computerized record of applications under exchange control regulations. This record does not show actual drawings and repayments. It only provides records of amounts applied for together with the ex ante schedule of amortizations. However, a new system is now being proposed. This would extend the information collected via administrative statistics to include amounts outstanding. The new system would permit a better monitoring of debt throughout the year even though the once-a-year check with Treasury data might still reveal some discrepancies. Dr. Mendes explained that the new system would not involve direct questionnaires to the enterprises since this would be too much of an administrative burden. Proposals regarding the new system are due to be discussed by the Board of the Bank in the near future.

As regards the discrepancies between Treasury data on direct debt, relative to that revealed by creditor sources, Dr. Mendes had no ideas to offer. However, he did request that IBRD might field a small mission to provide assistance to the Treasury in resolving these matters. Mr. Roe agreed to pass on this request.

The meeting also discussed the very rapid buildup of short-term debt (of about US$1.5 billion) between December 1979 and September 1980. Much of this could be accounted for by the rising burden of Portugal's oil bill and Petrogal's method of paying for this. In the month of September alone, Petrogal contributed US$200 million, EPAL US$71 million, Quinigal $34 million, and ARGA $46 million, to the rise in short-term liabilities. It was not clear whether comparing the December figure of one year with the September figure of the following year introduced any significant seasonal distortion. Dr. Mendes explained that exchange control approval is normally not needed for external suppliers' credits if repaid within one year. However, certain public enterprises do need such approval. Therefore, the recorded short-term debt outstanding is probably understated.

Dr. Mendes confirmed that the Bank of Portugal's schedule of projected debt service relates only to disbursed debt. It makes no allowance for debt which is already committed but not disbursed.

On the question of the monitoring of debt and general debt policy, Dr. Mendes explained that control is highly decentralized on to individual ministries. DCP does not intend to set up a system of scrutinizing external borrowing on a project-by-project basis. For the moment, however, it does so only on a global basis. Dr. Girão saw the need for a better monitoring and control of the debt position, but saw very real difficulties in removing control from individual ministries until the idea of medium-term planning gets much better established. However, he felt that it would be useful for the mission to make clear and strong statements on this matter.

INTERNATIONAL MONETARY FUND

Portugal--Use of Fund Resources

Minutes of Meeting No. 9
held at the Bank of Portugal
on November 21, 1980

Portuguese Representatives	Fund Representatives
Dr. Rui Nuñes Proença, Ministry of Commerce	Mrs. T. Ter-Minassian
Dr. J. A. Girão, Bank of Portugal	Mr. B. Aghevli
	Mr. P. Dhonte
	Mr. G. Kopits
	Mr. A. Roe

Dr. Proença explained the Portuguese system of price controls (for which there is a long tradition), and its application in the recent past. Twenty-four per cent of the food basket consists of subsidized items, namely the Cabaz. Other items are covered by either the "maximum" price system (which regulates consumer prices), or the "declared" price system (which regulates prices on an enterprise basis). In general firms (producers or distributors) having total sales in excess of Esc 100 million in 1979 (Esc 50 million in 1978) have to seek approval for prices under the declared price system for any item for which sales exceed Esc 30 million (Esc 10 million in 1978). There is no limit to how many times during the year a firm can apply under this arrangement. The basis of approval involves a scrutiny of costs including an allowance for a return on capital employed (equity issued plus accumulated reserves). In practice, under this scheme, firms can riase prices which are tacitly approved unless the Government challenges the increase within 60 days. In turn, the firm can challenge a price determination by the Government, by presenting accounting evidence of actual costs developments. Fewer applications have been turned down in the recent past but this may be because firms have learned to submit applications which are more in accordance with what is likely to be accepted. The maximum price system applies mainly to "sensitive" items in the consumption basket (e.g., potatoes). Even within some categories (e.g., meat), some items are subject to the maximum price system and some to the declared price system.

Dr. Proença indicated that in 1981 as in 1980, subsidies for the Cabaz items would be set to restrict price increases to about 18 per cent. The mission enquired whether there is any move to relate subsidies more to income level. Dr. Proença indicated that this would be desirable but that no practical steps had yet been taken in this direction. However, it was hoped to reduce food subsidies by about 30 to 40 per cent in 1981 compared with 1980. His calculation suggested that the following price increases would result from full removal of subsidies:

	In per cent
Cereals, bread, cakes, etc.	20
Cooking oil	1-2
Meat products	10-15
Fish	7-10
Sugar (with only a small weight in CPI)	20
Milk--pasteurized	90
Milk--sterilized	30

Altogether Esc 23 billion were budgeted (Esc 6 billion for milk alone), and Esc 20 billion are expected to be disbursed, in subsidies for these products in 1980.

The Ministry of Finance wishes to study the implications of this system of subsidies since the costs can build up rapidly if it is not well designed. Also, the practicalities of using subsidies in a discriminatory fashion were difficult. The only easy way of doing it would be to relate subsidies to number of children but this was clearly only a very imperfect way of assisting those in greater need. The 1980/81 expenditure survey will not cover income levels but it may nonetheless be able to identify the target groups whose deprivations are particularly serious. However, since this is only a survey, it will not be able to solve the administrative problem of actually paying out the subsidies. Eventually, the new income tax numbering system may be of assistance in this regard.

INTERNATIONAL MONETARY FUND

Portugal--Use of Fund Resources

Minutes of Meeting No. 10
Held at the Ministry of Finance
December 4, 1980, at 3:30 p.m.

Portuguese Representatives	Fund Representatives
Dr. Ohen Gonçalves	Mrs. T. Ter-Minassian
	Mr. B. Aghevli
	Mr. P. Dhonte
	Mr. G. Kopits
	Mr. A. Roe

1. Dr. Gonçalves provided three tables presenting the 1981 budget and its implications for the public administration (attached).

2. For revenues, there are few new measures, except for the tax on tobacco and some adjustments to the inheritance tax. Revenue estimates of Esc. 257.6 billion have been derived with some optimism, particularly for the transactions tax, contrasting with the caution used last year. They are based on the assumption of 16 per cent inflation and 4 per cent GDP growth. Provisional results for 1980 are Esc. 219.8 billion, larger than original estimates for most items except current transfers to the budget. These included Esc. 5,880 million that were to be collected by the local authorities and did not show up revlecting an error of estimate and/or poor collection. The Unemployment Fund is appended to the 1981 budget as a conta de ordem, pending its possible incorporation into the social security (SS) system in the course of the year. It will contribute Esc. 8 billion out of a total Esc. 8.7 billion projected for capital receipts, which is a very ambitious target given the Fund's expected receipts of Esc. 19.4 billion (and its other contributions to SS totalling Esc. 10 billion).

3. The extrabudgetary Supply Fund will provide net subsidies of Esc. 11.8 billion for edible oil, sugar, fertilizer, milk and Esc. 6.5 billion for cereals; the cabaz system will be reformed, however, so that the implications for the CPI of containing subsidies at a total of Esc. 18.3 billion, versus Esc. 17-18 billion in 1980, cannot be ascertained. Resources will come from the budget (Esc. 13 billion), the energy sector (Esc. 4.2 billion) and the use of cash balances. Net receipts from the energy sector are a target; product prices will need adjustment, depending on crude oil prices, to achieve it.

4. While the overall deficit of Esc. 177.5 billion is a firm figure, the distribution of expenditure items is partly estimated.

Interest payments will rise to Esc. 66.5 billion including Esc. 11.6 billion for external debt and Esc. 3 billion for the floating debt to the Bank of Portugal, to cover interest at 18 per cent.

Personnel expenditure totals Esc. 121.4 billion, including Esc. 10 billion in the "other" items. The wage bill at constant wage rates and employment of June 1980 would be Esc. 105 billion, versus Esc. 99 billion estimated outturn for 1980 (which includes the "other" items), reflecting the full year impact of the June 1980 pay increase.

The increase in expenditure on goods and services reflects mainly higher military procurements.

Transfers of Esc. 99.2 billion include Esc. 13 billion to the Supply Fund, Esc. 15.1 billion to local authorities, Esc. 44 billion to health services, and Esc. 1.6 billion to SS for retirement payments. Corresponding figures for the original 1980 budget were Esc. 12.6 billion, Esc. 12.4 billion, Esc. 40 billion, and Esc. 1.3 billion.

"Other" expenditures include Esc. 10 billion for personnel, and Ecs. 5.5 billion for current expenditure for investment projects.

Investment plan expenditure is Esc. 31.6 billion, to which should be added Esc. 5 billion transferred to local authorities and Esc. 2.5 billion to be covered by a new autonomous fund with EC financing.

"Other" capital expenditures include Esc. 4 billion in interest subsidies for housing and the SIII.

Total transfers to local authorities will be limited to Esc. 41 billion (Esc. 15.1 billion current and Esc. 25.9 billion capital) under a restrictive interpretation of the law.

5. Figures for the whole public sector are still provisional, owing notably to uncertainties about expenditures by local authorities. These authorities estimate that their capital outlays could increase from a revised estimate of Esc. 25 billion in 1980 to Esc. 30 billion in 1981, which is likely to be an overestimate. Pension payments would increase from Esc. 95.9 billion in 1980 (revised) to Esc. 116.3 billion in 1981.

The financing of the projected Esc. 149.6 billion deficit (still 10 per cent of GDP) is not yet finalized.

Attachment

INTERNATIONAL MONETARY FUND

Portugal--Use of Fund Resources

Minutes of Meeting No. 11

Held at the Department of Central Planning

December 4, 1980

Present:

Portuguese representatives	Fund representatives
Dr. C. de Sousa	Mrs. Ter-Minassian
Dr. Carlos Alcobia	Mr. Aghevli
Dr. Perreira d'Amaral	Mr. Dhonte
Dra. Eleina Cordeira	Mr. Kopits
	Mr. Roe

Dr. de Sousa began by reporting that the Grand Options were now ready for presentation to the National Council of the Plan. Following this the 1981 plan and the four years plan for 1981-84 which includes the PISP, will be prepared. This latter document should be ready by about April or May 1981. As regards the 1981 plan, the final list of investments should be ready in about 2 weeks time. This will involve something like a 50 per cent cut in investments in Public Administration as originally presented.

Dr. de Sousa explained that the PIDDAC included a broader range of items than would be included in the budget. The main differences were funds for housing channelled via Fondo Fomento Habitaçao, and external credits which are clearly assigned to particular projects. In 1980, for example, only Esc 40.0 billion out of total expenditures of Esc 67.7 billion were shown in the budget. The corresponding figures for 1981 will be Esc 46.0 billion (as against proposals of Esc 79 billion), compared to total expenditures of about Esc 75 billion(?)

The discussion moved to the integration of investment and financing plans. Dr. de Sousa explained that the total capital tranfers figure in the budget is fixed before decisions are made about the allocation of transfers to specific public enterprises. Thus the financing of certain public enterprise investments in terms of the government contribution is not guaranteed.

Dr. F. d'Amaral explained the basis of the financing plan 1981-84 which we had reviewed earlier. The proportion of financing coming from bank credit is estimated by assuming that the 1979 ratio of bank credit to investment is maintained. A similar procedure is followed for external credit. Self financing (including subsidies) is the residual of the exercise. Although this exercise is devoid of any operational content, it may provide a global basis for being tough with the companies by demonstrating the need for self-financing the increase.

A general discussion about investment financing gave rise to the opinion from DCP that the quality as well as the quantity of credit was a serious problem. In particular, there is an insufficiency of long-term credit. As regards external financing, Dr. de Sousa suggested the principle that the self-financing share of total finance should rise as a condition for an increased absolute reliance on external credit.

Dec 4, 80

Receitas Orcamentais

(Milhares de contos)

	1980 Orçamento in vital		1981 Previsão estim.	
Impostos directos				
Contribuição industrial profits tax	20 500	21	25 500	
Imposto profissional wages, salaries	18 500	16.9	23 000	
Imposto de capitais	15 900	15.1	18 700	
Imposto complementar	8 200	9.1	10 000	
Imposto s/ sucessões e doações	800	0.9	1 200	
Sisa	3 500	4.2	5 500	
Outros	2 400		1 400	
Soma	69 800		85 300	
Impostos indirectos				
Direitos de importação	6 200	6.5	8 500	31%
Sobretaxa de importação	4 500	4.8	5 600	17%
Estampilhas fiscais	5 800	5.6	6 900	
Imposto do selo	15 700	16.4	20 300	
Imposto de transacções	52 800	53.6	65 000	
Imposto s/ venda de automóveis	9 500	11.0	12 000	
Imposto deconsumo s/ tabaco	11 100	11.5	15 000	
Outros	8 683	9.7	11 800	
Soma	114 283		145 100	
Taxas, multas e outras penalidades	1 302		1 500	
Rendimentos da propriedade bks, publ. ent.	10 964	10.7	8 500	
Transferências correntes	6 880	3.0	1 900	
Venda de bens duradouros	10	0.6	700	
Venda de serviços e bens não duradouros	1 608		1 800	
Outras receitas correntes	1 120	2.0	800	
Receitas de capital	4 584	6.6	8 700	
Reposições não abatidas aos pagamentos	3 300		3 300	
Total das receitas (sem Contas de Ordem)	213 851	219800	257 600	

Dec 4/78

CONTA GERAL DO ESTADO

Em termos de contabilidade pública

(Milhões de contos)

	1980		Public account basis 1981
	Orçamento	Previsão	Orçamento (a)
RECEITAS CORRENTES	209,3	213,2	248,9
Impostos	184,1	190,9	230,4
Rendimentos da propriedade	11,0	10,7	8,5
Transferências correntes	6,9	3,0	1,9
Outras receitas correntes	4,0	5,3	4,[illegible]
Reposições não abatidas	3,3	3,3	3,3
DESPESAS CORRENTES	263,0	256,0	329,7
Pessoal	93,2	99,0	111,4
Bens e serviços	18,0	16,2	21,4
Juros	38,7	36,9	66,[illegible]
Transferências correntes	84,0	84,9	99,4
Subsídios	11,2	11,1	10,2
Outras despesas correntes	17,9	7,9	20,3
DEFICIT CORRENTE	-53,7	-42,8	-80,8
RECEITAS DECAPITAL	4,6	6,6	8,7
DESPESAS DE CAPITAL	92,1	93,2	105,4
Activos financeiros	19,0	19,0	18,0
Passivos financeiros	13,3	16,2	16,6
Investimentos do Plano	34,7	31,9	31,6
Transferências - Autarquias locais	13,0	18,0	25,9
Outras despesas de capital	7,1	8,1	13,3
DEFICIT TOTAL	-141,2	-129,4	-177,5

(a) Valores provisórios

SECTOR PÚBLICO ADMINISTRATIVO

(em termos de contas nacionais)
(milhões de contos)

mil SS [illegible]

	1979 Estimatíva	1980 Previsão inicial	1980 Previsão revista	1981 Projecções
RECEITAS CORRENTES	264,3	360,0	363,2	425,2
Impostos directos	59,4	84,5	81,5	94,0
Contribuições para a Previdência	64,6	92,9	93,0	113,0
Impostos indirectos	122	161,2	166,7	197,9
Outras receitas	18,3	21,4	22,0	20,3
DESPESAS CORRENTES	302,2	400,5	404,2	490,9
Bens e Serviços	147,6	180,2	185,0	217,3
Subsídios	46,5	59,7	59,7	63,7
Juros da dívida pública	28,5	40,8	39,0	69,2
Transferências correntes	79,6	119,8	120,5	140,7
POUPANÇA CORRENTE	- 37,9	- 40,5	- 41,0	- 65,7
RECEITAS DE CAPITAL	4,2	5,0	6,5	8,6
DESPESAS DE CAPITAL	46,9	59,7	66,4	75,1
Investimentos	36,4	40,3	45,8	57,2
Transferências de capital	10,5	19,4	20,6	17,9
POUPANÇA FINANCEIRA	- 80,6	- 95,2	-100,9	-132,2
Empréstimos concedidos (líquidos)	18	20,4	20,9	17,4
SALDO GLOBAL	- 98,6	-115,6	-121,8	-149,6

cc: SED

1709 EST

440040 FUND UI

ATTENTION : EUROPEAN DEPARTMENT

RECEIVED
I.M.F.

PORTUGAL MISSION AGHEVLI, DHONTE, KOPITS,
ROE, JONES AND MYSELF ASSEMBLED.

1980 NOV 17 AM 7: 44

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REGARDS
TER-MINASSIAN

CABLE
ROOM

Called: Mr. TerMinassian
Mrs. Kopits
Being Called: Mrs. Dhonte

ORIG: EURO
CC: ETR

440040 FUND UI
13314 ALTIS PO

Called IBRD – Mr Roe's sec. who will inform his wife
11/17.

EUR
ETR

ITT World Communications

SPECIAL DELIVERY
CABLE

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: November 17, 1980

TO: Mr. L. A. Whittome, Counsellor, IMF

FROM: Attila Karaosmanoglu, Director, EMENA Country Programs Department 1 AK.

SUBJECT: PORTUGAL

We are pleased to cooperate with you in the analysis of the public investment program in Portugal. In response to your memorandum of November 12, 1980, we would be agreeable in principle to having Mr. Roe participate in your follow-up mission in December or January. During that time he will be preparing a draft economic memorandum at headquarters on domestic resource mobilization in Portugal. Therefore, we hope the mission dates can be arranged in such a way as not to substantially delay the completion of this memorandum which we are hoping to review with the Portuguese in February.

cc: Mrs. Ter-Minassian
Mr. Roe

Office Memorandum

November 10, 1980

MEMORANDUM FOR FILES

Subject: Italy, Portugal, and Greece

I spoke to Mr. Lovato today. The following points were raised:

1. He will seek through informal contacts to find out whether it would be agreeable to Rome for the next Article IV consultation discussions to be held during the middle two weeks of March 1981. He himself personally favored June but I explained the difficulties that this would create for us.

2. He would like to be present during the last days of the discussions in Portugal which would lead to final agreement on a stand-by program. He is aware that such discussions may take place in January. I promised that we would give him as much warning as possible but stressed that at the present time it was quite unclear when agreement could finally be expected.

3. He plans to visit Athens in late 1980 and asked for our help in bringing him up to date nearer the time. I said that we would willingly do this and asked him to get in touch directly with Mr. Tyler or if Mr. Tyler was away with Mr. Mountford.

L.A. Whittome

cc: Mr. Tyler
Mrs. Ter-Minassian

Office Memorandum

NOV 7 1980

TO : The Managing Director
The Deputy Managing Director

DATE: November 7, 1980

FROM : L.A. Whittome /LAW/

SUBJECT : Briefing Paper for the Use of Fund Resources Mission with Portugal

Attached please find for your approval a copy of the briefing paper for the forthcoming Use of Fund Resources mission to Portugal. It has been cleared with the Exchange and Trade Relations (Mr. Mookerjee), Research (Mr. Schwartz), Treasurer's (Mr. Cutler), and Legal (Mrs. Lachman) Departments. Please return the original to the European Department.

cc: Mr. Watson

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

PORTUGAL

Briefing Paper - Use of Fund Resources

Prepared by the European and Exchange and Trade Relations Departments

Approved by L. A. Whittome and S. Mookerjee

November 7, 1980

I. Introduction

At the request of the Portuguese authorities a staff team consisting of T. Ter-Minassian (EUR), B. Aghevli (ETR), P. Dhonte (ETR), G. Kopits (EUR), and, as secretary, I. Jones (EUR) will visit Lisbon from November 16 to 25 for informal discussions on a possible EFF arrangement. Mr. A. Roe of the IBRD will join the staff team.

The political outlook in Portugal has been considerably clarified by the outcome of the October 5 parliamentary elections, which substantially strengthened the ruling center-right coalition of Prime Minister Sa Carneiro. Some degree of uncertainty, however, remains concerning the Presidential elections scheduled in December. If President Eanes is reelected and Mr. Sa Carneiro maintains his announced determination not to serve under him, there could be another period of political unrest which, among other things, would probably prevent progress in the presentation and implementation of the medium-term economic program currently being prepared. Given the political background, it is very unlikely that a formal agreement on a program to be supported by an EFF arrangement would be reached before at least January or February of next year.

However, as work is proceding at the technical level on the definition of a medium-term economic strategy, the Portuguese authorities have found it useful to request another round of discussions with the staff on both the medium-term program and more specifically the policy strategy for 1981. The staff sees merits in this dialogue which allows it to provide a significant input in the formulation of the program.

If sufficient progress is made during the discussions, the mission may leave with the Portuguese authorities a preliminary draft letter of intent indicating the main lines of the policy program as outlined below that could form the basis of an EFF arrangement in the future.

Fund holdings of Portuguese escudos (exclusive of purchases under the oil and compensatory financing facilities) amounted on October 31, 1980 to 92.3 per cent of Portugal's present quota of SDR 172 million. The proposed quota under the Seventh review (to which Portugual has consented) amounts to SDR 258 million. The staff has indicated to the Portuguese authorities that the combined amounts available to Portugal under the EFF and SFF could reach SDR 1,032 million (600 per cent of the present quota) over three years, if warranted by the program.

II. Background

The economic performance of Portugal in 1980 has been significantly better than expected. Activity has remained relatively sustained, on the strength of a continued good performance of exports (projected to increase by at least 10 per cent in volume) and of a recovery of investment, especially in construction and stocks but, more recently, also in plant and equipment. GDP is likely to rise by 4 per cent this year, about the same rate as in 1979. The rate of inflation has declined sharply and is projected at around 17-18 per cent for the year as a whole, compared with over 24 per cent in 1979. The deceleration is partly a reflection of delays in the passing on of the full increase in oil prices to final users and in adjusting some administered prices (notably those of public transport) in line with cost increases. It also reflects the favorable impact of a 6 per cent revaluation of the escudo in February and of the decision to reduce the monthly rate of effective depreciation from 0.75 per cent to 0.5 per cent in July. There is little doubt, however, that the authorities have been remarkably successful in reducing inflationary expectations, as evidenced also by a favorable trend in recent wage settlements.

The external position has worsened significantly as a result of an estimated 10 percentage points deterioration in the terms of trade, and the current account has shifted from near equilibrium in 1979 to a projected deficit equivalent to around US$700 million (3 per cent of GDP) in 1980. The non-oil current balance, however, has continued to improve substantially reflecting the strong performance of exports, receipts from tourism and especially workers' remittances. An outflow of short-term capital in the early months of the year, mainly reflecting a worsening of interest rate differentials was subsequently reversed as foreign interest rates declined. The overall balance may show a small surplus for the year as a whole. Foreign exchange reserves at the end of August stood at US$847 million, equivalent to about five weeks' of imports. Gold reserves amount to over 22 million ounces.

The authorities have also achieved a significant success in containing the seemingly endless escalation of the public sector deficit. A determined attack on tax evasion has allowed a substantial increase in revenue and the growth of public consumption has been curbed. The Government has attempted to promote efficiency in the public enterprises by freezing subsidies.

However, the failure to promptly and adequately adjust many administered prices has contributed to a further deterioration in the financial position of the major public enterprises, forcing them to resort increasingly to domestic and especially foreign financing.

The rapid expansion of liquidity continues to be a source of concern. Broad money (M2) increased by about 35 per cent during the 12 months to August 1980, reflecting mainly the rapid expansion of domestic credit. Recently, the increase in liquidity has been mainly reflected in higher real balances, as the rate of increase in prices has slowed down. The continuation of recent trends in liquidity expansion, however, would eventually lead to a resurgence of inflationary pressures and a deterioration in the external position. It is therefore important that the increase in supply of liquidity be brought in line with the increase in demand arising from targeted increases in prices and income. In addition, a flexible interest rate policy should continue to be pursued, in order to maintain a positive real rate.

III. Work of the Mission

During the first round of informal discussions in September of this year, there was broad agreement between the Portuguese authorities and the staff team on the main lines of a medium-term economic policy strategy for Portugal. It was recognized that the successful stabilization effort of the past two years had created the conditions for resumption of a higher growth rate but that, for this to be sustainable over the medium term, the productive capacity of the country needed to be substantially enlarged and strengthened through a wide ranging public and private investment effort. To this end, the authorities have streamlined and improved incentives to private investment, especially in export-oriented sectors. In addition, they have been preparing in collaboration with the IBRD a four-year (1981-84) public investment plan, which is expected to be officially presented at the end of this year. The mission will discuss with the authorities the content of this plan. In this respect, the participation of a staff member of the IBRD is especially welcome. The mission will also discuss the recent and prospective impact of the investment incentive scheme, as well as other possible ways to promote a lasting recovery of private investment.

The investment effort will need to be supported by an increased resort to external and domestic savings. A moderate increase in the current balance of payments deficit over the next few years would not appear inappropriate, especially in the current international environment characterized by a large OPEC surplus, and in the light of Portugal's relatively comfortable reserve position, debt service burden (estimated at less than 17 per cent of foreign exchange earnings) and standing in international capital markets. It is, however, important that the recourse to external financing be carefully managed so as to ensure the stabilization of the debt service burden in the medium term, at a level which shelters the country from the consequences of sudden changes in the international environment and/or of shortfalls in foreign exchange receipts. The mission will discuss with the authorities the policies with respect to external debt and the steps required to improve its control, as well as possible ways to increase the flow of foreign investment capital to Portugal. It will stress the importance of promoting a sustained growth in the debt servicing capacity of the country, primarily through the continuation of flexible exchange rate policy, aimed at preventing any substantial deterioration in the present competitive position.

A substantial contribution to the financing of the investment effort will need to be made by a reduction in dissaving of the public sector. Progress in this area is likely to be gradual because of rigidities in some items of expenditure (for example, interest payments on the public debt) and the difficulty of increasing efficiency in tax administration. The mission will discuss with the authorities the steps contemplated to reform and streamline the tax system, adapt it to the requirement of the forthcoming EC membership, and to make further progress in reducing evasion. It will also discuss the measures envisaged to strengthen control over expenditure, especially of the local authorities and autonomous funds, and to improve productivity in the public sector and in the public enterprises. The staff will stress that, to ensure a lasting improvement in the financial position of the latter, future increases in costs of imported inputs and in labor costs not in excess of government guidelines must be fully and promptly passed on to prices. Moreover, an adequate adjustment in some administered prices must be made in the near future, to reflect cost increases that took place in 1980.

The mission will review the 1981 budget, currently in preparation, in the light of the medium-term fiscal objectives, and discuss with the authorities the implications of its financing for the development of financial aggregates. In this respect, it will point to the worrisome buildup of liquidity in the economy and discuss possible ways of absorbing it, through, for example, the issuance of shorter-term government debt instruments carrying attractive interest rates. It will stress the importance of maintaining, in the near as well as in the medium term, an adequate level of real interest rates and of avoiding the reappearance of adverse differentials with interest interest rates prevailing abroad.

The staff shares the Portuguese authorities' view that a continued deceleration of inflation toward the average EC level should be an important medium-term objective. Further progress in this respect is likely to be hampered in the near term by the need to make sizable adjustments in some administered prices. But, barring external shocks, a further decline in the rate of inflation should be possible over the longer run, provided a continued moderation is secured in the growth of wages, and the rate of expansion of monetary aggregates decelerates significantly. The mission will stress the importance of maintaining indicative wage guidelines that allow for a moderate growth of real labor incomes, not in excess of anticipated productivity gains, and of backing these guidelines with appropriate policies with respect to public sector wages. It will also underline that financial policies should be consistent with the targeted deceleration of inflation.

Fund Relations with Portugal

(As of end-October 1981)

Quota:	SDR 172 million
Fund's holdings of currency:	SDR 263.4 million or 153.1 per cent of quota, including holdings under the compensatory financing facility amounting to SDR 37.5 million (21.8 per cent of quota), and under the oil facility amounting to SDR 67.2 million (39.0 per cent of quota)
Holdings of SDRs:	SDR 9.1 million or 25.5 per cent of net cumulative allocation
Distribution of profits from gold sales:	US$18.6 million
Gold distribution:	100,131.991 ounces

cc: Mr. Whittome

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

November 3, 1980

Dear Professor Taylor:

Professor Bela Balassa suggested that I send you the attached draft paper on Economic Stabilization and Growth in Portugal. Please note that it is a draft still. It was approved as such by the Portuguese authorities as the basis for a talk I am to give at Princeton later this week. We are waiting for more extensive comments they have promised to give. I hope it will be of some use to you.

Sincerely,

Hans Schmitt

Hans Schmitt
Senior Advisor
European Department

Attachment

Professor Lance Taylor
Department of Economics
Massachusetts Institute of Technology
Cambridge, Massachusetts 02139

cc. Mr. Whittome

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

November 3, 1980

Dear Professor Lundberg:

Dr. Silva Lopes asked me to send you a copy of a draft paper on Economic Stabilization and Growth in Portugal. Please note that it is a draft. It was approved as such by the Portuguese authorities as a basis for a talk I am to give at Princeton later this week pending more detailed comments which they intend to give us soon. I hope it may be of some use to you.

Sincerely yours,

Hans Schmitt

Hans Schmitt
Senior Advisor
European Department

Attachment

Professor Erik Lundberg
Skandinaviska Enskilde Banken
Box 16067
S-10322 Stockholm 16
Sweden

Office Memorandum

Mr. Whittome

TO : Mr. Mohammed

DATE: October 31, 1980

FROM : Hans Schmitt HS

SUBJECT : Balassa

You may be interested in the attached note by Bela Balassa concerning my paper on the Portuguese stabilization program.

Attachment

cc: Mr. Whittome

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Hans Schmitt, IMF

DATE: October 28, 1980

FROM: Bela Balassa, DRC

SUBJECT: Paper on Portugal

1. Your paper makes an important contribution in indicating the combined effects of adopting realistic exchange rates and interest rates in the framework of a stabilization program. I am impressed by the continued rapid growth of exports that confirm my belief in the high elasticity of export supply in Portugal. You should send a copy to Lance Taylor who just the other day expressed the view that devaluation had little to do with the improvement of the Portuguese balance of payments.

2. I enclose a paper that examines policy responses to external shocks in newly industrializing countries. The method utilized in the paper will further be applied to twelve less developed countries.

Enclosure
BBalassa:nc

EUR

cc: SEC

Office Memorandum

TO : Mr. Dini

DATE: October 30, 1980

FROM : Rasheed O. Khalid

SUBJECT : Portugal: Technical Assistance on Value-Added Taxation

At the request of the Portuguese Ministry of Finance, Mr. Alan A. Tait (Assistant Director, Fiscal Analysis Division) and Mr. Thanos Catsambas (Economist, Fiscal Analysis Division) will visit Portugal November 27-December 12, 1980. They are to work with the Committee on Value-Added Taxation and with economists in the Ministry of Finance to calculate the VAT tax base, alternative structure of the tax, different adjustments in other taxes, and possible VAT rates. Some estimates are to be made of possible distributional impacts. A Board paper will be issued shortly.

If you wish further information on this, Mr. Tait will be happy to discuss the matter with you.

cc: EUR
SEC
Mr. Tait
Mr. Catsambas

Mr. Whittome

October 14, 1980

MEMORANDUM FOR FILES

Subject: Portugal--Timing of November Visit

I spoke to Dr. Cavaco e Silva about the timing of the next mission to Lisbon. He said that he still regarded a visit in November as desirable, had spoken about it to some Cabinet members (I assume this included the Prime Minister), but wished to have it discussed by the full Cabinet sometime this week. He promised to call me early next week to let us know the result of the discussion. I said that we would be keen to go next month in order to discuss policies while they were being formulated. He agreed that our visit, especially if combined with that of the World Bank, would put pressure on taking some important policy decisions in the near future. I also alerted him to the fact that I needed to be in Madrid by November 26. He seemed to think that this would not pose a problem as the visit, if it were to take place, could well start around the middle of the month.

T. Ter-Minassian T.T.M.

cc: Mr. Whittome
Mr. Dhonte
Mr. Kopits
Mr. Aghevli

Mr. Whittome

October 6, 1980

MEMORANDUM FOR FILES

Subject: Portugal - Meeting with Delegation

On October 1, Mr. Whittome and I met with Messrs. Cavaco e Silva, Minister of Finance of Portugal, Nuñes, Governor of the Bank of Portugal, Vilar, Deputy Governor, and Saldanha do Valle, head of the International Relations Department.

Mr. Whittome began by saying that, on the basis of the report received on the last staff visit to Lisbon, it appeared that there was general agreement between the Portuguese authorities and the staff on the broad lines of a medium-term policy program that could be supported by the Fund through the EFF and SFF. It would be helpful if a new round of informal discussions could take place in November, to agree to the details of the program, both with respect to the public investment program and the supporting financial and other economic policies. The final and formal agreement could be reached at the beginning of next year, after the Government had presented the program to Parliament. The Minister emphasized that it was important that the program should be seen as the Government's own and Mr. Whittome agreed that this was also necessary to ensure commitment by the authorities to it.

On the size of the support, Mr. Whittome indicated that the staff would see no objection to going to 200 per cent of quota per year (based on the present quota). If this amount (SDR 344 million a year) did not need to be fully utilized, it could be saved for later use. In fact, although the arrangement would initially have to cover three years, it could later be extended if it appeared appropriate. In response to a question on the availability of SFF funds beyond the beginning of 1981, Mr. Whittome indicated that if an agreement in principle was reached in November, the staff would be prepared to recommend to Management an informal commitment to provide the stipulated amount, through the Fund's own or borrowed resources, even if the SFF fund were exhausted by the time the arrangement was approved by the Board.

On the question of charges, Mr. Whittome indicated that, because of its level of per capita income, Portugal could not qualify for an interest subsidy. The level of charges would depend on the proportion of own resources to borrowed funds used to finance the arrangement. This was a somewhat open question at present as it was unclear when the new quotas would come into effect (because of delays in approval by the U.S. Congress) and how the addition to resources it provided would be allocated among facilities. In any case due attention would be paid to uniformity of treatment of countries in this respect.

The Minister inquired about the type of conditionality that would be attached to an EFF arrangement. Mr. Whittome indicated that the program would need to contain an indication of the main policy objectives for the three-year period, with more specific targets for the first year. Annual reviews would set targets for subsequent years. On performance clauses, he said that they provided a needed trigger for consultation, should events differ from the projected path. The staff was of course prepared to review and adjust them if such deviations appeared due to causes beyond the authorities' control.

In conclusion, the Minister indicated that, if political circumstances allowed it, he would be prepared to call for another round of discussions sometime in November.

T. Ter-Minassian T.T-M.

cc: Mr. Whittome
Mr. Schmitt
Mr. Dhonte
Mr. Kopits
Mr. Mitra

SED

Annual Meeting 1980

Country: Portugal

Delegate: Mr. Emilio Rui Vilar, Director, International Relations Department, Central Bank of Portugal

Bureau: Messrs. Nose, Bouter, Muirragui, Ortiz and Sundgren

Date: September 30, 1980

With respect to the Bureau's proposal for a Balance of Payments visit, the delegate indicated that the Bank of Portugal would be pleased to receive a visit, preferably before February 1981 when the work on the Annual Report begins. Some delays in the receipt of data for deposit money banks were brought to the delegate's attention and he promised to take up this matter with the Research Department of the Bank. He will also try to find out how the Research Department and the National Statistical Institute have reacted to Mr. Sundgren's recommendations in his recent report on general statistics.

A GFS visit to the Ministry of Finance of Portugal will take place in October. It would be useful from the Bureau's point of view if the visiting staff member could also be given the opportunity to meet the Bank of Portugal staff working on government finance statistics. The delegate agreed to such a visit.

Finally, the issue was raised of turning the *Quarterly Bulletin* into a monthly one. The delegate responded that due to printing problems, the Bank is not yet prepared to take this step.

EUR
cc. SED
Hotel

September 30, 1980

MEMORANDUM TO FILES

Subject: Meeting with Sr. Anibal Cavaco Silva, Minister of Finance, Portugal

I met the Minister for about 15 minutes this morning. He emphasized at once that the FAD technical assistance on VAT was to proceed. He said he had written a letter to the Chairman of the VAT committee Sr. de Basto confirming that the program outlined in my letters of August to the Minister and Sr. de Basto would be followed. The Minister had informed the EEC Commission of the FAD technical assistance on VAT.

The Minister said the technical assistance on VAT would proceed as planned no matter what was the outcome of the October 5 general election; apparently the VAT is now seen as part of Department of Finance policy and it is extremely unlikely that any Minister would stop the work on this tax.

It seems, therefore, that we should plan for a mission in November to assist the Portuguese economists in their work on the tax base, tax rates, and the effects of alternative tax packages on revenue and distribution. A tax administration mission should be planned for the first quarter of 1981--probably in March. I will write to Sr. de Basto mentioning my meeting with the Minister and seeking to establish a firm date for the first mission.

AT

Alan A. Tait
Assistant Director

cc: European Department

PORTUGAL

Special Brief for the Managing Director's
Meeting with the Portuguese Delegation

Political background: The present center-right coalition, in government since January, faces new parliamentary elections in October. Presidential elections are to be held in December 1980. The Minister of Finance, Dr. Cavaco e Silva, was previously Director of the Research Department of the Bank of Portugal. He has indicated interest in negotiating a three-year extended arrangement with the Fund, if returned to power, after the completion of the electoral cycle. Dr. Nuñes is the Governor of the Bank of Portugal and for the Fund.

Economic developments and prospects: A successful stabilization effort in 1978-79 has allowed Portugal to improve substantially its external position, while maintaining a growth rate well in excess of 3 per cent in both years. For 1980 growth may reach 4 per cent. The current deficit is projected to rise to US$600-700 million (2.5-3 per cent of GDP), reflecting a sharply higher oil bill. The non-oil balance is likely to continue to improve in 1980. Inflation is projected to decline to about 18 per cent from 24 per cent in 1979, partly reflecting inadequate adjustments in some administered prices.

Main issues: Especially in view of its accession to the EC, currently targeted for 1983, Portugal needs to step up substantially its public and private investment effort, especially in export-oriented sectors. The authorities have been collaborating with the IBRD in designing a four-year public investment plan, scheduled to be presented in January of next year. The investment effort will need to be supported by a substantial increase in domestic savings, especially through a reduction of the current deficit of the public sector. A staff team, which visited Lisbon in September, indicated that, if the medium-term program warrants it, financial support from the Fund through the EFF and SFF could reach over SDR 1 billion (600 per cent of quota) for three years.

September 1980

Brief for the Thirty-Fifth Annual Meeting

Exchange rate: Since August 1977 Portugal has used a crawling peg system of exchange rate adjustments to compensate for the difference between domestic and international price developments. After a step adjustment of 6.1 per cent in May 1978, the authorities announced that the escudo would be allowed to depreciate at a monthly rate of 1.25 per cent in effective terms. During 1978 the rate fell by 20 per cent in effective terms. The monthly rate of depreciation was reduced to 1 per cent from April 1979 and to 0.75 per cent from July 1979. In February 1980 a one-step revaluation of 6 per cent took place as the authorities believed that Portuguese exports continued to be highly competitive in international markets and as an anti-inflationary measure, but the monthly downward crawl of 0.75 per cent was continued until June 1980 when it was reduced to 0.5 per cent. If this policy is maintained until the end of the year the escudo will depreciate by about 3 per cent in effective terms in 1980.

Quota: SDR 172 million, to rise to SDR 258 million under the Seventh General Review. Portugal has consented to the increase.

Fund position: Fund holdings of escudos amounted to 94.7 per cent of quota at end-August 1980 excluding purchases under the oil and compensatory financing facilities. The present Portuguese Government has expressed an interest in negotiating a three-year extended Fund arrangement and a mission is due to engage in preliminary discussions in September. These may be followed by further negotiations following Parliamentary elections in October.

Last consultation discussions: April 1980.

Political developments: Portugal is governed at present by a center-right coalition that enjoys a clear majority in Parliament. A general election is due on October 5, 1980, and in December 1980 a presidential election is to take place. In recent years Portugal has suffered from a series of unstable governments, but it is hoped that a clear majority for either of the two main party groupings in the October election would lead to the completion of the next Parliament's normal term of four years.

Personalities: Mr. Anibal Antonio Cavaco Silva, the present Minister of Finance and Planning, belongs to the Social Democrat party. He has long experience of negotiating with the Fund from his earlier position as head of the Bank of Portugal's Research Department, and enjoys substantial influence in the present Government. Mr. Jacinto Nunes, the Governor of the Bank of Portugal and Governor for the Fund, is experienced in the management of the economy and, as Minister of Finance, negotiated with the Fund in 1979. Mr. Rui Vilar, Deputy Governor of the Bank of Portugal and Alternate Governor for the Fund, carries responsibilities in the Bank for external and domestic credit operations and is linked to the opposition Socialist Party.

Balance of payments and reserves: In 1978 the deficit on the current account fell to US$800 million (4 1/2 per cent of GDP) from US$1.5 billion in 1977 (9 per cent of GDP) largely as a result of a stabilization program supported by a stand-by arrangement that included the establishment of realistic interest and exchange rate policies. The improvement in the current account continued in 1979 when a small surplus of US$150 million was achieved and the authorities felt able to moderate the monthly rate of depreciation. The adverse swing in the terms of trade and a revival of domestic demand is expected to reverse this process and a deficit of US$700 million is projected for 1980, which will be largely financed by recourse to borrowing from the Eurodollar market. The deficit for 1981 is presently expected to reach US$1 billion. Excluding gold holdings of 22.2 million fine ounces, reserves amounted to SDR 336 million at the end of June. Valued at current gold prices, gold reserves amount to nearly SDR 10 billion.

Exchange and trade restrictions: A 60 per cent surcharge affects 2 per cent of imports and a 10 per cent surcharge applies to nearly one third of imports. Restrictions existing at the time of the last Annual Meeting on the outward remittances of profits and dividends have been removed.

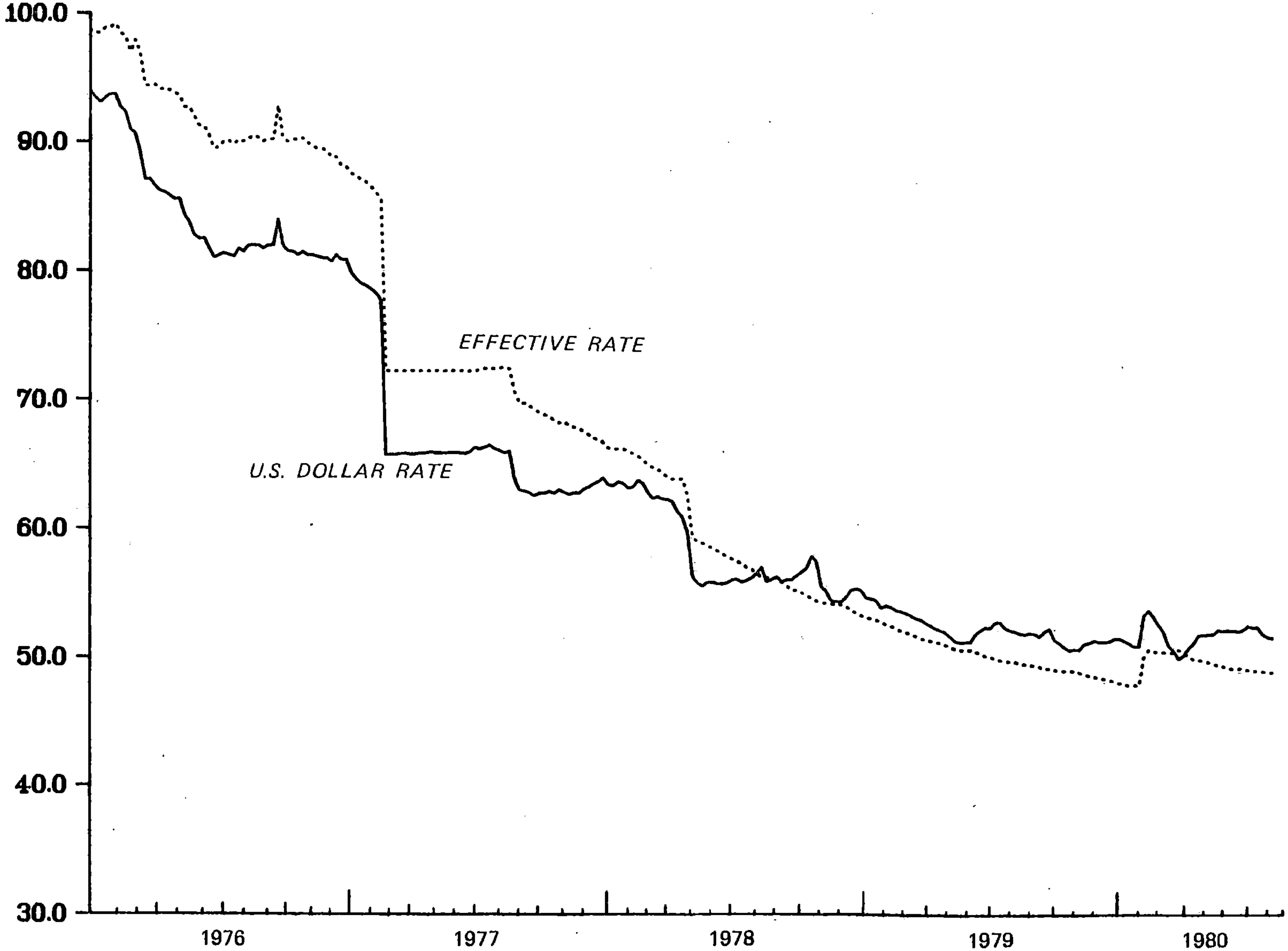
Domestic developments: In 1979 GDP grew by 3.7 per cent largely on the strength of a very favorable export performance; domestic demand showed little change. GDP is projected to grow at a similar pace in 1980--above the OECD average--but the entire contribution is likely to be provided by domestic demand. The rate of inflation is forecast to decelerate to 19 per cent from 24.6 per cent in 1979, but this improvement partly reflects intensified price control in the public sector and a reduced rate of depreciation. The expansion of credit has proceeded at a very brisk pace so far this year, mainly reflecting higher credit requirements of the public sector (including the public enterprises). This development, in conjunction with the implementation of overdue pricing measures in the public sector, is likely to lead to a faster increase in the general price level in 1981, but the overall rate of economic growth is projected to show little change from this year.

September 1980

PORTUGAL

INDICES OF U.S. DOLLAR RATE AND TRADE WEIGHTED EFFECTIVE EXCHANGE RATE

(INDEX 1975 = 100, WEEKLY DATA)



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OFFICIAL MESSAGE
INTERNATIONAL MONETARY FUND
Washington, D.C. 20431

23 PM 6 18
TIME RECEIVED

ADDRESS

Dr. Manuel Nunes
Governor
Bank of Portugal
Lisbon, Portugal

Special Instructions

I would appreciate a chance of meeting with you during the Annual Meeting. I have suggested to the Minister that we meet at 10.30 a.m. on Wednesday, October 1. Will you be present or shall we arrange to meet separately.

Regards

Whittome

Distribution

MESSAGE MUST END HERE

Drafted by: LAWhittome
Department: European
Date: September 23, 1980

L.A. Whittome — NAME (TYPE) — SIGNATURE: [signature]

NAME (TYPE) — SIGNATURE

FOR CABLE ROOM USE ONLY

No. of words: 41wds Log: 557353 Route: WUI Operator: PD

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OFFICIAL MESSAGE

INTERNATIONAL MONETARY FUND

Washington, D.C. 20431

SEP 23 ... 6 10

TIME RECEIVED

ADDRESS

Dr. Cavaco Silva

Minister of Finance

Ministry of Finance

Lisbon, Portugal

Special Instructions

If it is convenient to you I would like to arrange a meeting with you on Wednesday, October 1 at 10.30 a.m. in the Sheraton Park Hotel in either your office or mine.

Regards

Whittome

Distribution

MESSAGE MUST END HERE

Drafted by: ~~LAWhittome~~

Department: ~~European~~

Date: ~~September 23, 1980~~

~~L.A. Whittome~~

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Front Office

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: September 23, 1980

FROM : T. Ter-Minassian T.T-M.

SUBJECT : Portugal - 48-Hour Report

At the request of the Minister of Finance a staff team visited Lisbon from September 14 to 20. The mission was officially billed as an informal visit to review recent economic developments and prospects, as the Government, which faces parliamentary elections on October 5, followed by presidential elections at the beginning of December, was concerned about a possible political fallout from a public display of renewed interest in financial assistance from the Fund. But, in private meetings, both the Minister of Finance and the Governor of the Bank of Portugal, Dr. Nunes, made it clear that the Government, if returned in the elections, would be interested in seeking the support of the Fund for a substantial medium-term development effort, centered on public and private investment aimed at increasing and modernizing the productive capacity of the country in preparation for entry into the EC, currently targeted for 1983.

The short-term outlook appears in many respects better than was anticipated at the time of the last Article VIII consultation in May. The pace of activity seems to have only slightly moderated; there is evidence that private investment, especially in construction, has recovered strongly from the low level of the past few years. This recovery is expected to continue and indeed accelerate next year, assuming favorable political conditions. Capacity limits are being approached in several sectors and profits have increased strongly, especially in export-oriented firms. The Government has also introduced a comprehensive scheme of fiscal and financial incentives. Inflation, a major target of the government effort this year, has decelerated sharply from 24 per cent to about 18 per cent. While this development is partly a reflection of the revaluation of the escudo in February the reduction of the rate of monthly depreciation of the escudo in June, and the failure to make adequate adjustments in some administered prices, it is also attributable to the moderation of labor costs and to a clear decline in inflationary expectations. The current deficit of the balance of payments is also likely to turn out lower than expected (at about US$600-700 million, 2.5-3 per cent of GDP) mainly as a result of a continued strong performance of exports, tourism, and workers' remittances. A reversal of the deteriorating trend in interest differentials and some tightening of credit policy have also caused a reflow of capital, and foreign exchange reserves, which had declined to less than US$500 million in the second quarter, are now back to about US$900 million (six weeks of imports).

The efforts of the Government to reduce tax evasion and contain the growth of public consumption and subsidies seem to have been rather successful and the outturn for the central government deficit is currently expected to be broadly in line with initial budgetary projections. But the finances of the local authorities, of some autonomous funds and, above all, of the public enterprises remain a source of serious concern. Another worrisome aspect of the present situation is the continuing rapid growth of liquidity in the economy, fueled by a high (albeit decelerating) growth of credit and a stronger than expected growth of foreign exchange receipts.

The mission also discussed medium-term policy intentions. There was agreement that the investment effort needed to be substantially stepped up. A four-year (1981-84) program of investment for the public sector, including the public enterprises, is currently being prepared, and the authorities seem to be generally in agreement with the IBRD recommendations on priorities for public investment, with possibly the exception of one or two important projects. The program, which is to be included in a broader medium-term framework, is scheduled to be presented to Parliament at the beginning of next year.

The staff team emphasized the need to make as fast progress as possible in setting up a number of structural policies aimed at increasing the contribution of domestic savings to the financing of the investment effort, particularly by reducing the current deficit of the public sector. It also stressed the importance of carefully programming and monitoring resort to external financing, to prevent the debt service burden from becoming excessive in the future. I told both the Minister and the Governor that, if a strong and credible program could be negotiated under the EFF, supplemented by the SFF, the financial assistance available to Portugal might reach 600 per cent of quota (or SDR 1,032 million) over three years. We would not envisage any significant front loading. The Minister indicated the intention, if returned to power after the Parliamentary elections, to request another informal staff visit possibly in November to negotiate in more specific terms the content of a possible EFF program. He thought that a final agreement could not be reached before the beginning of 1981, namely until after the presidential elections.

cc: Mr. Habemeier
Mr. Hood
Mr. Whittome
Mr. Finch
Mr. Mohammed
Mr. Nicoletopoulos
Mr. Van Houtven
Mr. Watson

Mr. Whittome

CONFIDENTIAL

September 19, 1980

MEMORANDUM FOR FILES

Portugal--Meeting with Minister Cavaco Silva

On Thursday, September 18, I met with the Minister of Finance, Dr. Cavaco Silva, to whom I had previously forwarded the attached aide mémoire. The Minister indicated that he was in broad agreement with the staff team's views on a desirable medium-term policy strategy for Portugal and hoped that agreement could be reached in the near future on an EFF program, supplemented by the SFF, as soon as the present political uncertainties had disappeared. He expressed some concern that the existence of credit ceilings with only an annual review clause could result in excessive rigidity of the program, should unforeseen circumstances develop. I explained that the main purpose of performance clauses was to trigger consultation with the Fund, in the event that some key variables (such as domestic credit expansion) were getting off-track. The staff, however, was always prepared to examine with the authorities the reasons for the divergence of these variables from the targets and to either adjust the ceilings, if this appeared appropriate, or to discuss the scope for corrective action. The Minister seemed reassured by these indications of flexibility.

On the question of the size of possible Fund assistance, I said that, in the light of the desire of Management and the Board to expand the role of the Fund in the recycling process in the near future, I had received indications that, if the medium-term program was a strong and credible one, Management might be prepared to support financing up to 600 per cent of Portugal's present quota of SDR 172 million over three years, which at present exchange rates would be equivalent to nearly US$450 million a year. I stressed, however, that on present policies, most of these funds would have to come from the SFF and that tentative staff projections suggested that the latter would be fully committed by end-1980 or beginning 1981. The Minister appeared obviously pleased to learn that the potential size of assistance was larger than expected and said that he hoped that, after another more specific round of discussions, possibly in November, we would be in a position to indicate to Management that an ageement could be reached shortly after the Presidential elections. He also volunteered to set up a meeting with the Secretary of State for Planning before our departure, so that we could have more details on the expected content and timetable of the investment plan.

The conversation then touched on various aspects of the current situation and on short-run policies. I indicated that we were favorably surprised by recent developments, particularly on the external and fiscal fronts. However, I saw a continued danger in the relentless buildup of liquidity in the economy. This underscored the need to keep credit ceilings tight and real interest rates unchanged. He said that excesses in bank credit were being gradually but firmly reduced, despite complaints by the banks about the effects of such a policy on their profit position. As for interest rate policy, he had resisted calls for reductions in their nominal level, despite the deceleration of inflation. However, he did not exclude at some point in the future a small downward adjustment (of maximum 2 percentage points) in the short end of the spectrum of deposit rates, coupled with stiffer penalties on early withdrawals for longer-term deposits, to create an incentive to reduce the degree of liquidity of financial assets in the hands of the public. He was also hopeful that the newly created one-year bonds with 18 per cent tax free interest rate would provide the public with an attractive alternative to the holding of more liquid assets. I replied that I favored flexibility in interest rate policy, as long as it was feasible in both directions and warned him against taking steps which might prove difficult to reverse, at least until trends in international interest rates became clearer. But I agreed that it would be desirable to improve the existing term structure of interest rates.

On exchange rate policy, he agreed that maintenance of a competitive exchange rate was important, especially in view of prospective EC entry. He thought that the most relevant indicator of competitiveness in Portugal were movements in relative unit labor costs, and indicated that, as long as substantial differences existed between changes in ULC in Portugal and abroad, it would be necessary to maintain the crawling peg system, although he hoped that the rate of depreciation could be gradually reduced as the differential narrowed.

On the public finances (a subject we had discussed in more detail in the previous meeting), he reiterated the view that a marked strengthening of the mechanisms of expenditure control (especially for the autonoumous funds and services and for the public enterprises) was essential, and expressed the hope that the next government would be in a position to move decisively in that direction.

On his personal position, he said he was somewhat tired of the many pressures of the job and suggested that Dr. Constancio would probably make a good next finance minister, if the PS won the election. But my impression was that, if the AD was returned to power, he would agree to serve again. Incidentally, this had been confirmed by Governor Nunes in an earlier conversation.

T. Ter-Minassian

T. Ter-Minassian

cc: Mr. Whittome
Mr. Schmitt
Mr. Dhonte
Mr. Kopits
Mr. Mitra

CONFIDENTIAL

September 19, 1980

MEMORANDUM FOR FILES

Portugal--Meeting With Governor Nunes

On Friday, September 19, I met with the Governor of the Bank of Portugal, Dr. Nunes, to whom the previous day I had given a copy of the aide mémoire for the Minister. The Governor was obviously pleased with the tone and content of the document and said that he shared our views on the main points, in particular on the expectation of a deceleration in the growth of workers' remittances, on the need to carefully program and control foreign debt and to check the growth of public dissaving. I said that we were concerned about the apparent lack of detailed knowledge about the present foreign debt position of most public and private enterprises, and that we saw rapid progress in the area, as well as the setting up of better mechanisms of control of future indebtedness as essential conditions for an appropriate policy of debt management in the next few years. We then discussed the management of foreign exchange reserves and of the Bank of Portugal debt. He said that the position had become worrisome in the second quarter of this year, when reserves had declined to around US$350 million, but that in recent months they had risen rapidly, reflecting a strong performance of tourism, workers' remittances and especially a reflow of capital, as the deteriorating trend in the interest rate differential during the first few months had been reversed. Foreign exchange reserves had also been boosted by the drawing of the Treasury loan and stood at about US$900 million at present. This level was regarded as very comfortable and in fact had given rise to pressures on the Bank to relax somewhat credit policy by revising upwards the September ceilings.

I replied that, while I could understand that the ceilings were probably tight in the light of the strength of activity and the recovery of investment, I thought that credit policy should remain cautious, as the seasonally favorable period for the current account was coming to an end and liquidity had been building up in the economy at an unsustainably high rate. It appeared that a high priority should be attached to finding ways of absorbing such liquidity, in particular by lengthening the maturity of financial assets in the hands of the public, for which a beginning had been made by the proposed issue of short-term Treasury bonds. It seemed also important to maintain the general level of interest rates relatively high in real terms. Dr. Nunes agreed and said that steps were being taken to improve the structure of interest rates.

On prospects for an agreement with the Fund, the Governor seemed hopeful that relatively rapid progress could be made once the political situation had been clarified. I stressed that, while we were in broad agreement with the Government's objectives of increasing investment and reducing the rate of inflation, a much more detailed discussion of the specific policy intentions of the Government and of the expected timetable for their implementation would be necessary before agreement could be reached. Therefore, I saw merits in resuming informal talks as soon as it was politically feasible after the parliamentary elections. I also indicated that if the program was a strong and credible one, the amount of financial assistance could be larger than indicated in the aide mémoire which we left behind last May.

T. Ter-Minassian

T. Ter-Minassian

Lynne,
May I have this the day when we meet with the Portuguese during the Annual Meeting

Aide Mémoire

The stabilization effort undertaken in the late seventies has created the conditions for resumption of a sustained growth of the Portuguese economy, consistent with external stability and a deceleration of inflation. The growth rate, led by a strong export performance, neared 4 per cent in 1979 and will probably do so again in 1980. The deficit that has reemerged in the current account this year is mainly a reflection of the higher oil bill.

If, however, growth is to continue and possibly accelerate, without leading to a reemergence of external constraints and to renewed inflationary pressures, the productive capacity of the country must be substantially enlarged over the next few years. In addition, the forthcoming membership in the EC is bound to pose serious challenges to both the industrial and agricultural sectors in Portugal. Such challenges can only be met through a wide-ranging restructuring process which is likely to require a substantial stepping up of investment through a careful choice of projects. We note that the Portuguese authorities attach a high priority to the definition of a policy strategy directed to promote public and private investment in priority areas, and hope that the technical groundwork currently in progress, also in collaboration with the IBRD, will be followed by the formulation of a comprehensive medium-term investment plan as soon as the political circumstances allow it. We agree with the thrust of the IBRD recommendation that the investment strategy should be primarily export-oriented, with a selective effort towards import substitution in specific areas such as agriculture and energy. In view of the seriousness of the unemployment situation, priority should be given to investment in relatively labor-intensive industries.

A substantial stepping up of the investment effort will require a corresponding increase in savings to finance it. One important source of savings has historically been represented by emigrants' remittances. While it is important to maintain the attractiveness of escudo assets for Portuguese workers abroad, through appropriate interest rate and other policies, the contribution of remittances to the financing of the investment effort (as per cent of GDP) can at best be expected to stabilize at its current level and may indeed be gradually declining over the medium term.

An increased resort to external financing (or to put it another way, a larger current account deficit) would appear appropriate especially in the current world environment characterized by the existence of a large surplus of the oil exporting countries which is unlikely to disappear in the short run. The choice of the appropriate degree of reliance on external borrowing is a difficult political decision for any Government. In the light of its past debt history and current standing in international capital markets, Portugal's present position would appear quite comfortable in this respect. Nevertheless, in a longer-term perspective, it would seem desirable to aim at the stabilization at some future point in time of the debt service burden, relative to foreign exchange earnings, at a level which shelters the country from the consequences of sudden changes in international market conditions and/or of shortfalls in foreign exchange receipts. This goal implies of course that the net flow of foreign financing should also eventually stabilize relative to foreign exchange earnings.

This highlights the need to base the program on policies that hold the promise of raising over the medium term the contribution of domestic savings to the increased investment effort. Policies aimed at broadening the scope of domestic capital markets by providing a more diversified range of financial assets, and the maintenance of near positive real interest rates would be instrumental in allowing some increase in the savings effort by the private sector. But the need to target a moderate rise in real consumption, while securing a deceleration in the growth of nominal incomes for antiinflation purposes, will probably preclude a substantial rise in the private savings ratio.

Thus a significant contribution to the financing of the additional investment will need to be made by a reduction of dissavings of the public sector. It is recognized that progress in this area, although vital, is likely to be gradual, because of rigidities in some items of expenditure and because of the difficulty of increasing the responsiveness of tax revenue to the base by redistributing the tax burden more efficiently and equitably among taxpayers, rather than by adding to the burden of taxation on those who are least able to evade it. A well designed reform of the tax system, including the shift to a unified personal income tax and the introduction of VAT, coupled with further improvements in tax administration, would appear to be essential ingredients of a medium-term fiscal program. Because such wide-ranging changes are likely to require considerable time to be prepared and implemented, it would seem desirable to press ahead with the necessary preparatory work in the near future.

Achievement of the goal of moderating the growth of public expenditure, especially public consumption and subsidies, will of course require first of all a firm political will. At a technical level, mechanisms of expenditure control, especially outside the central government, will need to be substantially strengthened. A major effort will be required to improve the financial position of some public enterprises by increasing efficiency, strengthening their capital structure and through pricing policies that fully reflect cost developments. The efforts, initiated in the 1980 budget to reverse some of the deteriorating trends in the public finances, will thus need to be continued and strengthened over the medium term.

An important objective of a medium-term policy strategy directed to ease the prospective integration of Portugal into the EC will undoubtedly be a continued decline in the underlying rate of inflation. While the deceleration in the actual rate of inflation in the near future will probably be moderated by the need to adjust some administered prices, particularly in the areas of energy and public transport, it can be hoped that, barring external shocks, a higher growth of productivity would allow a significant progress on inflation, along with a moderate growth of real wages. Financial policies should be consistent with the targeted deceleration of inflation.

In summary, it appears that the definition of a clear and credible medium-term strategy aimed at strengthening the productive structure of the country, reducing unemployment and moderating inflation should be the highest priority of the Portuguese authorities in the economic field, once the present political uncertainties have been eliminated. A medium-term program of this kind could benefit from substantial financial assistance from the Fund through the Extended and Supplementary Financing Facilities. The core of the program would be a commitment of the authorities to specific policy measures designed to promote the achievement of the program objectives, with indications of the expected timetable for their implementation. The agreement would also have to include as performance clauses at least ceilings on domestic credit expansion, with subceilings on credit to the public sector. Such ceilings would make adequate provision for the targeted financing requirements of the private and public sectors. They should be viewed primarily as trigger clauses for consultation with the Fund in the event that unforeseen developments necessitated a revision of some policy targets or that additional measures proved necessary to achieve them. As the program would extend over three years, an annual review clause would provide the necessary flexibility to adapt it to the evolving circumstances. We hope that we may be of assistance to the Portuguese authorities in supporting such a program in the near future.

Teresa Ter-Minassian
Chief, Southern European Division
International Monetary Fund

September 18, 1980

Called: Mrs. Kopits
Mr. M. Hnatysh
Being Called: Mr. V. Ter-Minassian
Mrs. N. Dhonte

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Reply via RCA: call 212-248-7000
RCA Global Telegram

Office Memorandum

TO : Mr. Whittome

FROM : Hans Schmitt HS

DATE: September 16, 1980

SUBJECT : Portuguese Review Paper

Attached please find a complete redraft of the Portuguese review paper I have been preparing, which takes account of editorial suggestions by Messrs. Pfeifer and Mitra. Though further stylistic improvements are doubtless possible, I hope that in terms of content and organization, it can now be considered to be in order.

I have also excised many of the footnotes. The ones that remain are meant to serve a number of constructive purposes. They underscore that the opposition to the program as finally agreed was not mainly Portuguese, but had a respectable academic pedigree abroad. More pointedly, they emphasize that to have described the Portuguese problem as structural did not look any more foolish at the time, than it does say with Jamaica today, but that it was anyhow wrong. Finally, it may not hurt to note that the 1975 OECD sponsored mission of MIT professors to Portugal set out to undermine both the Fund and the GATT with their recommendations.

You may wish to introduce further changes in the text. At some point we should perhaps also engage Silva Lopes and Mohammed. There will be an opportunity to show the next draft to Caraco Silva for clearance during the Annual Meetings.

CC: SED

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PORTUGAL MISSION ARRIVED SAFELY.

PLEASE TELL STRAYER TO PHONE DR. DAVID CASEY, OPTICIAN(452-8055)

TO ORDER ONE CLEAR RIM PERFORATED RIGHT EYE LENS FOR MITRA

BY SEPTEMBER 30 TO REPLACELENS

TER- MINASSIAN

Called: Mr. Ter/Minassian
Mr. Hnatysh (for E. Bell)
Mrs. Kôpits

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Reply via RCA: call 212-248-7000
Reply via RCA: call 212-248-7000
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RCA Global Telegram RCA Global Telegram

cc: SED

Office Memorandum

SEP 4 1980

(Comment conveyed by 'phone to Mrs Ten-Minassian before she left. 9/12)

TO : The Managing Director
The Deputy Managing Director

DATE: September 4, 1980

FROM : L. A. Whittome

SUBJECT : Briefing Paper for the Use of Fund Resources Mission with Portugal

Attached please find for your approval a copy of the briefing paper for the forthcoming Use of Fund Resources mission to Portugal. It has been cleared with the Exchange and Trade Relations (Mr. Mookerjee), Research (Mr. Artus), Treasurer's (Mr. Cutler), and Legal (Mrs. Lachman) Departments. Please return the original to the European Department.

cc: Mr. Watson

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

PORTUGAL

Briefing Paper--Use of Fund Resources

Prepared by the European and Exchange and Trade Relations Departments

Approved by L.A. Whittome and S. Mookerjee

September 4, 1980

I. Introduction

At the request of the Portuguese authorities, a staff team consisting of T. Ter-Minassian (EUR), P. Dhonte (ETR), G. Kopits (EUR), S. Mitra (EUR), and, as secretary, E. Bell (EUR) will visit Lisbon from September 14 to 25 to begin negotiations for an arrangement under the Extended Fund facility. The political timetable, which calls for Parliamentary elections in early October, followed by Presidential elections in early December, makes an early agreement virtually impossible. One or possibly more rounds of further negotiations are likely to be required. However, the Portuguese authorities have seen merit in requesting a preliminary, informal visit by the staff to review the present position and prospects for the economy, discuss the budget for 1981 currently being prepared and indicate the broad lines of a program that could be supported by an EFF arrangement. It is hoped that these contacts would pave the way for a more rapid agreement once the present political uncertainties have disappeared.

Fund holdings of Portuguese escudos (exclusive of purchases under the oil and compensatory financing facilities) amounted on August 31 to

94.6 per cent of Portugal's present quota of SDR 172 million. The mission will indicate that the combined amounts available to Portugal under the EFF and SFF could reach SDR 1,032 million (600 per cent of quota) over three years, if warranted by the program and by the extent of prospective balance of payments need.

II. Background

The stabilization effort, supported by a stand-by arrangement with the Fund in 1978, led to a swift reversal of the external position, from a current deficit equivalent to 9 per cent of GDP in 1977 to virtual equilibrium in 1979, at a remarkably small cost in terms of activity and employment, as growth, led by exports, remained in line with OECD averages in both 1978 and 1979. The success of the program was mainly attributable to exchange rate and wage policies which allowed a sharp improvement in competitiveness and to an interest rate policy which raised the attractiveness of domestic financial assets, contributing, among other things, to a large increase in workers' remittances and in the private savings ratio.

The short-term outlook is for the continuation of a sustained growth rate (3.5-4 per cent) in 1980, largely reflecting a recovery of domestic demand. The adverse effects on the balance of payments of the consequent upswing in imports and of the increase in oil prices are expected to be partly offset by a continued good performance of exports, tourism receipts and workers' remittances, albeit at substantially lower rates than in the past year. A current account deficit equivalent to about US$700 million (less than 3 per cent of GDP) is projected for the year as a whole, which will be largely financed through autonomous capital inflows and medium- and long-term borrowing by the Treasury. Inflation is expected to decelerate markedly, to below 20 per cent, compared with over 24 per cent in 1979, but this development is partly a reflection of the failure to adjust many administered prices in line with cost developments as well as of intensification of some price controls.

Despite these achievements, serious structural weaknesses continue to plague the Portuguese economy, weaknesses which, in the absence of meaningful corrective actions, threaten to eventually undermine the potential for a more rapid growth without external constraints and for a relatively painless entry of Portugal into the EC (presently targeted for 1983). A major area of weakness is undoubtedly represented by the public sector finances. The current deficit of the public sector has risen sharply in recent years to an estimated 6 per cent of GDP, reflecting an inadequate response of tax revenue to growth in the tax base, a rapid increase of public consumption and of social transfers and growing calls on the budget by the public enterprises, plagued by serious inefficiencies and rigidities in the productive structure and, above all, by inadequate pricing policies. The weakness of the public finances is made more acute by the fact that the deficit is largely monetized, thus leading to either a severe squeeze on credit to the private sector or, as has been the case in recent months, to unsustainably high rates of credit expansion (the rate of growth of domestic credit had accelerated to 10 per cent in real terms by mid-1980).

Structural obstacles continue to hinder the investment performance as well. Although investment appears to have recovered markedly in export-oriented sectors, reflecting a strong profit position and narrowing margins of unutilized capacity, there is little question that it will need to be stepped up substantially further to prepare Portuguese industry for entry into the EC. Moreover there is a recognized need for larger investment in key sectors such as agriculture and housing. The IBRD has recently issued a report on priorities for investment by the public sector (including the public enterprises). It calls for an investment strategy aimed at promoting export-oriented light industries (which are expected to enjoy a clear comparative advantage in the EC), agriculture, in view of its potential for import substitution, and construction especially in housing and tourism, because of its relatively low import content and high labor intensity. The Portuguese authorities are in the process of preparing a comprehensive five-year public investment program, which is expected to be presented by end-September 1980.

III. Work of the Mission

The mission will discuss with the Portuguese authorities the broad lines of a medium-term strategy aimed at securing maintenance of a steady, sustainable growth rate, improving the productive structure of the country to prepare it for EC entry, achieving a deceleration in inflation while correcting some existing price distortions, and reversing the deteriorating trends in public sector finances.

It appears that the external constraint on growth has been considerably eased by the stabilization effort of the past few years. Workers' remittances have risen by nearly 6 percentage points of GDP and the private savings effort by 5 points. The marked improvement in the competitive position has allowed the recovery of market shares lost after the

Revolution. The relatively low level of the present debt burden and Portugal's improved standing in international capital markets suggest that the country could finance a higher growth rate through borrowing for a few years. However, to ensure that the growth in debt does not exceed the increase in the debt servicing capacity of the country over the longer term, it is important that the increased resort to external borrowing be mainly directed to finance a higher investment effort in industrial sectors that present a good export potential, as well as in agriculture, energy and housing. The mission will review the public investment program currently being prepared, also in the light of the IBRD report. It will also discuss with the authorities the recent and prospective impact of an investment incentive scheme introduced earlier this year, as well as other possible measures to encourage private investment and to attract an increased flow of foreign investment.

Maintenance of a relatively sustained growth rate (in the range of 4-4.5 per cent on average for the period 1981-83, depending on the extent of the targeted investment effort) which would allow at least a stabilization and possibly some decline in the unemployment rate (officially estimated at present at about 8 per cent of the labor force but in fact considerably higher) is likely to require an increase in the current deficit of the balance of payments during the program period. The extent of this increase, which should in any case be consistent with debt servicing capacity over the medium term, will depend of course on the external environment and especially on the development of foreign demand and of the real price of oil. It is, however, also likely to be influenced by domestic policies, particularly with respect to interest rates and the exchange rate. The mission will press for maintenance of a level of interest rates sufficiently attractive to ensure a continued growth of workers' remittances at least in line with the incomes of Portuguese workers abroad and to discourage capital outflows. Maintenance of near-positive real interest rates would also promote some further decline in the velocity of circulation of money and allow a larger expansion of domestic credit than would otherwise be the case.

Since 1977 Portugal has maintained a crawling peg with respect to a basket of partner countries' currencies, with a preannounced monthly rate of depreciation which has been gradually reduced from a peak of 1.25 per cent in 1978 to the present 0.5 per cent. The escudo was revalued by 6 per cent in effective terms in February of this year to correct what the authorities deemed to have been an excessive depreciation in the previous two years. While the Portuguese authorities recognize the major contribution that this policy of gradual depreciation, in conjunction with a decline in real wages, has made to the improvement in competitiveness and the spectacular performance of exports in recent years, their choice of a depreciation rate over the next few years is likely to be influenced as well by the desire to secure a further moderation of costs and prices. The mission will discuss with the authorities the trade-offs between the partly conflicting (at least in the short run) goals of exchange rate policy. It will, however, emphasize the need not to dissipate a substantial part of the gains in competitiveness accrued so far, particularly in the light of the prospects that would open up for Portuguese export industries with entry into the EC.

The prospects for a substantial deceleration of inflation over the next few years will be affected by the need to make considerable adjustments in some administered prices, particularly for oil products and some public services. The correction of distortions in those areas is important in the context of the energy policy and, above all, to secure a lasting improvement in the public sector finances. The mission will ascertain the authorities' intentions regarding the extent and timing of prospective measures in this field.

A necessary condition for securing some decline in inflation will be moderation in the growth of incomes. If then the growth of private consumption is to recover from the low rates of the past few years, albeit remaining somewhat below the overall rate of GDP growth, it will not be possible to target a significant increase in the private savings effort. Therefore, the main domestic contribution to the financing of increased investment effort will need to be made by the public sector through a reduction in its dissaving. The mission will discuss with the authorities the range of policy measures contemplated to secure a lasting improvement in the public sector finances. In particular it will explore the scope for increasing the response of tax revenue to growth in economic activity,through a rationalization of the tax system and improved tax administration. It will also discuss the scope for reducing the growth of current expenditure, particularly public consumption and subsidies and the steps the authorities are contemplating to strengthen the mechanisms of control of public spending, especially in the areas of local finance and social security. The mission will review the progress made so far in nonmonetary financing of the budget deficit and discuss the institutional changes that would be necessary to substantially increase such financing over the program period.

Fund Relations with Portugal

(As of end-August 1980)

Status: Article XIV

Quota: SDR 172 million. The proposed maximum quota under the Seventh General Review is SDR 258 million. Portugal has consented.

Fund holdings of escudos:

	Amount (In millions of SDRs)	In Per Cent of Quota
Total	281.0	163.4
Of which:		
Compensatory financing	44.0	25.6
Oil facility	74.3	43.2

Distribution of profits: US$18.61 million

Gold distribution: 100,131.991 fine ounces

SDR department: Net cumulative allocation SDR 35.8 million. Holdings as of August 31, 1980 were SDR 9.1 million (25.5 per cent of net cumulative allocation).

Exchange rate: Portugal maintains a crawling peg system for the escudo, based on a basket of currencies of major trading partners (weighted by the shares of each country in Portugal's trade, tourism, and emigrants' remittances). Following a step adjustment of 6.1 per cent in early May 1978, the escudo was allowed to depreciate at a monthly rate of about 1.25 per cent. The total depreciation in 1978 was about 20 per cent vis-à-vis the basket. The monthly rate of depreciation was reduced to 1 per cent in April 1979 and further to 0.75 per cent in July 1979, resulting in a total depreciation of 10.4 per cent in effective terms by the end of that year. In February 1980 the escudo was revalued by 6 per cent. In June 1980 the monthly rate of depreciation was reduced to 0.5 per cent.

Restrictions on international trade and payments: In October 1978 the 30 per cent import surcharge, applied to some 29 per cent of 1976 imports, was reduced to 20 per cent, and in April 1979 was further reduced to 10 per cent. A 60 per cent surcharge affects a further 2 per cent of 1976 imports. Quantitative import quotas in value terms are imposed on about 4 per cent of 1976 imports, and similar quotas on automobile parts account for some 3 per cent of 1976 imports. These value quotas were raised in 1979 in escudo terms to leave their foreign exchange value roughly unchanged. In the May 8, 1978 letter of intent the Portuguese authorities stated their intention to study alternative domestic tax measures with a view to phasing out the 60 per cent surcharge beginning in 1979 and to reducing or limiting the quantitative import restrictions in 1979. There has so far been no progress in these two areas.

Portugal had been phasing outward remittances of profits and dividends. In the decision concluding the 1978 Article IV consultation with Portugal, the Fund granted approval of this restriction until December 31, 1979. On December 28, 1979 (EBS/79/319) the Executive Board extended approval on a lapse of time basis for this restriction "until the completion of the 1980 Article IV consultation with Portugal or December 31, 1980, whichever is the earlier." The restriction was abolished on January 10, 1980.

Last consultation: The last consultation discussions under Article IV were held in April 1980 and the report was discussed by the Executive Board on June 30, 1980.

September 5, 1980

Portugal - Brief

clesta Oct 5

A successful stabilization effort in 1978 and part of 1979 led to a sharp improvement of the balance of payments, with the deficit declining from about US$1.5 billion (9 per cent of GDP) in 1977 to around US$50 million in 1979. Mainly as a result of a strong export performance, growth remained above 3 per cent in 1978 and accelerated to 3.7 per cent in 1979. Inflation declined from over 27 per cent in 1977 to about 24 per cent in 1979. The marked improvement in the external position led the authorities to progressively ease the stance of credit policy since mid-1979 and lessened the pressure to contain the public sector deficit. As a result, the rate of growth of the money supply accelerated from about 30 per cent in mid-1979 to over 35 per cent in the first half of 1980. The public deficit, which had been targeted to decline to 7 1/2 per cent of GDP in 1979, reached 10 per cent instead and is likely to rise further to over 12 per cent in 1980. Exchange rate policy has been subject to periodic adjustments; the monthly rate of depreciation was reduced in steps from 1.25 per cent to 0.5 per cent between April 1979 and July 1980 and in February 1980 the escudo was revalued by 6 per cent. This is likely to lead this year to some deterioration in the competitive position, which remains, however, quite strong.

The short-term outlook is for the continuation of a sustained growth rate (3.5-4 per cent) in 1980, entirely reflecting a recovery of domestic demand. The adverse effects on the balance of payments of the consequent upswing in imports and of the increase in oil prices are expected to be partly offset by a continued good performance of exports, tourism receipts, and workers' remittances, albeit at substantially lower rates than in the past year. A current account deficit equivalent to about US$700 million (less than 3 per cent of GDP) is projected for the year as a whole, which will be largely financed through autonomous capital inflows and medium-term and long-term borrowing by the Treasury. Inflation is expected to decelerate to below 20 per cent, but this development is mainly a reflection of the failure to adjust many administered prices in line with cost developments, a freeze on others, as well as of intensification of some price controls.

Over the longer term, the main area of difficulty continues to be the situation of the public finances. Corrective steps will be required to increase the responsiveness of tax revenue to growth in the base and especially to moderate the growth of current expenditure, particularly subsidies and transfers. Sizable adjustments in some administered prices will be necessary to improve the position of the public enterprises and promote energy conservation. In the absence of such steps it would be virtually impossible to contain the growth of domestic credit to rates consistent with a continued deceleration in the underlying rate of inflation and a sustainable external deficit, without squeezing the private sector and jeopardizing the sustained recovery of investment to which the Portuguese authorities attach great importance, also in the light of the need to prepare the country for EC entry.

The staff is now beginning negotiations for an EFF (plus SFF) which could reach over SDR 1 billion (600 per cent of quota) over three years. The main purpose of such a program would be to ensure that (a) the planned investment effort is designed to strengthen the productive capacity of the country, especially in export-oriented sectors and (b) policy measures are taken to promote an additional domestic savings effort (especially by the public sector) to sustain the investment program, without "excessive" reliance on foreign financing.

Office Memorandum

TO : Mr. Whittome

FROM : T. Ter-Minassian T.T-M.

SUBJECT : Programmatic Sketch for Portugal

DATE: August 21, 1980

(1) Tactics: FH want a letter or a quid?
(2) Sensible for a serious govt able to keep commitments but given the little to stay for surprises, features of civil etc.
(4) joining EEC not going to have some dynamic effects?

Messrs. Dhonte, Mitra, and I have been making a first attempt at quantifying the main elements of a three year (1981-83) program for Portugal, as background for our preliminary discussions in Lisbon next month. I should like to stress the very preliminary and tentative nature of this exercise: there are a number of areas in which our assumptions are "heroic" ones reflecting considerable information gaps, that we hope will be at least partly filled during our forthcoming visit. Thus, the main purpose of this programmatic sketch is to highlight some of the issues that will probably have to be faced during the negotiations, particularly the trade-offs between partly conflicting policy objectives. This note spells out some of the assumptions underlying the projections summarized in Tables 1-4, and discusses the major policy issues raised by them.

A first issue that needed to be confronted in designing the program was the choice of a growth target. In this respect, it should be recognized that the external constraint on growth has been substantially eased by the stabilization effort of the past few years. Workers' remittances have risen by nearly 6 percentage points of GDP and the private savings ratio by 5 points. Market shares for exports have been largely recovered. Moreover, some preliminary projections of a "permissible" current deficit on the assumption of a long-run stabilization of the debt service ratio at the relatively low level of 15 per cent of foreign exchange earnings, suggest that Portugal could finance a relatively high growth rate through borrowing for a few years, because of a favorable initial debt position.

However, the composition of growth appears to be crucial. Given a relatively depressed outlook for external demand during the initial years of the program period, it would probably be unrealistic to expect a large contribution to growth from exports. The contribution of consumption (both public and private) is limited by the need to reduce the public sector's calls on real and financial resources, on the one hand, and by the need to moderate the growth of wage costs on the other. Thus, much hinges on the scope of the investment effort. Our projections are largely based on the report of a World Bank team which, by their own reckoning, could be considered somewhat optimistic. They may, however, warrant an upward revision on the basis of an analysis of the medium-term investment plan that the Portuguese government is currently preparing. This may allow us to raise the overall growth target (4 per cent on average for 1981-83) to somewhere nearer the 5 per cent, which we understand the Portuguese are presently thinking of.

unemployment

~~session~~ term of new Parliament?

A second important issue concerns the target for inflation. On the one hand, it would appear that a significant deceleration of inflation should be an essential ingredient of a medium-term structural adjustment program, designed to ease entry of Portugal into the EC. On the other hand, it should be taken into account that a part of this adjustment will involve the elimination of some distortions resulting from inappropriate pricing policies for, among other things, some oil products and some public services in recent years. While we do not have sufficient information to accurately estimate the magnitude and impact of the required price adjustments, it is likely that they will add several points to inflation over the program period.

An additional dimension of the problem relates to the role of exchange rate policy. There is clearly in the short run a trade-off between progress on inflation and maintenance of competitiveness. The Portuguese are likely to press for a further reduction in the rate of depreciation. Our calculations indicate that (on the rather mechanical assumption of a full pass through of cost developments onto prices) a reduction in the rate of depreciation to 1/4 per cent per month would contribute to a substantial slowdown in inflation, provided the growth of real wages remained moderate (Table 1). Competitiveness would deteriorate significantly but the position would still remain substantially better than in the prerevolutionary years (Table 2). An alternative strategy of maintenance of the present rate of depreciation, coupled with limits on the growth of nominal wages to ensure maintenance of the present competitive position, would involve a decline in real wages in the first year of the program and a slower deceleration of inflation. Presumably, however, it would allow a better performance of exports and perhaps of investment in the export sector.

row?

not much

The external projections were built on rather conservative assumptions, allowing for some further deterioration in the terms of trade, a marked slowdown in gains in market shares compared to recent years, a relatively high import elasticity (1.4) and a return of the growth of workers remittances to rates in line with the expected growth of wages abroad (especially in France). On these assumptions the current balance could be expected to deteriorate significantly in the course of the period, to a deficit equivalent to about 5 per cent of GDP by 1983 (compared with a projected 3 per cent in 1980). Viewed in a flow of funds framework, the additional resort to foreign savings would be a counterpart for the return of the remittances GDP ratio to more normal levels and for the increase in the investment effort (Table 1).

essentially over but after EEC?

One may wonder whether the program should not target a larger domestic savings effort; this may be desirable in a longer term prospective, but it would, of course, have a cost in terms of growth in the short run. Indeed, a decline in the household savings ratio from its historically rather high level of 1979 appears a necessary condition for maintenance of a moderate growth of private consumption given the targeted restraint in the growth of real incomes. Of course, if the investment effort should be stepped up compared with the projections it would appear that the major contribution to its financing should be expected from domestic savings.

An important element of the program would have to be a reduction in the dissaving by the public sector. The budgetary projections presented in Table 3 are especially tentative as there is a large element of uncertainty concerning the starting point, namely the likely outturn for 1980. In addition, we know very little about "room for maneuver" on the expenditure side, particularly on current items. It is also as yet unclear what forms should take the fiscal effort on the tax side (which, if one were to extrapolate past trends in the elasticity of tax receipts, would be considerable). Thus, it is impossible to say whether the normative element in the projections would prove a realistic one. In the light of the investment effort targeted, the program would have to allow for an increase in the share of capital expenditure (both direct investment and equity participation in public enterprises) in total expenditure. This would moderate the decline in the overall deficit as a per cent of GDP.

The monetary program was also designed on relatively conservative assumptions as regards velocity; the decline anticipated is considerably smaller than experienced in recent years. However, the starting position is one of ample liquidity in the economy (although it is difficult to gauge to what extent it is excessive) and, moreover, the fastest growing component of M_2, namely emigrant deposits can be expected to decelerate substantially in future years, following the slowdown of remittances. Of course, the behavior of velocity is likely to be strongly influenced by real interest rates and there may be some trade-off between interest rate policy and credit ceilings. The monetary program would allow a significant decline in the share of the public sector in DCE, from an admittedly quite high base in 1980. The decline would be more marked if that share was adjusted for capital transfers and net lending from the public to the private sector.

In conclusion, the programmatic sketch outlined here provides one example of a possible gradualist approach, attempting to secure some progress on various fronts without going "all out" on any of them. The obvious question is: is this the best strategy? The trade-offs are fairly clear, although their exact quantification difficult. My colleagues and I would welcome your guidance on these questions.

cc: Mr. Schmitt (o/r)
Mr. Dhonte
Mr. Kopits (o/r)
Mr. Mitra

Table 1. Portugal: National Accounts Projections

	Percentage Changes				
	1979	1980	1981	1982	1983
Demand and output (in constant prices)					
Private consumption	0.6	3.8	3.5	4.0	4.5
Public consumption	5.2	2.0	2.0	2.0	2.0
Fixed investment	-1.6	3.5	5.0	6.0	7.0
Stockbuilding 1/	-0.8	0.4	0.1	0.1	0.1
Total domestic demand	--	3.8	3.6	4.1	4.6
Exports of goods and services	27.4	11.0	6.0	7.0	7.0
Imports of goods and services	5.8	9.0	5.5	6.6	7.0
GDP	3.7	3.8	3.5	3.9	4.4
Prices, costs and incomes					
Wage rate	18.0	20.0	22.0	19.0	16.0
Unit labor costs	15.0	17.0	19.0	16.0	13.0
CPI	24.6	19.0	20.0	17.0	14.0
GDP deflator	21.7	16.5	19.9	17.1	13.8
Disposable income	31.1	23.7	22.4	20.1	18.5
Memorandum items (level):					
Investment/GDP ratio	21.1	21.8	22.0	22.2	22.6
Workers' remittances/GDP ratio	12.3	12.1	11.3	10.6	10.2
Foreign savings 2/ /GDP ratio	-2.9	0.4	1.4	2.2	2.7
Domestic savings/GDP ratio	11.7	9.3	9.3	9.4	9.7
of which:					
Public sector	-3.8	-6.0	-5.5	-5.0	-4.5
Private sector	15.5	15.3	14.8	14.4	14.2
Household savings/disposable income ratio	19.9	20.0	19.2	18.1	17.6

Source: Staff estimates and projections.

1/ Contribution to GDP growth.
2/ Balance on goods and nonfactor services (surplus -).

Table 2. Portugal: Balance of Payments Projections

(In millions of U.S. dollars)

	1979	1980	1981	1982	1983
Percentage changes in:					
Export volume	...	12.0	5.5	7.0	7.0
Export prices	...	17.0	10.0	9.0	9.0
Import volume	...	9.0	5.5	6.6	7.0
Import prices	...	28.0	12.0	10.0	9.0
Trade balance	-2,422	-3,680	-4,450	-5,250	-6,100
Balance on nonfactor services	530	680	800	920	1,050
Of which:					
Tourism	940	1,190	1,430	1,690	1,980
Investment income, net	-430	-600	-650	-720	-800
Transfers	2,472	2,900	3,250	3,600	4,000
Current account	150	-700 (3%)	-1,050	-1,450	-1,850 (5%)
Medium-term and long-term capital	813	577	927	1,250	1,550
Of which:					
Borrowing	752	507	807	1,100	1,350
Drawings	(927)	(1,160)			
Amortizations	(175)	(653)			
Direct investment	49	80	120	150	200
Short-term capital	366	100	--	--	--
SDR allocation	23	23	23	--	--
Overall balance	1,352	--	-100	-200	-300
Memorandum items:					
Change in effective rate	-15.0	-3.0	-3.0	-3.0	-3.0
Change in escudo/dollar rate	-10.5	-1.5	-3.0	-3.0	-3.0
Index of relative ULC (1973=100)	79.6	82.0	86.4	89.2	90.9

Source: Staff calculations.

why is "normally sustainable" capital inflow? $1 bn?

Table 3. Portugal: Budgetary Projections

(In billions of escudos)

	1979	1980	1981	1982	1983
Current receipts	264.3	340.0	439.0	530.0	637.0
Direct taxes	124.0	165.0	215.0	270.0	327.0
Indirect taxes	122.0	154.0	199.0	230.0	275.0
Other	18.3	21.0	25.0	30.0	35.0
Current expenditure	302.2	411.0	525.0	620.0	733.0
Goods and services	147.6	185.0	229.0	275.0	323.0
Subsidies	46.5	65.0	75.0	90.0	105.0
Transfers to households	79.6	120.0	146.0	175.0	205.0
Interest payments	28.5	41.0	60.0	80.0	100.0
Current balance	-37.9	-71.0	-81.0	-90.0	-96.0
Capital receipts	4.2	5.0	6.0	7.0	8.0
Capital expenditure	64.9	80.0	100.0	120.0	143.0
Overall balance	-98.6	-146.0	-175.0	-203.0	-231.0
PSBR	-100.9	-155.0	-185.0	-214.0	-243.0
Financed by:					
External borrowing	18.2	18.0	26.0	30.0	35.0
Nonbank borrowing	6.0	7.0	12.0	15.0	20.0
Domestic credit	76.7	130.0	147.0	169.0	188.0
Memorandum items:					
(As per cent of GDP)					
Taxes	24.7	26.8	28.1	27.9	28.2
Current expenditure	30.7	34.6	35.6	34.6	34.4
Current balance	-3.8	-6.0	-5.5	-5.0	-4.5
Overall balance	-10.0	-12.3	-11.9	-11.3	-10.8

Source: Staff estimates and projections.

Table 4. Portugal: Monetary Survey Projections

(In billions of escudos)

	Stock End 1979	1980	Flows 1981	1982	1983
Net foreign assets 1/	40.8	--	-5.0	-10.6	-16.0
M2	991.8	293.0	300.0	360.0	410.0
Domestic credit	1,100.6	328.0	345.0	420.0	476.0
Of which:					
To the public sector	248.4	130.0	147.0	169.0	188.0
To the private sector	852.2	198.0	198.0	251.0	288.0
Other items, net 1/	149.6	35.0	40.0	45.0	50.0
Memorandum items:					
Percentage changes in:			20%		
M2	36.5	29.5	23.3	23.0	21.0
Velocity	-7.0	-8.8	-1.0	-2.0	-2.0
Domestic credit	25.8	29.9	24.1	23.6	21.7
Domestic credit to the private sector	21.2	23.2	18.9	20.2	19.2
Percentage shares of public sector in DCE:					
a) Unadjusted	34.0	39.6	42.6	40.2	39.5
b) Adjusted 2/	21.4	30.8	28.1	25.5	23.7

Source: Staff estimates and projections.

1/ Excluding revaluation of gold reserves.
2/ Excluding capital transfers and net lending from public sector to private sector.

cc: European Department 8/19/80

ec: SED

Office Memorandum

CONFIDENTIAL

TO : Mr. Goode

DATE: August 19, 1980

FROM : A. A. Tait AC

SUBJECT : Visit to Portugal to Discuss Possible Technical Assistance in Connection with the Introduction of the Value Added Tax

I visited Lisbon from July 19 to July 25, 1980. The authorities had left a substantial number of documents and statistical tables for me at the hotel and it was fortuitous that I had the time to consider this material before meeting the committee on Monday morning.

Dr. Xavier de Basto, a member of the law faculty of the University of Coimbra and new chairman of the VAT committee, met me at the Ministry of Finance and introduced me to the permanent staff of his committee. These comprise an economist Mr. Paul Jorge Correia Esteves, a tax administrator, Mr. Arlindo Negueira Marques Correia, and a lawyer Miss Maria Teresa Silva. All spoke English. An agenda had been prepared and everyone I met and worked with in Portugal could not have been more charming or more helpful.

However, there were difficulties. It was not until Tuesday afternoon that I became increasingly aware of an uneasy gap between my sense of timing and the committees. I had been asked to outline the timetables and the sequence of organizational changes needed to introduce VAT in Britain and Ireland; in each country the time taken was just under three years from the tentative, almost theoretical, start to the implementation of the tax. A similar timetable in Portugal would indicate a date in mid-1983 or even January 1983 as the introduction date for VAT. Some reservations were expressed about this but it was only at my pressing that the chairman eventually agreed that he was thinking of a date sometime in 1986.

On Wednesday the committee did not meet and I devoted the day to preparing a chart outlining the various organizational responsibilities in Britain, as I understood them, up to and including the introduction of VAT (see attached paper). I also prepared summaries of the different ways of calculating the VAT bases as I had done in Ireland, Britain, Korea, and Mexico. The committee had also asked that I give a short paper on other countries' experience of the introduction of VAT and its effect on the retail price index; luckily I was able to do this using the research I was doing just before leaving headquarters.

I think the discussions on the actual organization needed to get a VAT off the ground focused the committee's mind for the first time on some of the structural changes required and the need for a timetable to integrate the many complex requirements for the VAT introduction.

Our meeting with the Minister of Finance emphasized his conviction that the VAT should be introduced in 1983/4 rather than in 1986, however, the push to proceed with the EEC application might be weakened if the present government coalition does not maintain its parliamentary power in the October elections.

I also met the secretary of state for the budget, Mr. A.J. de Figueiredo Lopes and the Director of Planning and Studies, Dr. Oehen Goncalves.

On the basis of all these discussions it was agreed that:

1. By October 1980 the economists associated with the work of the committee would prepare a document showing what they had done up to that date, summarizing their main difficulties, and outlining a future program of work. From this it should be clear what sort of staff member would be of most help to the authorities to help sort out their difficulties and produce the figures for tax bases and alternative tax packages for the VAT substitution. The staff mission would be for a couple of weeks in November/December 1980. English would be the preferred language.

2. In 1981 a follow-up mission might be requested depending on the work done in (1) above.

3. The committee will produce a consultative paper in January 1981 on the likely technical and administrative problems of introducing a VAT. A request for a staff mission in March 1981 is anticipated which would include, amongst others, the following responsibilities:

- description of the outline administrative structure for a VAT in Portugal;

- an examination of the present sales taxes administration (but perhaps including company taxation);

- appropriate relations with the corporate tax;

- registration for VAT;

- tax forms for VAT;

- the appropriate organization of the flow of paper work for VAT;

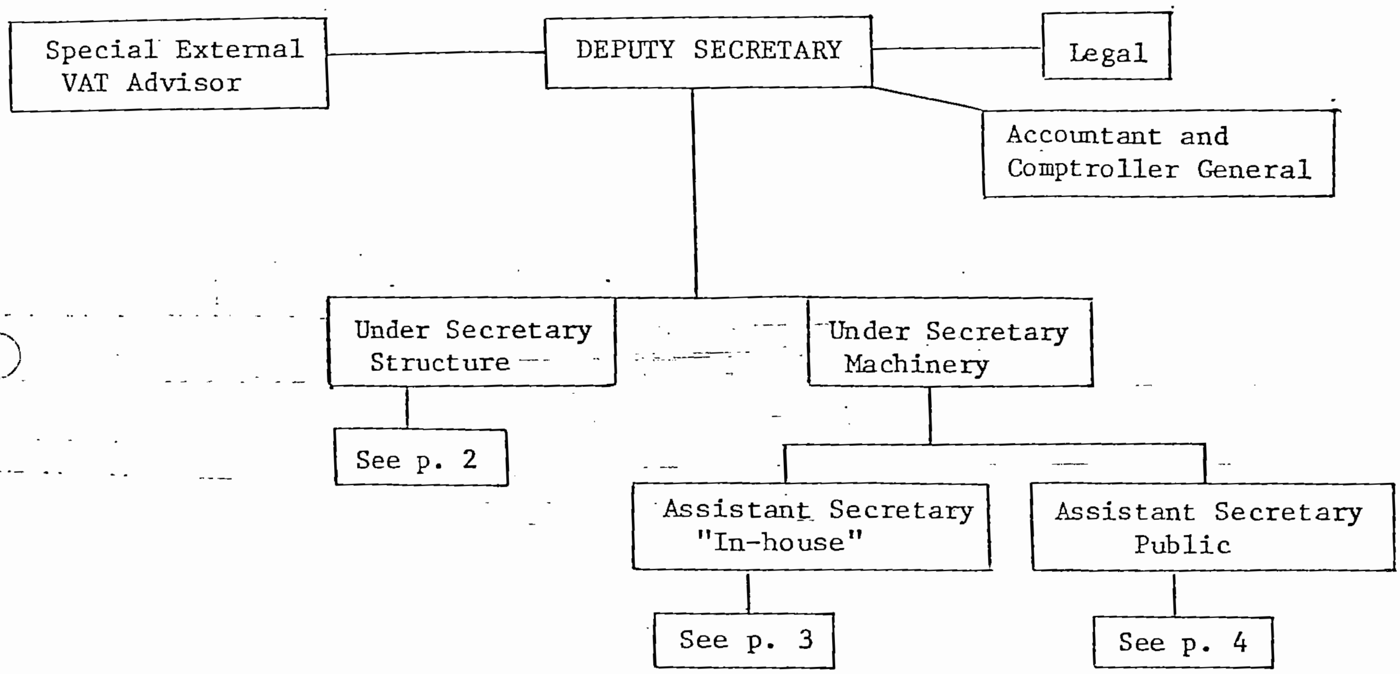
- alternative treatment for small firms;

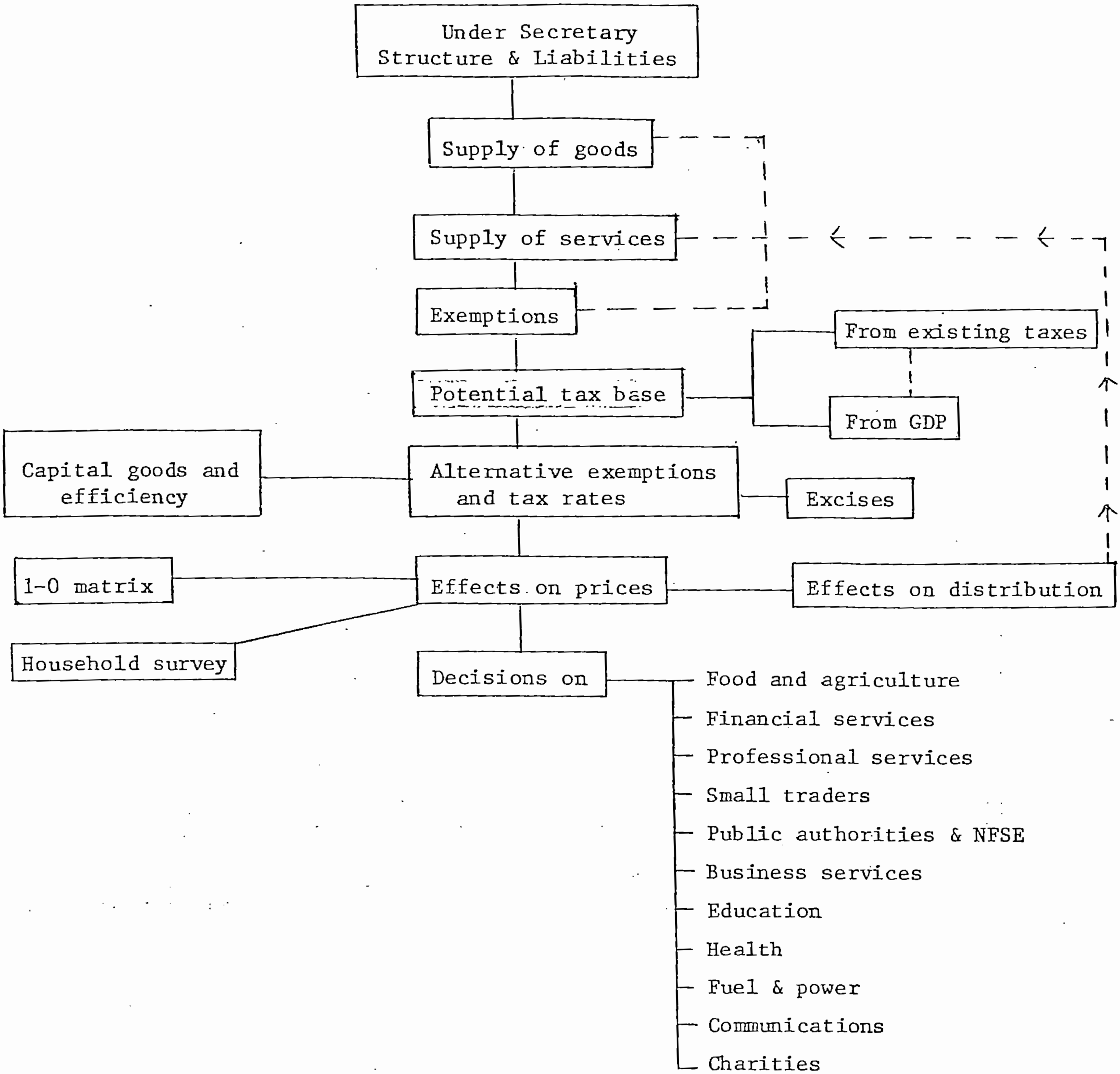
- possible exemptions and treatment of partial exemptions;

- the training of VAT officers and the setting up of a training program.

The member or members of this staff mission should be able to speak Portuguese or Spanish; French might be acceptable as a second best. The mission might last 2-3 weeks. Naturally, the implementation of some of these problems might need the assignment of a panel member for a longer period later in 1981 or 1982.

Rough Outline of VAT Preparation

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From GDP
Capital goods and efficiency
Alternative exemptions and tax rates
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Effects on prices
Effects on distribution
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Food and agriculture
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Small traders
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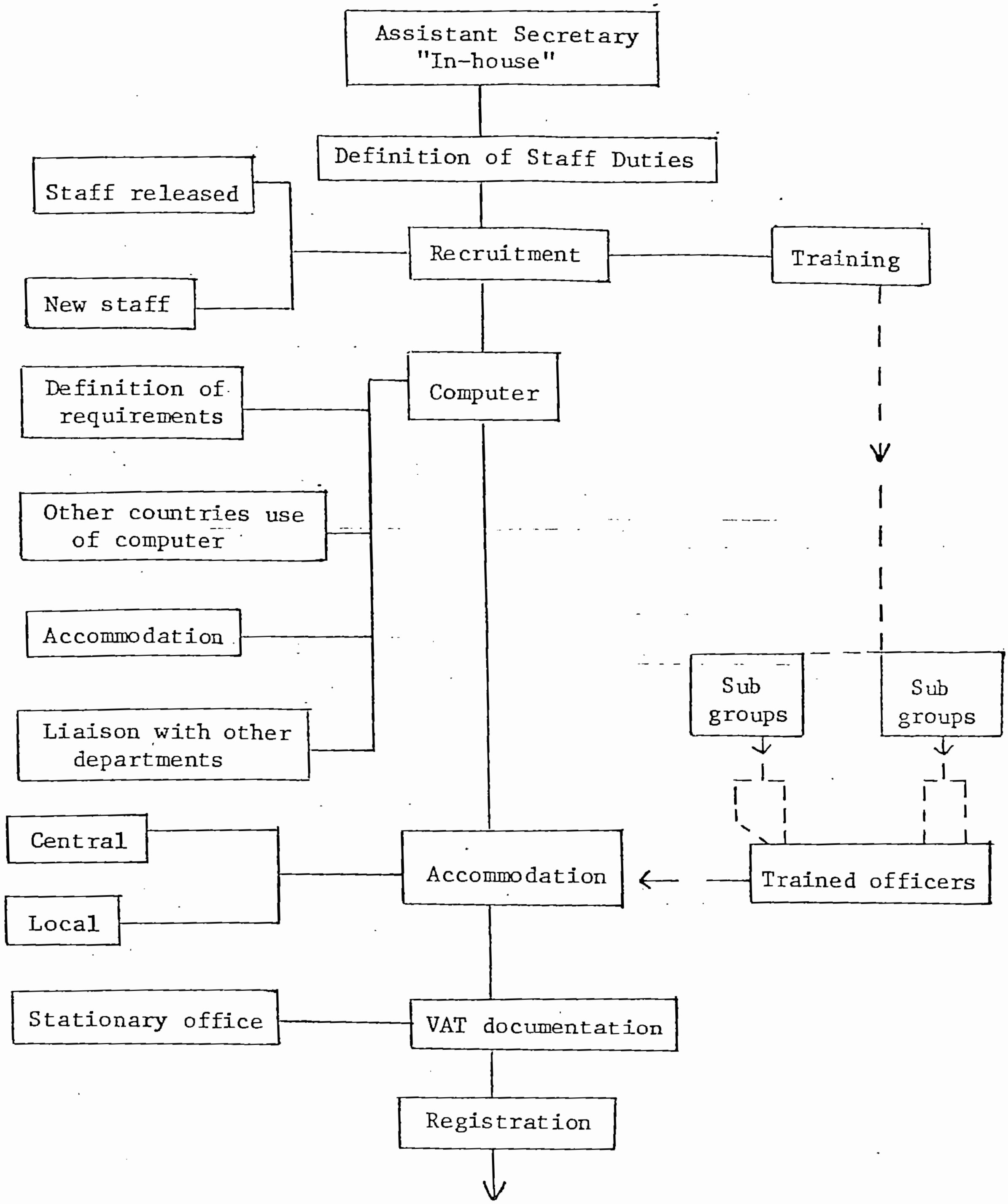
Business services
Education
Health
Fuel & power
Communications
Charities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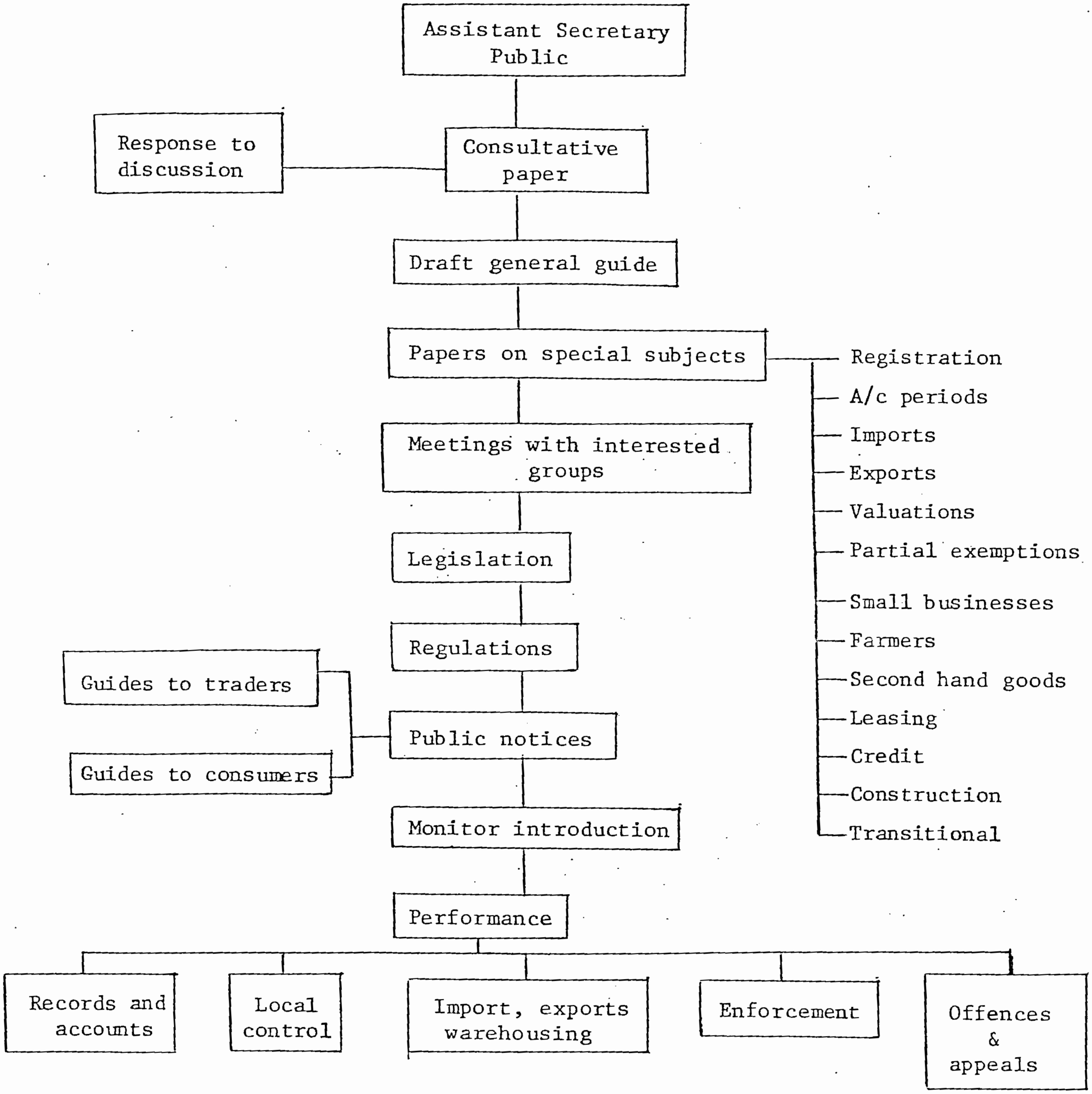
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Second hand goods
Leasing
Credit
Construction
Transitional
Meetings with interested groups
Legislation
Regulations
Guides to traders
Guides to consumers
Public notices
Monitor introduction
Performance
Records and accounts
Local control
Import, exports warehousing
Enforcement
Offences & appeals

Office Memorandum

TO : The Acting Managing Director

DATE: August 13, 1980

FROM : L.A. Whittome *LAW*

SUBJECT : Mission to Portugal

We have now had confirmation from the Portuguese that they wish to start discussions with the Fund before the Annual Meeting on a possible use of the EFF. We have therefore arranged for a mission to start discussions in Lisbon on September 15 and stay for about ten days. The team would be headed by Mrs. Ter-Minassian and would consist, in addition, of Messrs. Dhonte (ETR), Kopits (FAD), and Mitra (EUR), plus a secretary. This mission was not foreseen on the official travel schedule. May I please have your approval?

JKW

ADM)
SEC) After approval

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INTERNATIONAL MONETARY FUND

Washington, D.C. 20431

TIME RECEIVED

ADDRESS

THE HON. PROF. ANIBAL ANTONIO CAVACO SILVA
MINISTER OF FINANCE AND PLANNING
MINISTRY OF FINANCE, PRAZA DO COMERCIO
LISBON, PORTUGAL

Special Instructions

I TAKE PLEASURE IN CONFIRMING THAT A STAFF TEAM LED BY MYSELF AND CONSISTING OF MESSRS. KOPITS, DHONTE AND MITRA WILL BEGIN INFORMAL DISCUSSIONS IN LISBON ON SEPTEMBER 15, 1980. BEST PERSONAL REGARDS.

TERESA TER-MINASSIAN
INTERFUND

Distribution

MESSAGE MUST END HERE

Drafted by: T. Ter-Minassian
Department: EUR
Date: 8/13/80

T. Ter-Minassian
NAME (TYPE)

T. Ter-Minassian
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NAME (TYPE)

SIGNATURE

FOR CABLE ROOM USE ONLY

No. of words: Log: Route: Operator:

1. Use OCR-B210 Sphere and set typewriter for DOUBLE SPACING—No other markings acceptable.
2. Align First Characters at Line Number 18.
3. Use 10 Pitch Type (Pica) required DO NOT exceed right-hand margin.

INTERNATIONAL MONETARY FUND

8 ix 80

Mr Whittome

In reply to your inquiry on the paper on Portugal, I have now completed rewriting the central section and redrafting some others and will let Hans have my drafts.

SD

Office Memorandum

TO : Mr. Whittome

DATE: August 12, 1980

FROM : A. Pfeifer

SUBJECT : Mr. Schmitt's Paper Renewing the Experience with Portugal

This paper contains an interesting review of economic developments and policies in Portugal in the years 1974-79. The emphasis is on the arguments that were used for and against the policies pursued by the authorities prior to mid-1978 when a Fund-supported stabilization program was finally introduced and succeeded in turning the situation around. The retracing of the old arguments against the background of subsequent developments suggests that some of Portugal's foreign advisors, notably those from MIT, were often wrong and the Fund staff was right.

I have two problems with this paper:

1. The manner in which the advice given by the MIT advisors is criticized--largely by footnoting the description of developments with quotes from the articles they wrote at the time--is too flippant and appears unfair. The arrogance and incompetence of certain advisors deserve to be shown up (particularly since Mr. Eckaus in his 1977 article suggested "malpractice" on the part of the IMF), but it would be preferable if this were done in a more straightforward manner by recalling their arguments and then showing how these were proven wrong by the facts.

2. Section III ("The Stabilization Debate") is unsatisfactory as it stands, because it does not adequately explain when, by whom and in what context the various issues were being debated, what policies were actually pursued at the time and what role was played by the Fund in the stabilization debate.

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- the serious deterioration of the balance of payments and reserves position in 1974-75 gave rise to a stabilization effort in 1977.

Continued/...

- to back up this effort, a group of friendly countries meeting in Paris in June 1977 pledged balance of payments support. (Did the Fund help too?) With this support it was estimated that a current account deficit of $800 million a year (which year?) could be supported. The aim of the stabilization effort was to bring the current account deficit (which eventually turned out to be nearly $1,500 million in 1977) down to that figure.

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- this strategy seemed also to be recommended by the increasing orientation of the Portuguese economy towards Europe and prospective membership in the Common Market.

- this basic strategy was sound, but until the spring of 1978 it was not pursued with sufficient vigor. Exchange rate policy, monetary policy and fiscal policy all were too weak. Throughout 1977 there was a lively debate on stabilization policy. The Fund staff advocated stronger policies, but the authorities, advised by a number of foreign advisors, were not prepared to go further. Some of the arguments used in the stabilization debate were similar to those used in other countries. They are recalled in some detail later in this Section III because it is considered significant that, as shown in Section IV, they held up poorly in the light of eventual developments.

- economic developments in the second half of 1977 and the early months of 1978 showed that the stabilization efforts of the Portuguese authorities were falling far short of the earlier hopes. In May 1978 it was, therefore, decided to strengthen these efforts. The stabilization program then initiated was supported by a second credit tranche stand-by arrangement with the Fund.

- as shown in Section IV, this stabilization proved successful and has considerably improved the potential of the Portuguese economy for further growth in the near future.

Mr. Whittome

August 12, 1980

A. Pfeifer

Mr. Schmitt's Paper Renewing the Experience with Portugal

This paper contains an interesting review of economic developments and policies in Portugal in the years 1974-79. The emphasis is on the arguments that were used for and against the policies pursued by the authorities prior to mid-1978 when a Fund-supported stabilization program was finally introduced and succeeded in turning the situation around. The retracing of the old arguments against the background of subsequent developments suggests that some of Portugal's foreign advisors, notably those from MIT, were often wrong and the Fund staff was right.

I have two problems with this paper:

1. The manner in which the advice given by the MIT advisors is criticized--largely by footnoting the description of developments with quotes from the articles they wrote at the time--is too flippant and appears unfair. The arrogance and incompetence of certain advisors deserve to be shown up (particularly since Mr. Eckaus in his 1977 article suggested "malpractice" on the part of the IMF), but it would be preferable if this were done in a more straightforward manner by recalling their arguments and then showing how these were proven wrong by the facts.

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Office Memorandum

AP Please

TO : Mr. Whittome

DATE: August 1, 1980

FROM : Hans Schmitt

SUBJECT : Portugal - Review Paper

Attached please find the first complete draft of the essay on Portugal's experience with stabilization that you asked me to do. I believe the first section on the background may now be in reasonably good shape. The second on the policy issues still suffers from expository defects. The last section on the outturn may have substantive problems as well.

I would like to have another go at this paper when I come back from vacation on August 25. What do we want to do with it then? Issue it as a DM might be one possibility with an option to publish in Staff Papers if there is interest. An argument can also be made for holding it closer and issuing it only to the Board on some restricted basis. There is finally the possibility of just adding it to departmental files for our own edification.

Attachment

cc: Mr. Pfeifer
Mr. Mohammed
Mr. Silva Lopes
Mrs. Ter-Minassian

DRAFT
8/1/80

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

European Department

Economic Stabilization and Growth in Portugal

Prepared by Hans Schmitt 1/

August , 1980

Table of Contents

1/ The author is indebted to Jose da Silva Lopes, Saumya Mitra, Brian Stuart, and Teresa Ter-Minassian for critical comments. Responsibility remains his own.

I. Introduction

Following a decade of rapid growth with external equilibrium the Portuguese economy in the early 1970s suffered a series of major shocks. Even before the Revolution of April 1974 the increase in world petroleum prices had sharply raised the import bill, and by deepening the recession elsewhere was to reduce export earnings and remittances from abroad. The end of the colonial wars in Africa meant a loss of privileged markets and brought a major reflux of settlers home. Domestically, the Revolution nevertheless achieved a substantial redistribution of income in favor of workers both in the factories and on the farms. Although the rate of economic growth slowed down, it now generated external deficits so large as to be unsustainable.

The problem of managing economic growth with a balance of payments constraint was new to Portugal. The authorities responded with progressively tighter austerity measures culminating in May 1978 in a stabilization program that was supported by the Fund. The program is noteworthy for the simplicity of its design. A monthly depreciation rate was fixed for the escudo together with a matching set of interest rates on bank deposits. The former would achieve a competitive economy by reducing costs, while the latter was to ensure that savings would not only increase but be placed at home. For safety, a limit was placed on domestic credit expansion, and to protect the productive sector, credit to the public sector was rationed within the total.

This approach succeeded in reconciling economic growth with external equilibrium once more, despite the changed external circumstances. An unsustainably large external deficit on current account was turned into a small surplus two years later. The growth of the economy was nevertheless maintained at a rate equal to or above the average for the country's main trading partners.

The reasons that made this performance possible are set out in the following sections. The first examines the economic background in which the disequilibrium arose. The next reviews the issues that had to be resolved in formulating an effective program. The economic outturn is given critical scrutiny in the last.

II. The Economic Background

Beginning in 1974 Portugal's balance of payments, which had traditionally been in surplus, moved into substantial deficit. In relation to GDP an external current account surplus equivalent to 3 per cent in 1973 was turned into deficits of 6 per cent in 1975 and 9 per cent in 1977. The overall balance on nonmonetary transactions changed from a surplus of US$328 million to deficits of US$1,013 million and US$1,430 million over the same years. (Table 9). External shocks account for part of this result. They were superimposed on more fundamental difficulties, however, that can be traced to the characteristics of the expansion that preceded it, and to the wage pressures to which these gave rise.

1. Rapid expansion

In the five years to 1973 real GDP growth in Portugal averaged 7.4 per cent. (Table 3). This very high rate of growth was facilitated in part by exports, particularly manufactured exports, which expanded at an average annual rate of 6.5 per cent in real terms over the same period. The main thrust of the export drive was directed toward Western Europe which provided, in addition to expanding markets, also an increasing stream of tourists and employment to a growing number of migrant workers. As the nine countries now in the European Community increased their share in Portuguese exports from

40 per cent to 49 per cent, that of the African territories dwindled from 25 per cent to 15 per cent, (Table 10), eroding the economic basis for keeping them Portuguese.

Despite the impressive performance of exports, it was mainly emigrants' remittances that underpinned the surplus in the external balance on current account. Remittances apart, a deficit on goods and nonfactor services equal to 5 per cent of GDP in 1968 had widened to 7 per cent in 1973, as the increase in imports outpaced that of exports. Fearing increasingly keen competition from imports of manufactures as well as of agricultural products, if the currency were to appreciate, the authorities held the exchange rate firmly fixed in effective terms throughout the period. Even so, by 1973 commodity exports covered only 49 per cent of imports of goods and services, gross tourist receipts some 15 per cent, and workers' remittances fully 30 per cent.

While Portugal had long exported labor as well as goods, gross emigration accelerated sharply in the mid-1960s, so that by 1973 some 14 per cent of the combined Portuguese labor force were employed in the European Community, leaving less than 2 per cent unemployed at home. The possibility of emigrating to better paying jobs elsewhere put upward pressure on wages in Portugal. Even without any help from currency appreciation, real wage increases put increasing pressure on the more exposed sectors of the economy such as agriculture, where value added by 1973 had dropped below its 1968 level. (Table 2). Nevertheless, reaching 3 per cent per annum by the end of the decade, real wage increases still fell substantially short of the rate of productivity growth for the economy as a whole.

Though stable exchange rates sustained the competitiveness of the Portuguese economy for a while, they could only be maintained by adding substantially to gross official reserves. These doubled between 1968 and 1973 to a level that covered over 12 months' imports. (Table 13). The consequent increase in bank liquidity permitted domestic credit expansion to accelerate from just over 10 per cent of the initial money stock in 1968 to no less than 25 per cent in 1973. Real GDP growth accelerated to more than 11 per cent, spurred by an increasingly speculative boom in construction and stockbuilding as hedges against inflation. The rate of price increase had more than doubled to 12 per cent, on average, while interest rates remained close to their traditionally low levels.

The acceleration of economic activity stretched labor markets as much as product markets, with the increase in money wages outpacing that of prices by an increasing margin. Real wages that had not kept pace with productivity before now began to catch up bringing a reverse shift in the distribution of income almost within reach. (Table 1). As workers did not have the right to form independent trade unions, and the right to strike was severely circumscribed, their mounting impatience took mainly political expression. To raise the standard of living of workers and small farmers as quickly as possible thus became one of the primary objectives of the April Revolution. The other objective was to put an end to the colonial wars.

2. The wage explosion

The international environment in which the Portuguese revolution took place was not propitious. A fourfold increase in the price of petroleum contributed to a 24 per cent deterioration in the external terms of trade between 1973 and 1975. (Table 9). Given that imports equaled 33 per cent of GDP in

1973, this meant an 8 per cent reduction in the real purchasing power of the national product. The drive for a higher standard of living could not be turned back, however. To remove some of the perceived barriers to it, about 23 per cent of the cultivable land excluding forests was nationalized, and major industries accounting for 27 per cent of GDP, 50 per cent of investment, and 20 per cent of the labor force were also expropriated.

In response to popular demand, wages jumped by 34 per cent in real terms in the two years to 1975, while exchange rates continued to be held rigidly fixed. (Table 1). The loss of international competitiveness induced producers to shift from exports to local markets, and consumers from home to imported goods. The opposite should have been required in face of higher import costs and the recession in export markets abroad. Exports to Africa would have fallen in any case. But the loss of market shares now became general and did not begin to be corrected until competitiveness was eventually restored. (Chart A). Perhaps for confidence reasons, the increase in tourist receipts and especially of workers' remittances was also arrested and then reversed.

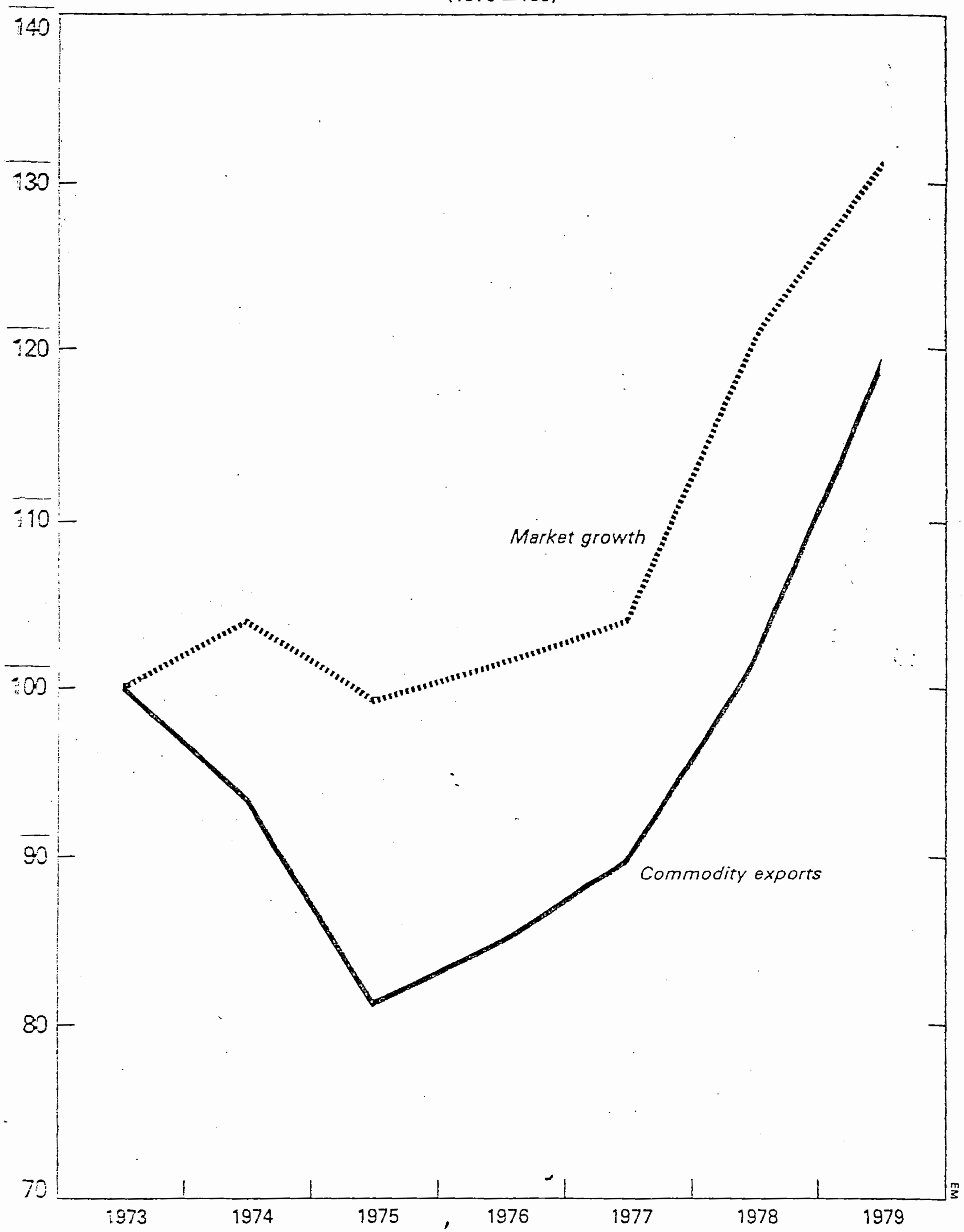
Had the momentum of growth been maintained, external deficits far higher still than those experienced would have emerged. Investment also fell, however. (Table 3). The catch-up in real wages produced a major shift in the distribution of income, raising the share of labor in the national income from 52 per cent in 1973 to 69 per cent in 1975, and squeezing profits. (Table 1). The external deficit, by draining liquidity from the banking system, reinforced the deflationary effect of the profit squeeze by adding a credit squeeze to it. (Table 6). Despite liberalized rediscount facilities domestic credit expansion slowed to 17 per cent of the initial money stock in 1975, from 25 per cent in 1973.

CHART A

PORTUGAL

INDEX OF EXPORT VOLUMES AND MARKETS

(1973 = 100)



Sources: IMF staff calculations; and Bank of Portugal, *Annual Report.*

In consequence, the growth of the economy slowed to 1 per cent in 1974, and then fell by over 4 per cent in 1975. (Table 3). The wage explosion had clearly played a major role in precipitating the loss of employment opportunities this entailed. In more normal external circumstances the excess labor supply should have been added to the flow of workers abroad. However, in consequence of the energy-induced recession, the flow of migrant workers to the European Community virtually dried up. Just when wage increases were being realized, therefore, the conditions for them had already disappeared. On top of this, the end of the colonial wars was bringing a reflow of settlers that added 12 per cent to the labor force. (Table 1). The unemployment rate accordingly rose to at least the 6 per cent officially recorded.

The fall in GDP would have been larger had not the same redistribution of income that produced the profit squeeze also buoyed consumption. 1/ Public and private consumption combined rose from 82 per cent of domestic expenditure to 96 per cent. (Table 3). The reduction in domestic saving at full employment did not match the drop in investment, but it narrowed sufficiently to moderate the decline in aggregate demand, and to produce a deficit on external current account equal to 6 per cent of GDP in 1975, compared to a surplus of 3 per cent two years earlier. Even excluding the relative decline in workers' remittances, the external deficit on goods and nonfactor services nearly doubled to 12 per cent.

The drop in private saving could not by itself have been enough to cushion the decline in output to this extent. A major contribution came from the public sector. The social goals of the Revolution required a considerable expansion of public sector activities; increases in tax rates and in social

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1/ "Portugal enjoys unexpectedly good economic health." (Dornbusch, Eckaus, and Taylor 1976).

security contributions could not keep pace with it. Accordingly, the public sector's current account swung from a surplus in 1973 to a deficit just under 3 per cent of GDP in 1975. (Table 5). The overall balance similarly swung into a deficit of 7 per cent of GDP. The liquidity created by it offset much of the drain from the banks abroad and into cash, but not enough to avoid a squeeze despite the prompt liberalization of rediscount facilities.

Since much of the fiscal deficit went to finance additional consumption, and to subsidize faltering enterprises, borrowing abroad to cover it proved impractical. Nevertheless, to protect real wages the exchange rate continued to be held rigidly constant, though to ease the pressure on the exchanges, an import surcharge was introduced in May 1975. Still, by the end of the year the stock of official reserves had dwindled to 46 per cent of its end-1973 level, (Table 15), with gold valued at its official price of SDR 35 an ounce. 1/ Even at this level, however, it covered the equivalent of six month's imports, sufficient, it was thought, to support an economic recovery that might validate existing real wage levels by raising productivity.

3. The crunch

In the spring of 1976 the Portuguese authorities took that chance and opted for reflation. Government spending was sharply increased. However, as the nationalizations of the preceding two years had concentrated on industries producing intermediate goods, and left the consumer goods and export industries largely untouched, the private sector had remained the main source of employment as well as of foreign exchange. To permit it to respond, a

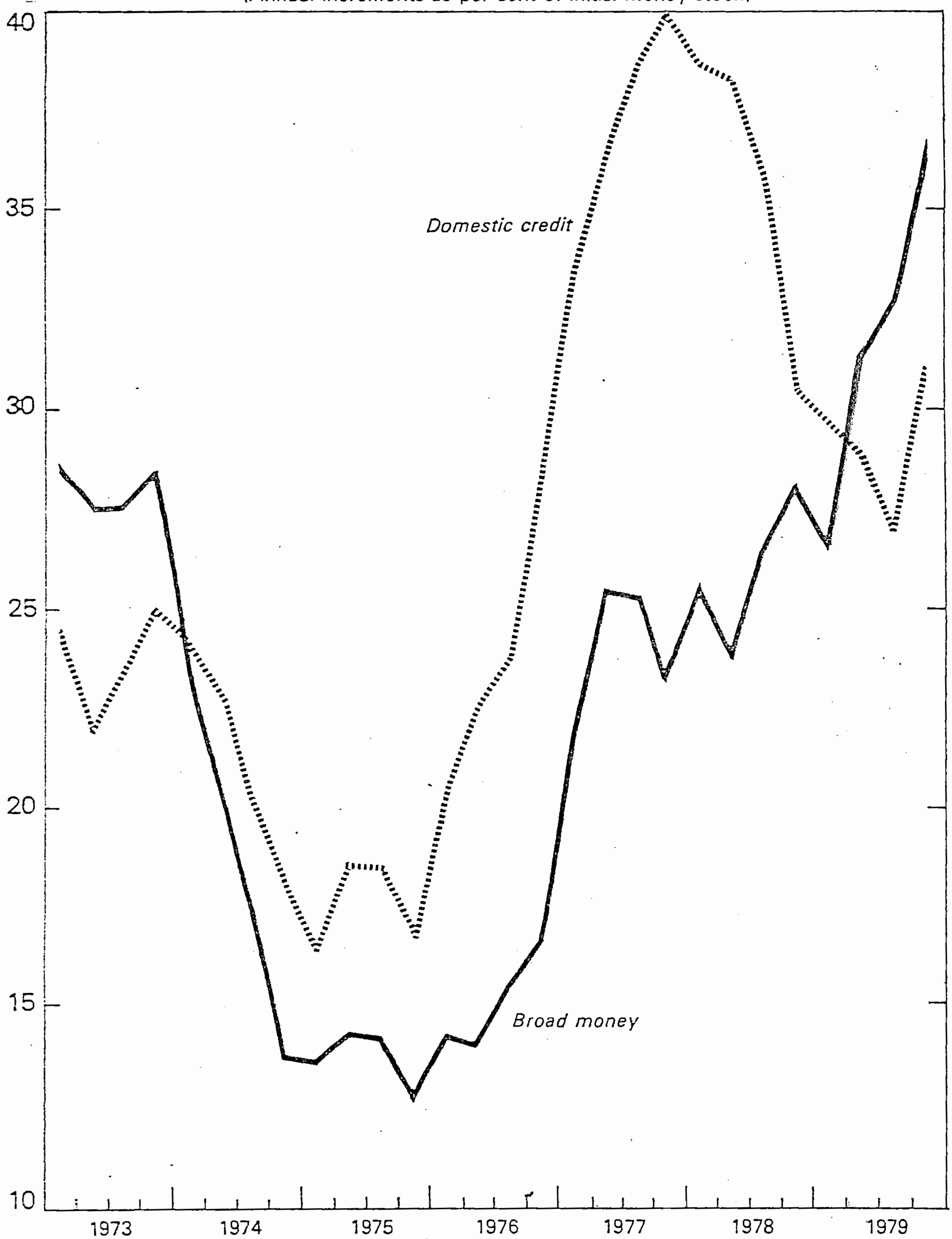
1/ "This is to be viewed as perfectly normal for a country in Portugal's position." (Dornbusch, Eckaus, and Taylor 1976).

CHART B

PORTUGAL

MONEY AND CREDIT

(Annual increments as per cent of initial money stock)



Source: Data supplied by the Portuguese authorities.

legal ceiling was imposed on nominal wage increases and administered prices were liberalized. Though some surreptitious depreciation of the escudo was tried early in the year, it was quickly abandoned because of speculation.

The restoration of profit margins still seems to have been modest on balance. (Table 4). Accordingly, interest rates were also kept low to encourage a recovery particularly in construction and also, some hoped, in exports, by keeping the cost of working capital down. (Cardoso 1979). Apart from providing needed housing for returning settlers and demobilized military personnel, construction would provide increased employment at little cost in foreign exchange. On the basis of the liquidity created by massive central bank financing of government deficits domestic credit was then to expand rapidly. (Table 1). It did, reaching 26 per cent of the initial money stock in 1976 and 39 per cent in 1977. (Chart B).

The response of GDP growth looked impressive. It accelerated to nearly 7 per cent in 1976 and held at 5 per cent in 1977. (Table 3). Launched on an uncompetitive base, however, the recovery was mainly directed to increasingly protected domestic rather than to foreign markets. 1/ Measured at international costs and prices the gain may well have been illusory over a wide range. Inflation followed, reaching 27 per cent in 1977 on average. The labor share of income, after reaching a peak of 69 per cent in 1976, now also fell back to 57 per cent. (Table 4). Employment benefited little, as many enterprises were holding excess labor because of legal barriers against dismissals. (Table 1). There was instead an apparent increase in productivity.

The increase in productivity was to be sustained beyond the recovery phase by increased investment, and gross investment did rise substantially. (Table 3). However, because of low interest rates and increasing inflationary expectations, it took mainly the form of speculative stockbuilding,

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1/ "The case for high tariffs or quantitative restrictions is clear cut." (Dornbusch, Eckaus, and Taylor 1976).

especially of imported goods, rather than of fixed capital (Table 4). House-building was held back by rent control and zoning problems, and also by the increasing competition of inventories and foreign currency holdings as hedges against inflation. (Cardoso 1979). Not surprisingly imports boomed, while exports and workers' remittances continued to lag behind.

In consequence the deficit on external current account widened inexorably to the equivalent of 8 per cent of GDP in 1976 and 9 per cent in 1977. 1/ An import surcharge had been introduced to stem purchases abroad as early as May 1975. Expanded in early 1976 it would raise effective protection to a range from 40 to 60 per cent. (Macedo 1979). Under severe pressure the authorities devalued the escudo by 15 per cent in February 1977 but again found that, without supporting measures, it could only fan speculation. By the end of 1977 the country's initial foreign exchange reserves had long been exhausted, (Table 15), and nearly 50 per cent of a dwindling gold stock had been pledged against short-term loans.

III. The Stabilization Debate

The earlier reorientation of the Portuguese economy toward Europe had found institutional expression first in 1962 when Portugal joined the European Free Trade Association, and then again in 1972 when a free trade agreement was signed with the enlarged European Community of the Nine. In March 1977 Portugal applied for full membership in the European Community, the democratic character of the Revolution having been confirmed in parliamentary elections the year before. The prospect of full membership by 1983 sharply raised the premium on Portugal's capacity to sustain high rates of growth in an open economy, which the acute balance of payments crisis was just then calling in question.

1/ "A disregard of external financing constraints" had been urged on the authorities. (Dornbusch, Eckaus, and Taylor 1976).

1. The Paris credits

The initial response to the mounting deficits in Portugal's external payments had been to try and finance them. 1/ Thus the European Free Trade Association, the European Investment Bank, and also the World Bank had begun to step up long-term development assistance. In addition, various European central banks either directly or through the Bank for International Settlements had helped by lending short-term against gold collateral, and the United States Treasury had supplied American gold for sale on Portuguese account against short-term repayment in kind. Even so, the Portuguese authorities, their foreign currency reserves now spent, would by mid-1977 find it necessary to sell their own gold outright.

With this prospect before them a group of 14 countries meeting in Paris agreed in June 1977 to supply US$750 million over 18 months in medium-term balance of payments support. (Table 13). While not tied to development projects nor secured by gold, most of the credits offered were to be linked to an upper tranche stand-by arrangement with the Fund. Portugal had already drawn on the Fund under the 1974 and 1975 oil facilities, also under the compensatory financing facility in 1976, and had entered into a first tranche stand-by arrangement following the February 1977 devaluation of the escudo. To ensure that the need for extraordinary assistance would be temporary, upper tranche conditionality was thought to be appropriate.

The availability of special balance of payments assistance was to permit a relaxation of restrictions in particular of the import surcharge. The required adjustment would still have to be large, however. The Paris credits, within a 12-month program period, would contribute US$500 million to which

1/ "The government should beg and borrow." (Krugman and Taylor 1978).

the Fund was prepared to add US$50 million. Based on recent experience, other capital inflows of perhaps US$250 million were thought to be in prospect on reasonable terms. The financeable current account deficit would therefore come to no more than US$800 million compared to one of US$1,200 million that was then estimated for 1977. The possibility of achieving this target without disastrous cuts in economic activity and growth was widely doubted.

2. The exchange rate

A policy was nevertheless proposed of holding real domestic expenditure constant in the program year, and by creating price incentives for a reduction in imports and expansion of exports, to allow an improvement in the external balance to produce a rate of growth sufficient to keep unemployment in check. Reducing the external deficit on current account to the US$800 million thought financeable in 1978, while keeping domestic demand unchanged, was calculated to produce a growth of GDP in that year not far below 4 per cent. It was of course necessary to assume that, whatever had originally contributed to the external deficit, an adequate depreciation of the escudo would help to correct it.

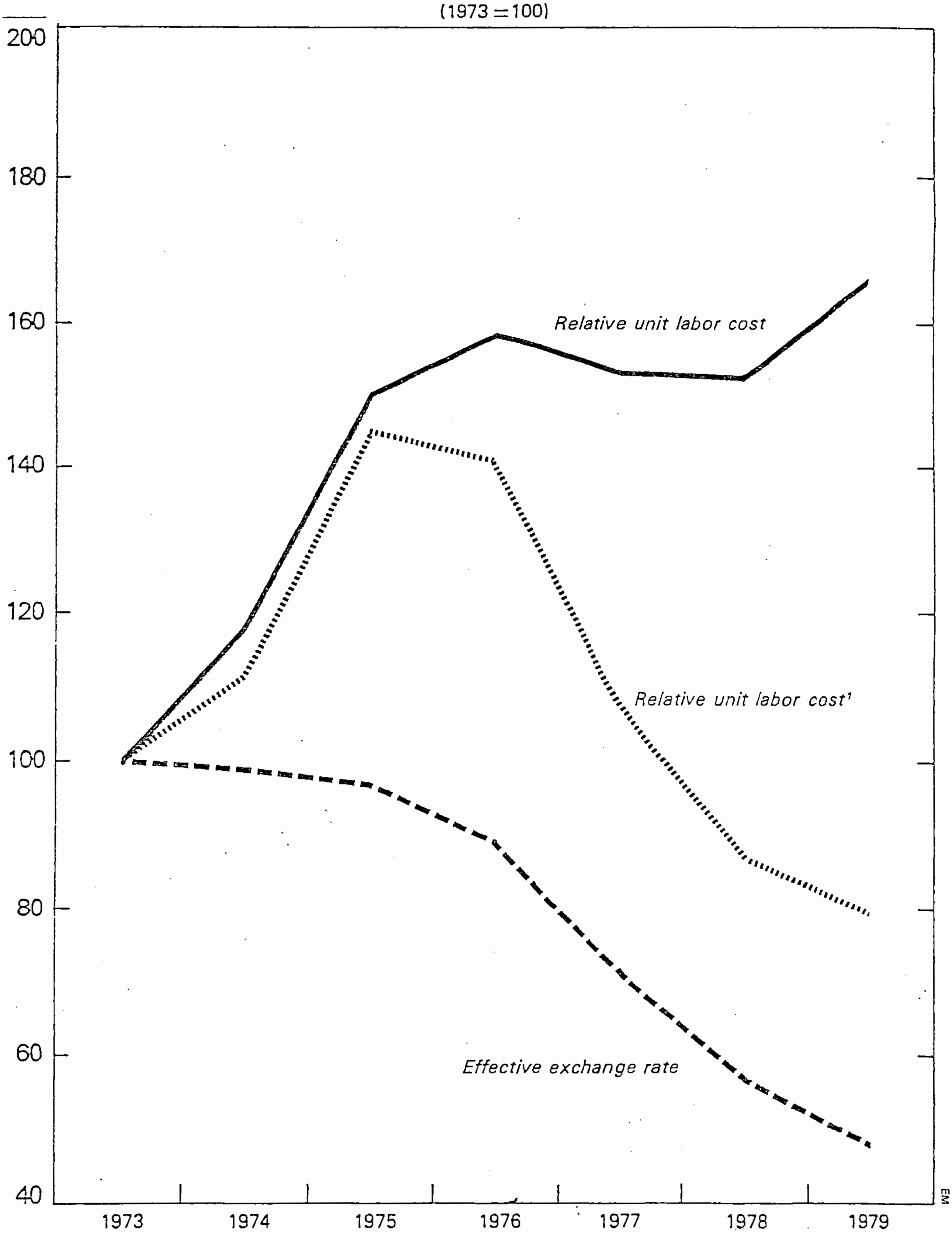
The devaluation that took place in February 1977 had not gone far enough to permit external equilibrium at full employment. (Chart C). Nevertheless, only such further exchange rate changes as would compensate for differential inflation rates were now thought acceptable, and a monthly depreciation to fit was announced in August 1977. Any attempt to do more was opposed on the grounds that both exports and imports were in fact highly insensitive to changes in relative prices. (Krugman and Taylor 1978). Additional depreciation would only increase the external deficit in local currency, and by causing leakages in purchasing power have a purely deflationary effect on economic activity.

CHART C

PORTUGAL

COMPARATIVE UNIT LABOR COSTS

(1973 = 100)



Sources: IMF staff calculations; and *IFS*.

[1] Adjusted for exchange-rate changes.

A more fundamental objection was that currency depreciation would require cuts in real wages to be effective. 1/ Raising the domestic price of exports and import substitutes would not give them an advantage if a parallel increase in money wages was allowed to push up the price of other goods, too. Similarly, without a shift of incomes from wages back to profits, saving was unlikely to rise to provide the margin over investment required for external adjustment. As long as the real wage was not corrected, therefore, the country would have to accept external deficits or else deflation-induced unemployment. (Krugman and Macedo 1979). Perverse price incentives, then, rather than any insensitivity to them, could still account for external deficits.

Exchange depreciation would have to go far enough to restore external balance at full employment. The enlarged labor force alone required that competitiveness would therefore have to be improved beyond its prerevolutionary level. Because of its distributional effects, however, there was great reluctance to risk further depreciation on the chance that exports and imports might after all prove responsive. An effort was to be made instead to tackle the current account deficit by substantially tighter control of import requirements in the government-controlled sector. The short-run effect of a shift in the composition of public investment, if it could be achieved, would at least buy time until a restructuring of the economy could take effect.

As a practical matter, however, the external deficit would have remained insupportably large without an early contribution from the nongovernment sectors. In the longer run surely, breaking the external constraint on growth would have required the encouragement of private investment in the external

1/ "Increases in real wages associated with political upheavals cannot be reversed." (Eckaus 1977).

sector, by raising its profitability through currency depreciation. (Krugman and Taylor 1978). If there was to be hope of keeping economic growth positive even in the short run, exchange rate action would have to be tried in any effort to reduce the external deficit to manageable proportions. In either case depreciation would have to go farther than it had in reducing the real wage to its competitive level.

3. Monetary policy

A program that would hold domestic expenditure constant, and rely on an improvement in the external balance as the sole source of growth, would require a firm monetary policy as well. An extraordinary expansion of domestic credit at low interest rates had not only financed a rapid expansion of domestic demand in the past, but also biased it substantially toward inventory accumulation particularly of imported goods. It had furthermore encouraged the illegal acquisition of foreign currency balances through over- and underinvoicing, and from tourists and emigrants. (Cardoso 1979). The relative unattractiveness of domestic financial assets had visibly reduced workers' remittances as well.

An apparent improvement in the external current account could have been achieved by reversing the capital outflows concealed in it. Domestic interest rates remained well below the expected escudo yield of foreign currency assets, however, even after substantial increases at the time the crawling peg was introduced in August 1977. It was hoped that financial markets might not be sufficiently integrated with those abroad to require parity. (Dornbusch and Taylor 1977). Adverse capital movements were argued to have been induced less by opportunities for interest arbitrage than by the prospect of discrete exchange rate changes, which the crawling peg should have eliminated.

The external current account might also have been improved by reducing the incentive to accumulate inventories as an inflation hedge. It was feared, however, that to raise interest rates above the inflation rate for this purpose, would have had an immediate adverse effect on economic activity and employment, while any effect on commodity speculation would at best have been delayed. 1/ The public would not shift from holding goods to holding money it was claimed. The increased cost of working capital would, on the contrary, create cash flow problems for all enterprises including those producing for export, and despite its low import content for the construction sector as well.

The claim that the demand for domestic financial assets should be quite so insensitive to the return on them could of course be doubted in turn. (Chart D). The banking system was virtually the only source of domestic finance and bank deposits the only financial instrument available to hold. The critical role of the banking system in providing efficient means for transferring claims over resources from savers to investors could hardly be in doubt. (Fry 1977). One should have thought, therefore, that any improvement in their yield could not fail to increase saving at any distribution of income. The public's holding of broad money had meanwhile shrunk in relation to GDP.

If commodity speculation continued while output declined due to cash flow problems, the external balance would certainly worsen rather than improve. On the other hand a failure to raise the demand for domestic financial assets could have had equally serious consequences. An increasing proportion of domestic credit expansion was being financed by bank borrowing abroad rather than at home, and by running down reserves. Now that these external sources were about to dry up, there was the threat that a commensurate reduction in credit expansion would create precisely the squeeze on working capital that

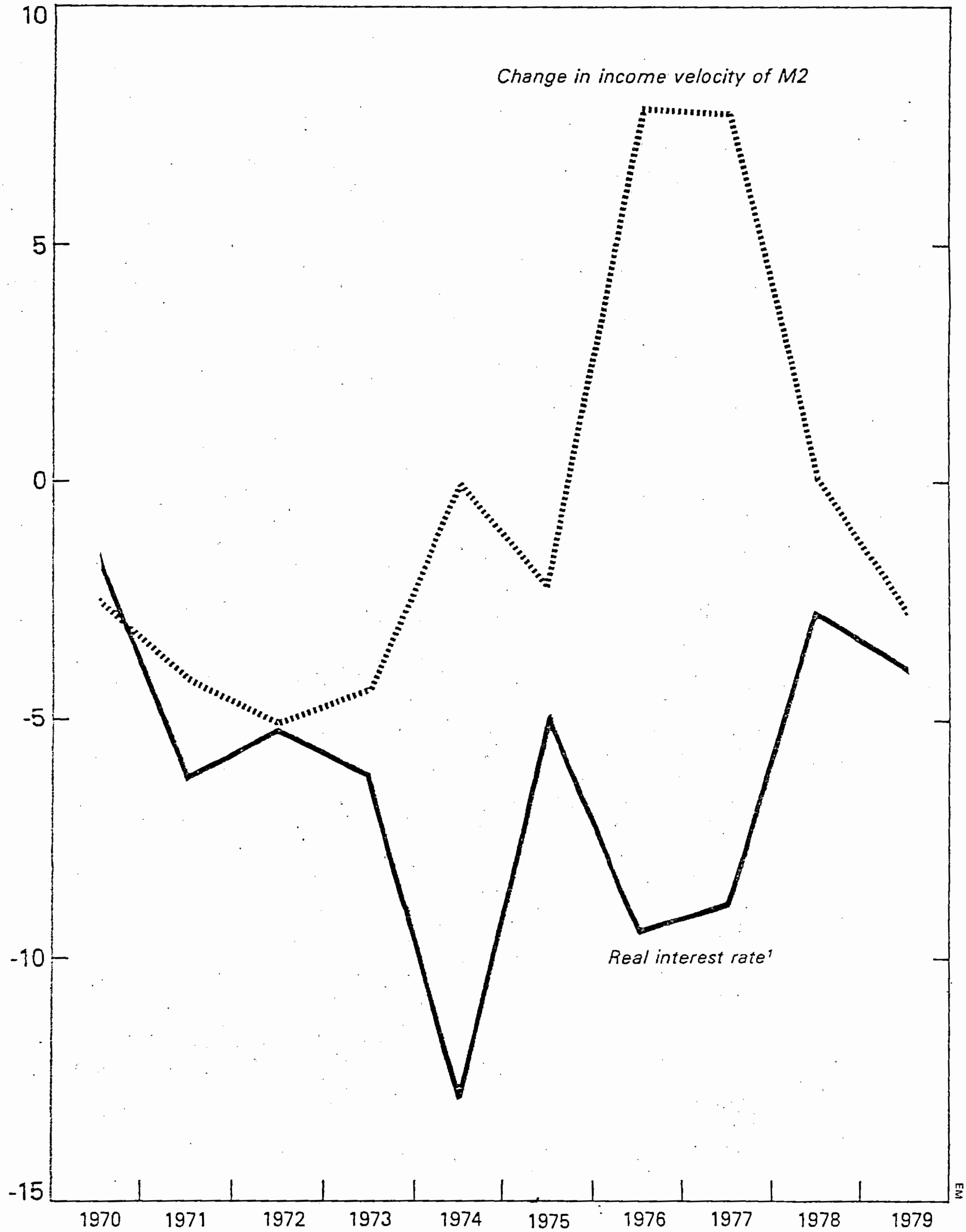
1/ "Large interest rate increases are completely unjustified" for this reason. (Dornbusch and Taylor 1977).

CHART D

PORTUGAL

VELOCITY AND INTEREST

(Per cent)



Sources: IMF staff calculations; and *IFS*.

[1] On 6-12 month deposits deflated by consumer prices including rents.

A recovery in the demand for domestic financial assets would permit a lesser credit squeeze for a given external result. Some increase in the cost of credit would of course be unavoidable to bring it about. But there seemed to be every reason to expect, in response, a fairly prompt and welcome dis-hoarding of speculative inventories and foreign currency balances. Even an across-the-board increase in lending rates, in line with deposit rates to safeguard operating margins for banks, need not have had perverse effects. The export sector would not suffer if a real depreciation was allowed to raise its operating surpluses. And the construction sector could similarly be spared by liberalizing rent controls.

In the end, the risk seemed worth taking, and domestic interest rates were raised to near parity with those abroad. Skepticism regarding their capacity to affect the demand for money also remained strong, however, and led to a supplementary fixing of ceilings on domestic credit expansion tighter than might otherwise have been thought consistent with the external target. There was of course no reason to expect the public sector to reduce its credit requirements for interest rate reasons alone. To protect the productive sector, therefore, and to ensure that its minimum working capital requirements would be met, bank credit to the public sector was limited within the total.

4. The government deficit

A policy of holding real domestic expenditure constant, while allowing an improvement in the external balance to produce continued growth, would require adjustments also in public finance. Along with the deterioration in the external accounts the financial position of the public sector had also worsened markedly. From modest surpluses, the balance of current revenues and expenditures had swung to a deficit of 3 per cent in relation to GDP, and the overall balance to one of 7 per cent. The social goals of the revolution required considerable expansion of public sector expenditures on both current and capital account. (Chart E). Revenues were also progressively increased but not by enough to close the gap.

The emergence of fiscal deficits was defended for their stabilizing effect on economic activity in a situation where the balance of payments was thought to have gone into deficit for structural reasons. With leakages of purchasing power abroad through the external deficit, the government should have had deliberately to inject fresh purchasing power by creating its own deficit to maintain employment. 1/ The drain of liquidity through the exchanges would otherwise put a squeeze on the private sector, adding another deflationary impulse by cutting investment, had it not been for the offsetting liquidity created by the public sector.

There had of course been no conscious policy to compensate for the worsening external balance. Given a certain investment effort, the public sector deficit was the result of a determined effort to redistribute income, mainly through transfers and subsidies, and of the failure of revenues to match them. (Cavaco-Silva 1979). Transfers supported expanded coverage of social security, the creation of unemployment insurance, and improvements in pensions; subsidies went mainly to public enterprises particularly in transport, and to support lower prices on certain essential products. Both, like higher wages, added costs to the economy that could be seen as contributing to rather than compensating for external deficits.

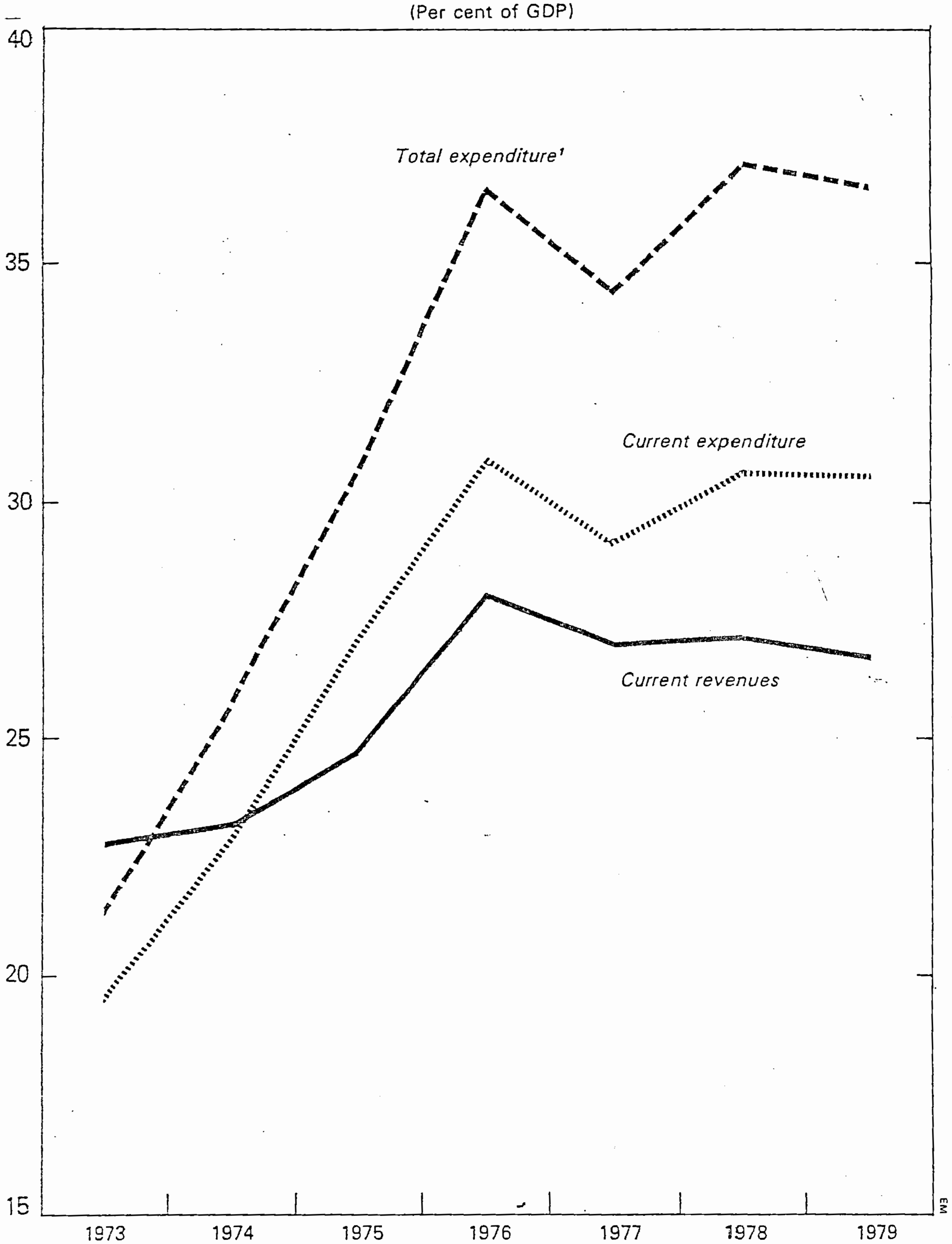
1/ "Far from being inflationary finance a government deficit in such circumstances supports demand." (Krugman and Taylor 1978).

CHART E

PORTUGAL

PUBLIC REVENUES AND EXPENDITURES

(Per cent of GDP)



Source: Bank of Portugal, *Annual Report*.

[1] Current plus net capital expenditures.

The need for a compensating fiscal deficit would in any case diminish once the external balance began to improve. There would then be no longer the same absorption of liquidity through the exchanges and no further deflationary contraction to offset. The liquidity created by continuing public sector recourse to bank credit would now have to be held at home, either by driving prices high enough to keep it there, or by tightening credit to the private sector. To keep the fiscal deficit from being inflationary under these circumstances, the cost of credit to the private sector would have had to rise, producing a contraction in output and employment rather than preventing it. (McKinnon 1979).

Whatever the direction of causation, therefore, a successful effort at external adjustment would need to have a fiscal counterpart. To safeguard an adequate supply of credit to private exporters and investors a limit would have to be placed on the overall public sector deficit. If the public sector was to make a contribution to the increased savings on which a reduction in the external current deficit depended, the fiscal balance on current account would also have to be improved. If the standard of social services was to be protected then the main emphasis would have to be placed on increasing revenues. It was recognized that the burden of increased revenues would have to fall mainly on consumption.

5. <u>The Fund stand-by</u>

When agreement was reached on the stabilization program in May 1978, the external current account deficit for 1977 was thought to have reached US$1,500 million. The program objective was therefore raised to a notional target of US$1,000 million for the 12 months to March 1979, despite the risk that its financing might at least initially require further sales of gold.

This was regarded as the outside limit, however. Setting inflows of nonmonetary capital at a likely minimum of US$200 million left a maximum permissible loss of net foreign assets by the banking system of US$800 million. This figure was made a performance clause, (Table 8), in the sense that Fund drawings would be contingent on compliance with it.

Attainment of this objective was to be ensured through interest and exchange rate policy; both were to be flexibly adjusted to developments in the net foreign asset position of the banking system. Interest rates had already been raised in two steps from 9 to 19 per cent on 6 to 12 month bank deposits for example. A crawling peg for the escudo was introduced in August 1977 and strengthened in May 1978 which, in combination with a continued ceiling on nominal wage increases, was to improve the country's relative cost position well beyond its 1973 level. Pressure on the external position would not lead to an intensification of restrictions, therefore. Indeed, adherence to a precise schedule for reductions in the import surcharge was also made a performance clause.

These provisions should in principle have been sufficient to produce the desired results, but in view of the uncertainties concerning the efficacy of the instruments chosen, a fall-back position was deemed desirable. In the context of the traditional ceiling on domestic credit expansion, it was thought possible to limit recourse to bank finance by the public sector as an inducement to fiscal discipline, and both were again made performance clauses. The ceilings looked tight, reflecting skepticism on the likely response of financial saving to interest rate increases, and led to caution also on the likely growth of GDP that would be consistent with them. Less than 2 per cent was officially forecast, together with an inflation rate of 25 per cent.

IV. Economic Outturn

The recovery of the Portuguese balance of payments, once the stabilization program was implemented, turned out to be as rapid as its previous deterioration had been. In relation to GDP an external deficit on current account equivalent to 9 per cent in 1977 was turned into a small surplus once more in 1979 (Table 9). The overall balance on nonmonetary transactions changed from a deficit of US$1,430 million to a surplus of US$1,350 million over the same the same two years. This dramatic turnaround was achieved with a minimum loss of momentum in the rate of economic growth, which was maintained at 3.2 per cent and 4.0 per cent in real terms in 1978 and 1979, respectively. (Chart F). The rate of price inflation dropped below 25 per cent on average.

1. Impact effects

Though the size of the adjustment may have caused surprise, its main features are not difficult to identify. 1/ Real domestic demand was held virtually constant in both stabilization years, leaving the recovery in the external balance on goods and nonfactor services to contribute all but one half of a per cent to the real growth of GDP. (Table 3). Even so, this improvement contributed only one third to the swing in the external current account in nominal dollar terms. (Table 9). Fully two thirds were contributed by an increase in the surplus on factor services, mainly of workers' remittances, even after allowing for increased interest payments abroad.

The external recovery can in the first instance be traced to exchange rate changes. These helped to improve the country's competitive position as measured by relative unit labor cost by 20 per cent beyond its 1973 level. Nominal wage increases had remained below their legal limits in both years,

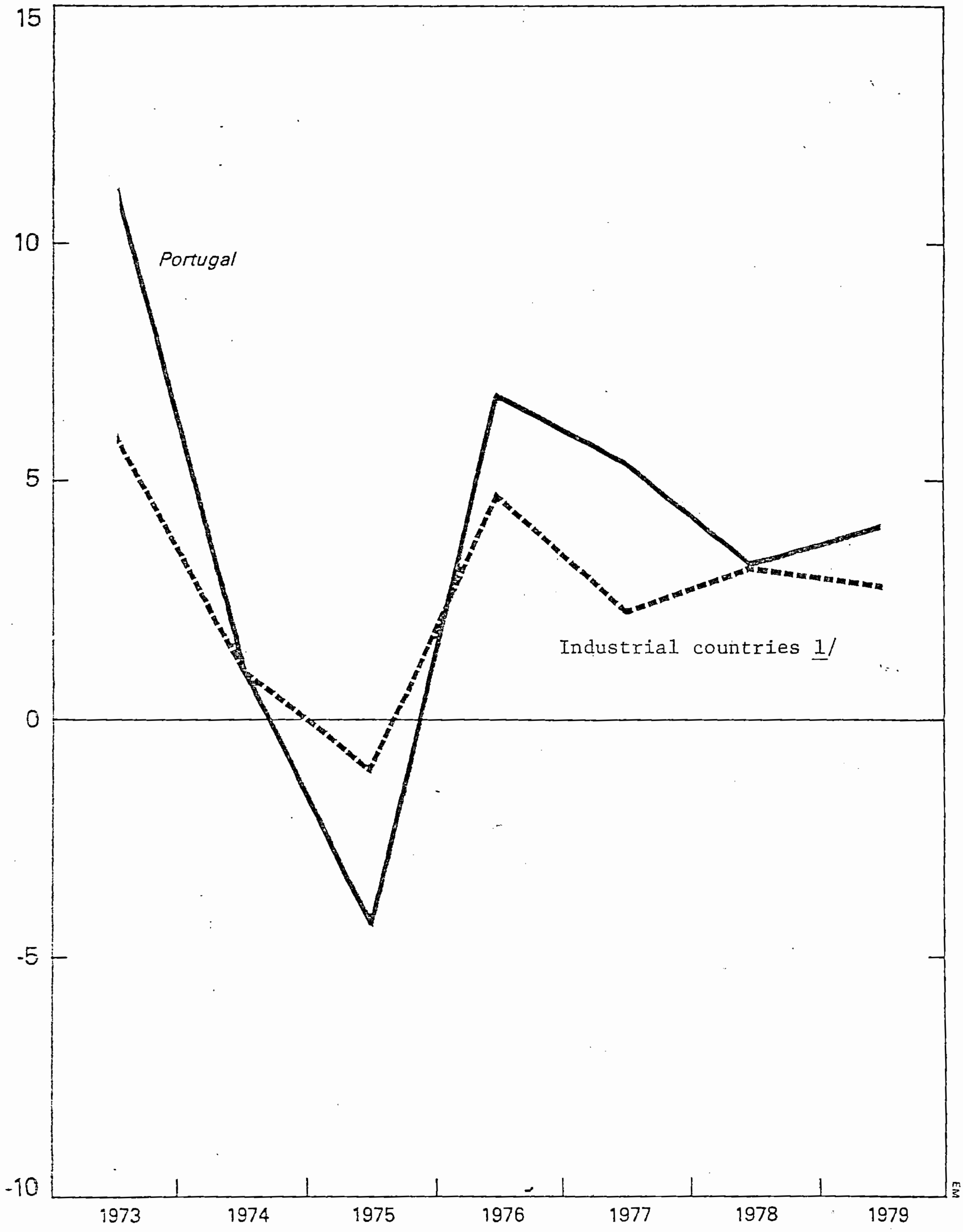
1/ "The macro-problems raised by a 'structural' foreign deficit have evaporated." (Eckaus and Taylor 1979).

CHART F

PORTUGAL

GROWTH RATE OF REAL GDP

(Per cent)



Sources: *IFS* and *DOT*.
1/ Trade-weighted.

reflecting downward pressure from the accumulated overhang of unemployed workers and returnees. 1/ Accordingly, the real wage dropped 20 per cent below the plateau it had reached in 1976. (Table 1). In response, exports of goods and nonfactor services rebounded, rising 15 per cent in volume in 1978, and fully 26 per cent in 1979, while imports paused before resuming a more normal growth. (Chart G).

The effect on the external balance of interest rate increases was equally striking. Though real interest rates remained negative, the margin below cost of living increases shrank from nearly 9 per cent to less than 3 per cent, arresting and then reversing the decline in the public's willingness to hold domestic financial assets. (Table 6). The consequent drop in stockbuilding was the major factor in holding real domestic demand, and imports, virtually constant between 1977 and 1978. (Table 3). Predominantly financial motives also prompted the overwhelming response of workers' remittances, and may have been a factor in the recovery of tourist receipts per night spent. (Cardoso 1979).

A final element in the external adjustment was the ceiling on domestic credit expansion. (Table 8). This ceiling had been set on the basis of a lower increase in the stock of domestic financial assets than in fact took place, and was therefore tighter than it was meant to be even with the degree of flexibility found in the exclusion of bad debt. However, the need for credit was also being reduced by an exchange rate policy designed to improve the possibilities of internal finance for enterprises producing exports and import substitutes. In addition, the response of foreign credit to domestic tightness turned out to be far more substantial than had been expected, sustaining output while adding to the improvement in the external balance.

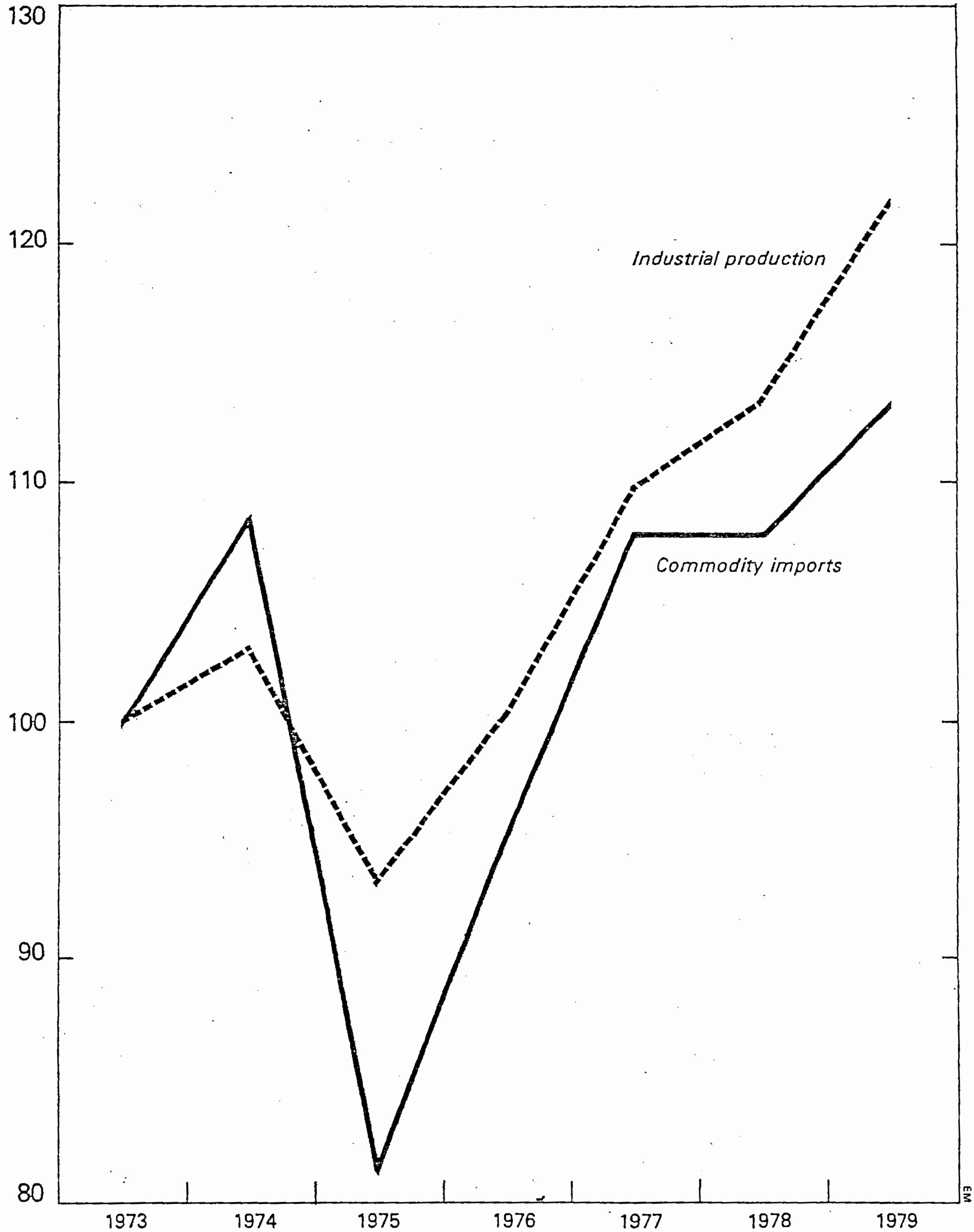
1/ "The eventual direction of Portuguese policy has thus been determined by the logic of the situation." (Krugman and Macedo 1979).

CHART G

PORTUGAL

INDEX OF INDUSTRIAL PRODUCTION AND IMPORTS

(1973 = 100)



Source: Bank of Portugal, *Annual Report.*

The public sector deficit unfortunately remained higher than had been planned. To be sure, the Government was also able to mobilize substantially larger amounts of financing abroad than had been anticipated. In the logic of credit ceilings, a greater recourse to foreign financing by the public sector should have left more of a margin of domestic credit expansion to go to the private sector. As it happened, however, there was also a greater recourse by the public sector to the banking system than had been intended. (Table 8). Within the domestic credit constraint, therefore, a greater burden of adjustment was placed on the private sector than should have been required. (Cavaco Silva 1979).

2. Structural change

A much greater than expected recovery in the external balance was achieved at rates of growth for the Portuguese economy equal to or above the average for its main trading partners. Industrial production alone continued to rise at 6-7 per cent through both stabilization years compared with 3-4 per cent elsewhere. The balance of payments constraint on growth was thus largely removed. In consequence it was possible to begin reversing the drift to trade and payments restrictions that had characterized the period of disequilibrium. With the stabilization program the authorities had announced a schedule for the phasing out of the import surcharge, and held to it for all steps but the last.

To achieve this result the stabilization program was designed to begin dealing with some of the more intractable structural problems of the Portuguese economy. The first was to restore the competitiveness of the economy to the point where it could sustain external balance at full employment. Apart from its effects on costs, the wage explosion had also contributed to a decline in national saving that reinforced rather than offset the effect on the external balance of the terms of trade, at a time when an increased labor force required of the terms of trade, at a time when an increased labor force required a higher level of activity to be absorbed. 1/ By 1979 real wages had been corrected, and the share of wages in the national income restored to the 52 per cent they had absorbed in 1973 (Table 4).

A second structural improvement set in train by the stabilization program concerned the mobilization of domestic saving through the financial system. The role of the financial system had shrunk in the crisis years as inflation accelerated while interest rates were kept low. Compared to 1973, the public's holding of broad money claims had declined in real terms to 85 per cent in 1977; the increase in real interest rates now restored it to 98 per cent. In relation to GDP broad money claims had declined to 91 per cent but now rose back to their initial 100 per cent. As the capacity of the monetary system to mobilize domestic saving continued to improve, domestic credit could also expand without placing undue stress on the external balance.

A strengthening of the financial position of the public sector was the third fundamental change the stabilization program was meant to initiate. Tax revenues had failed in the past to keep up with rising social expenditures. The current account of the public sector had thus moved sharply into deficit and the capacity of the economy to grow was thereby reduced. The 1978 budget planned to eliminate that deficit which had stood at 2 per cent of GDP the year before. (Table 5). Instead it rose to 3.5 per cent in 1978, the result in

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1/ "Real wages are at the heart of Portugal's experience in recent years." (Krugman and Macedo 1979).

equal parts of revenue shortfalls and expenditure overruns, and to 4.5 per cent in 1979. 1/ A large part of the increase in private saving was thus dissipated by an increase in net public consumption.

The stabilization program had also been intended to foster a substantial redirection of domestic investment. Leaving stockbuilding aside, the investment boom that had raised real gross fixed capital formation by fully 12 per cent in 1977, was thought to have been seriously misdirected toward capital-intensive production for the home market. (Table 3). A careful reappraisal of the public sector investment program was in any case overdue. It was also recognized that any general reorientation toward labor-intensive export-oriented investment would entail at least a temporary reduction in the total. After slowing down to 4 per cent in 1978, gross fixed domestic investment did in fact drop slightly in 1979.

A last structural change that the stabilization program was meant to encourage concerned labor markets. There had been no recovery at all since 1975 in the flow of migrant workers aborad. (Table 1). Nor had the rapid expansion in economic activity prior to stabilization increased employment opportunities sufficiently to prevent a persistent rise in unemployment. The change in the direction of economic growth after 1978 was expected to foster labor intensive export-oriented enterprises. These have now begun to draw on the pool of openly unemployed, bringing the unemployment rate down for the first time since the Revolution, and will soon need to draw labor from declining enterprises to maintain their momentum.

A large part of the improvement in the external position of the economy came on capital account. The Government which borrowed net some US$90 million in 1976-77 could now raise over US$ 800 million in 1978-79, while the private nonbank public turned from small repayments to net borrowing of over

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1/ "A reduced fiscal deficit or an actual surplus in devoutly to be wished." (McKinnon 1979).

US$1,000 million. No limits were set in the stabilization program on the accumulation of nonbank foreign debt. As access to international capital markets has eased, however, the authorities have begun to monitor external borrowing more closely, with a view to conserving the country's borrowing capacity for the time when a more firmly managed development effort can be launched.

3. Current prospects

The external terms of trade of Portugal remained broadly stable, after declining by nearly 25 per cent between 1973 and 1975, until the international price of petroleum jumped once more at the end of 1979. The energy import bill is likely to nearly double once more as a result, and to rise in proportion to total imports from some 11 per cent to perhaps 14 per cent. The Portuguese economy is in a better position this time to absorb the shock. The external current account is bound to swing back into deficit and to absorb national saving that might otherwise have been added to investment. Nevertheless, if care is taken to maintain a steady policy stance, an adequate capital inflow should be forthcoming to cover the gap.

The recent growth of the Portuguese economy has again been predicated on a rapid expansion of exports. As the growth of world markets begins to slow down once more, the need to maintain external competitiveness takes on added importance. While continued wage restraint remains essential for the purpose there appears to be no present case for further reductions in real wages. The main concern will shift instead to the need to expand market access abroad. After some hesitation, exports to the European Community have expanded once more from 52 per cent of the total in 1977 to 57 per cent in 1979.(Table 10). To safeguard this trend against protectionist pressures, full membership in the Community is being sought.

Superimposed on buoyant exports it has again been workers' remittances that underpinned the recovery of the external balance on current account. However, without any upsurge in the flow of emigrant workers abroad, remittances have contained a large capital repatriation element, and are therefore unlikely to continue expanding at recent rates. Even with entry into the Community, the flow of workers to the rest of Europe should not recover very soon, and while this prospect will reinforce the need for less reliance on emigrants' remittances in the future, it should also prevent renewed upward pressure on real wages unrelated to the growth of productivity at home.

The massive capital inflow following stabilization has been a novel feature in the Portuguese balance of payments. It is no doubt appropriate that in place of labor moving abroad in search of capital, capital should now come into employ labor at home. Most of the inflow to date has been of portfolio capital and of debt, including short-term debt, and should continue as long as interest rates are kept at realistic levels. As yet there has been no major response of direct investment, however. The attraction of direct investment for Portugal lies in the fact that it is drawn to productive projects that do not give rise to an outflow of income and amortization payments abroad unless they succeed.

The deficit in the public sector budget on current account continues at a level equal to 3 per cent of GDP, and for a given investment effort, places a commensurate burden on the external balance on current account. As long as this condition persists, there is no warrant for financing external deficits at a rate that raises the debt service burden faster than the country's foreign exchange earnings rise. An external deficit that cannot be financed on this criterion risks being unsustainable over time, and needs to be reduced. In Portugal, future reductions in the external deficit are best achieved by reducing the deficit in the public sector budget on current account.

V. Conclusion

The Portuguese balance of payments, after recording substantial deficits for a number of years, swung back into a surplus with the implementation of a comprehensive stabilization program in 1978. The external adjustment was achieved while maintaining the growth of the economy at a rate equal to or above the average for the country's main trading partners. The thrust of the stabilization program had been to ease the balance of payments constraint on growth by increasing national savings at full employment. The outturn confirmed that there was in Portugal no conflict between balance of payments adjustment and the pursuit of growth and development objectives.

The critical element in the Portuguese stabilization effort was its heavy reliance on exchange and interest rate policy. They could not have had their desired effect on saving without a substantial reduction in real wages. It was recognized that such a reduction would make for a more unequal distribution of income by shifting it against labor. It had become abundantly clear, however, that a more equal distribution of income had lowered saving, and therefore tightened the balance of payments constraint on growth. The distribution of income therefore offered a rather tight trade-off between present and future welfare for the nation as a whole, including in particular the labor force.

In designing the Portuguese stabilization program a choice was made against controls and in favor of incentives. The efficacy of price incentives was widely doubted on the grounds that Portugal's balance of payments difficulties were structural in character. If the misallocation of resources that produced the deficit was due to rigidities that had to be accepted, financing it would be the only alternative to controls. If on the other hand distortions rather than rigidities lay at the root of it, then adjustment would be an option. It seemed unwise, in the end, to add perverse incentives to whatever rigidities may have been present. The decision to correct incentives was amply vindicated by the results.

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Table 1. Portugal: Population and Employment

(In thousands; end of period)

	1968	1973	1974	1975	1976	1977	1978	1979
Population	9,068	8,564	8,650	8,947	9,123	9,168	9,204	9,338
Civilian labor force	3,525	3,546	3,853	3,957	4,096	4,107	4,157	4,251
Employment	3,208	3,303	3,767	3,739	3,820	3,781	3,809	3,906
Unemployment 1/	...	...	86	222	276	326	348	344
Unemployment rate 2/	...	...	2.2	5.6	6.7	7.9	8.4	8.1
Memorandum items:								
In thousands per annum:								
Net immigration 1/		-119.9	-70.3	-44.9	-33.2	-28.8	-24.5	-24.4
African returnees		--	99.4	339.6	--	--	--	--
Military manpower		...	95.0	108.0	65.0	70.0	53.0	54.0
Annual per cent changes in:								
Annual earnings in manufacturing		24.7	40.0	37.9	17.1	15.5	11.9	18.0
Consumer prices including rents		12.9	25.2	15.2	21.1	24.0	22.5	18.0
Real earnings in manufacturing		10.5	11.8	19.7	-3.3	-6.8	-8.7	-4.8

Source: Data provided by the Portuguese authorities.

1/ Excluding African returnees.
2/ As per cent of civilian labor force.

Table 2. Portugal: National Product Accounts

	1968	1978	1968/73	1974	1975	1976	1977	1978	1979
	In per cent of total		Real annual per cent change						
Agriculture 1/	20.8	13.8	-0.8	-2.1	-1.9	-1.5	-10.0	4.0	6.5
Mining	0.7	0.6	5.0	14.8	2.9	-14.3	15.3	1.2	10.0
Manufacturing	32.5	35.5	9.6	3.1	-9.7	4.5	9.4	3.3	3.6
Electricity, gas, and water	2.5	2.8	10.4	13.9	3.2	0.3	20.0	6.5	6.5
Construction	5.1	5.5	9.2	3.5	-15.8	5.0	11.0	5.0	-1.8
Private services	28.9	30.0	8.4	-4.5	-5.3	7.7	5.8	3.1	4.0
GDP at factor cost less public administration	90.5	88.2	7.5	0.5	-6.0	4.6	5.4	3.1	3.9
Public administration	9.5	11.8	9.5	15.0	30.9	18.6	7.0	6.0	6.0
GDP at factor cost	100.0	100.0	7.6	1.8	-2.7	6.1	5.6	3.4	4.1
Memorandum items:									
Annual percentage changes:									
Industrial production index			6.2	2.3	-4.8	3.2	13.2	6.8	7.2
Real GDP per employed worker			7.0	-1.1	-2.0	3.8	6.7	3.0	1.6
Real GDP per head of population			8.8	0.8	-5.9	4.0	5.1	3.0	2.6
Escudo billions at current prices:									
GDP at factor cost				308.6	347.4	434.9	563.8	715.4	915.8
GDP at market prices				338.4	376.2	467.6	622.2	781.9	991.1

Source: Data provided by the Portuguese authorities.

1/ Includes forestry and fisheries.

Table 3. Portugal: National Expenditure Accounts

	1968	1978	1968/73	1974	1975	1976	1977	1978	1979
	In per cent of total		Real annual percentage growth						
Private consumption	76.5	74.2	6.8	9.7	-0.9	2.0	0.6	0.8	1.0
Public consumption	13.2	14.3	6.6	17.3	6.6	7.0	9.3	8.4	5.2
Investment	16.4	23.1	13.2	-8.5	-45.3	32.8	29.5	-4.7	-4.3
Fixed capital	(16.4)	(20.0)	(11.2)	(-7.0)	(-11.3)	(1.0)	(12.0)	(4.0)	(-1.4)
Stockbuilding 1/	(--)	(3.1)	(1.9)	(-0.8)	(-8.5)	(5.2)	(3.7)	(-2.0)	(-0.7)
Domestic expenditure	105.0	111.6	8.1	6.3	-8.9	8.2	7.0	0.5	0.5
Exports of goods and services	23.6	20.0	6.5	-15.7	-15.6	--	5.9	14.5	26.2
Imports of goods and services	-28.6	-31.5	9.5	4.8	-25.2	3.4	12.0	-0.1	5.7
Gross domestic product at market prices	100.0	100.0	7.4	1.1	-4.3	6.9	5.3	3.2	4.0
Memorandum items:									
Partner countries' real GDP 2/			4.6	1.0	-1.1	4.7	2.3	3.2	2.9
Contributions to growth rate: 1/									
Domestic expenditure			9.9	6.9	-10.2	8.0	8.1	0.6	0.5
Stockbuilding			1.9	-0.8	-8.5	5.2	3.7	-2.0	-0.7
Foreign balance			-3.5	-5.8	5.9	-1.1	-2.9	2.6	3.5
GDP deflator			6.3	19.4	15.8	16.0	26.4	21.8	22.6

Sources: Data provided by the Portuguese authorities; and staff estimates.

1/ Change in constant prices over previous year's GDP.
2/ Industrial countries trade weighted.

Table 4. Portugal: Saving and Investment

(Per cent of GDP at market prices)

	1968	1973	1974	1975	1976	1977	1978	1979
Investment	19.9	26.3	24.9	16.4	20.8	25.4	23.5	22.1
Gross fixed capital formation	16.8	20.4	19.7	19.7	19.0	20.2	20.6	19.8
Stockbuilding	3.1	5.9	5.2	-3.3	1.8	5.2	3.1	2.3
Saving	19.9	26.3	24.9	16.4	20.8	25.4	23.5	22.1
External saving	...	...	6.2	5.6	8.0	9.2	4.3	-0.9
Remittances from abroad (net)	...	...	8.3	7.0	6.3	7.0	9.5	12.4
Private domestic saving	...	...	10.0	6.3	9.2	11.5	13.1	14.4
Public sector saving	2.9	3.2	0.4	-2.5	-2.8	-2.0	-3.4	-3.8
Memorandum items:								
Wage bill as per cent of national income 1/	...	...	...	66.3	68.7	60.6	56.5	52.6
Private saving as per cent of disposable income	...	...	...	13.1	14.3	13.2	16.3	19.7

Source: Data supplied by the Portuguese authorities.

1/ Including social security contributions.

Table 5. Portugal: Public Sector Accounts

(National accounts basis; in billions of escudos)

	1968	1973	1974	1975	1976	1977	1978	1979 1/
Current receipts	31.3	63.8	77.8	93.2	131.4	168.0	212.2	264.3
Direct taxes	13.7	28.8	36.1	47.1	60.7	80.9	103.6	124.0
Indirect taxes	15.1	30.4	37.0	41.8	61.7	79.3	97.5	122.0
Other	2.5	4.6	4.7	4.3	9.0	7.8	11.1	18.3
Current expenditure	27.1	54.8	76.6	102.5	144.4	180.6	238.5	302.2
Goods and services	19.6	37.1	49.1	58.0	66.1	88.2	114.7	147.6
Subsidies	2.0	2.9	7.6	7.5	17.1	20.9	30.9	46.5
Transfers	4.6	13.6	18.4	34.3	56.1	60.9	71.3	79.6
Interest payments	0.9	1.2	1.5	2.8	5.1	10.6	21.6	28.5
Current balance	4.2	9.0	1.2	-9.3	-13.0	-12.6	-26.3	-37.9
Capital receipts	--	3.8	4.5	5.0	2.4	3.6	3.5	4.2
Capital expenditures	5.1	10.2	12.7	14.2	22.3	36.5	66.5	64.9
Investments	3.8	5.8	6.8	9.1	12.8	25.1	30.9	36.4
Transfers	-0.5	2.5	3.4	6.1	7.7	8.7	11.7	10.5
Net lending	1.8	1.9	2.5	-1.0	1.8	2.7	23.9	18.0
Capital balance	-5.1	-6.4	-8.2	-9.2	-19.9	-32.9	-63.0	-60.7
Overall balance	-0.9	2.6	-7.0	-18.5	-32.9	-45.5	-89.3	-98.6
Memorandum items:								
Ratios to GDP:								
Current revenues	22.0	22.7	23.0	24.8	28.1	27.0	27.1	26.7
Current balance	3.0	3.2	0.4	-2.5	-2.8	-2.0	-3.4	-3.8
Overall balance	-0.6	1.4	-2.3	-4.9	-7.0	-7.3	-11.4	-9.9

Source: Data supplied by the Portuguese authorities.

1/ Provisional.

Table 6. Portugal: Monetary Survey

(Stocks in billions of escudos; end of period)

	1973	1974	1975 1/	1975 1/	1976	1977	1978	1979
Net foreign assets	77.8	63.3	38.9	39.1	5.0	-33.5	-18.9	40.8
Net domestic credit	248.5	303.0	359.8	406.6	518.3	702.6	874.9	1,100.5
Private sector 2/	249.5	293.8	326.3	365.9	442.8	579.3	703.2	852.2
Public sector	-1.0	9.2	33.4	40.9	75.5	123.3	171.7	248.4
Per cent of total	(-0.4)	(3.0)	(9.3)	(10.1)	(14.6)	(17.5)	(19.6)	(22.6)
Monetary liabilities	301.3	342.3	385.5	394.9	460.8	567.4	726.6	991.8
Money supply	165.6	182.5	227.2	227.7	246.3	274.8	314.9	396.5
Currency in circulation	(38.3)	(69.7)	(109.8)	(111.7)	(110.4)	(113.3)	(121.4)	(142.1)
Demand deposits	(127.3)	(112.8)	(117.4)	(116.0)	(135.8)	(161.2)	(192.9)	(251.2)
Quasi-money	135.7	159.8	158.2	167.2	214.5	292.6	411.7	595.3
Other items, net	25.0	24.0	13.3	50.8	62.5	101.6	129.4	149.5
Memorandum items:								
Percentage changes in:								
DCE over initial money stock	25.0	18.1	16.6	--	28.3	40.0	30.4	31.0
Money stock over year earlier	28.4	13.6	12.6	--	16.7	23.1	28.0	36.5
Per cent change in income velocity 3/	-4.5	--	-2.2	--	7.8	7.7	0.1	-2.8
Level of real interest rates 4/	-6.1	-12.9	-4.9	--	-9.6	-8.9	-2.9	-4.0

Source: Data provided by the Portuguese authorities.

1/ Change in series.
2/ Including uncollectible items.
3/ Annual averages on GDP at market prices.
4/ Annual averages on 6-12 month deposits.

Table 7. Portugal: Monetary Base

(Stocks in billions of escudos; end of period)

	1975	1976	1977	1978	1979
Base money	130.8	139.6	147.3	169.5	223.1
Currency in circulation	111.7	109.2	113.3	121.4	142.2
Reserves of other banks	19.1	29.2	33.7	47.5	77.8
Legal	(...)	(...)	(25.8)	(42.3)	(59.3)
Excess	(...)	(...)	(7.8)	(5.2)	(18.5)
Other monetary liabilities	--	1.3	0.3	0.6	3.1
Financing	165.4	169.9	202.2	240.7	288.6
Net claims on abroad	32.0	3.1	-13.4	-4.9	7.6
Net credit to public sector	33.8	59.5	112.2	158.5	238.3
Net credit to other banks 1/	86.1	99.7	92.4	73.8	24.4
Net credit to nonbank public 2/	13.5	7.6	11.0	13.3	18.3
Other items, net	-34.6	-30.8	-54.9	-71.2	-65.5
Memorandum items:					
Currency to deposit ratio (M2)	0.39	0.31	0.25	0.20	0.17
Reserves to deposit ratio (M2)	0.07	0.08	0.07	0.08	0.09
Money multiplier	2.40	3.30	3.90	4.30	4.45

Source: Data provided by the Portuguese authorities.

1/ Excluding the Sociedade Financeira Portuguesa.
2/ Including uncollectible items.

Table 8. Portugal: Performance Criteria Under Stand-By Arrangement

	1977	1978				1979
	December	March	June	September	December	March
	(In billions of escudos)					
Net domestic credit of the banking system						
Ceiling						
Excluding uncollectible debt	651.2 1/	674.3 1/	698.8	735.8	792.9	808.6
Actual						
Excluding uncollectible debt	645.7	666.6	705.5	738.7	784.6	808.8
Including uncollectible debt	702.6	734.2	782.8	821.5	874.9	910.2
Banking system credit to the public sector						
Subceiling	123.3 1/	133.3 1/	137.3	142.3	160.3	177.3
Actual	123.3	132.7	142.0	156.6	171.7	188.6
	(In millions of U.S. dollars)					
Net foreign liabilities of the banking system 2/						
Ceiling	1,217 1/	1,521 1/	1,787	1,957	2,162	2,322
Actual	1,243	1,634	1,821	1,500	1,086	1,011

Sources: Data provided by the Portuguese authorities; and EBS/78/707 (12/26/78).

1/ Presumed to have been actuals at the time the ceilings were fixed.
2/ With gold valued at SDR 35 per ounce and excluding profits from sales of gold in 1977-78.

Table 9. Portugal: Balance of Payments

(In millions of U.S. dollars)

	1973	1974	1975	1976	1977	1978	1979 1/
Exports	1,843	2,288	1,936	1,824	2,001	2,410	3,594
Volume change in per cent 2/	15.9	-6.8	-12.6	4.8	5.9	13.5	23.5
Price change in per cent 2/	10.8	33.0	-2.7	-10.2	5.2	6.5	16.4
Imports	2,753	4,277	3,606	3,925	4,533	4,791	6,016
Volume change in per cent 2/	6.4	8.4	-23.5	17.8	12.7	-2.0	4.6
Price change in per cent 2/	13.6	43.0	7.3	-4.4	2.1	4.6	19.5
Trade balance	-910	-1,989	-1,670	-2,101	-2,532	-2,381	-2,422
Per cent of GDP	-8.0	-15.0	-11.0	-13.0	-15.0	-14.0	-11.8
Nonfactor services		-74	-170	20	82	275	530
Investment income		129	-14	-131	-179	-329	-430
Private transfers	1,097	1,111	1,037	963	1,134	1,635	2,472
Current balance	341	-823	-817	-1,249	-1,495	-800	150
Per cent of GDP	3.0	-6.0	-6.0	-8.0	-9.0	-5.0	0.0
Overall balance	328	-633	-1,013	-1,125	-1,430	160	1,352
Memorandum items:							
Dollars received per tourist night	97	115	108	89	67	89	123
Dollars received per migrant worker	564	529	446	484	617	867	1,254
Per cent change in export markets		2.0	-4.5	11.2	3.2	5.7	8.8
Per cent change in relative unit labor cost		17.9	27.3	5.4	-3.2	-3.2	8.4
Per cent change in effective exchange rates	1.7	-1.4	-2.3	-7.7	-20.9	-19.6	-15.0
Terms of trade 2/ (1973 = 100)	100	87	76	73	75	76	74

Sources: Data provided by the Portuguese authorities; and staff estimates.

1/ Estimates.

2/ Customs basis.

Table 10. Portugal: Exports by Destination

(In per cent of total)

	1968	1973	1974	1975	1976	1977	1978	1979
EEC	40	49	48	50	52	52	55	57
Of which: United Kingdom	20	24	23	21	18	18	18	18
Old escudo zone	25	15	11	8	5	7	6	5
United States	12	10	10	7	7	7	7	6
Japan	1	2	2	1	1	1	1	1
Planned economies of Eastern Europe and China	--	1	1	2	5	4	3	2
Oil exporting countries	1	1	1	2	2	2	1	1
Rest of world	21	22	27	30	28	27	27	28
Memorandum item:								
EFTA (excluding the United Kingdom)	13	17	14	15	16	15	15	15

Source: IMF, Direction of Trade.

Table 11. Portugal: Imports by Economic Category

(Annual per cent rates of change in 1970 prices)

	1974	1979	1975	1976	1977	1978	1979
	Share in total imports						
Capital goods 1/	16.4	23.9	-35.0	16.0	24.2	-0.4	...
Machinery and equipment	13.6	17.5	-35.0	14.9	22.1	1.9	5.0
Transport equipment 1/	0.9	5.9	-43.8	37.2	56.9	-26.1	-15.4
Ships and planes	1.9	0.5	-32.9	-14.1	-70.8	49.9	-12.7
Intermediate goods	54.5	47.0	-22.5	21.8	20.1		...
Primary products 2/	15.5	17.3	-0.3	19.5	21.8	0.6	10.7
Semifinished products	39.0	29.7	-30.7	22.8	20.3	-4.7	0.8
Fuels and lubricants	12.4	19.4	-7.5	6.7	-1.5	10.6	14.9
Consumer goods	16.7	9.7	-25.8	17.8	-22.0	-24.6	...
Food	6.6	2.9	-25.2	28.0	-21.1	-36.0	16.5
Other nondurables	1.9	...	-21.2	16.0	-5.9	-2.7	...
Semidurables	2.6	...	-30.3	3.8	-21.5	-33.2	...
Durable goods	3.6	3.3	-26.9	12.4	-36.5	-17.4	-3.3
Total 3/	...	...	-22.3	19.2	13.6	-2.6	...
Total	100.0	100.0	-23.5	17.8	12.7	-2.0	4.6

Source: Data provided by the Portuguese authorities.

1/ Except ships and planes.
2/ Except diamonds.
3/ Except diamonds, ships, and planes.

Table 12. Portugal: Financing the External Current Account

(In millions of U.S. dollars)

	1973	1974	1975	1976	1977	1978	1979
Current account balance	341	-823	-817	-1,249	-1,495	-800	150
Medium-term and long-term capital, net	-142	272	-107	26	95	758	780
Government	-105	-82	-86	11	76	509	318
Private nonbank	-37	354	-21	-26	-75	214	291
Bank liabilities	n.a.	n.a.	n.a.	41	90	26	173
Bank assets	n.a.	n.a.	n.a.	--	4	9	-2
Basic balance	199	-551	-924	-1,223	1,400	-42	930
Residual flows	129	-82	-89	98	-30	202	422
Overall balance	328	-633	-1,013	-1,125	-1,430	160	1,352
Monetary movements	-328	633	1,013	1,125	1,430	-160	-1,352
Treasury	-3	-46	-29	-18	-13	-63	-136
Other banks	--	64	-10	153	567	-201	-992
Bank of Portugal	-325	615	1,052	990	876	104	-224
IMF	--	--	33	179	83	-53	-41
Compensatory borrowing, net	--	--	303	665	421	197	-274
Gold sales	--	--	--	--	534	357	--
Direct intervention, net	-325	615	716	146	-162	-397	68
Allocation of SDRs	--	--	--	--	--	--	23

Source: Data supplied by the Portuguese authorities.

Table 13. Portugal: Outstanding Compensatory Debt Incurred
by the Bank of Portugal

(End of period)

Creditor	Initial Amounts In millions	1975	1976	1977	1978	1979 1st half	1979
		Outstanding amounts (In millions of U.S. dollars)					
IMF	SDR 245		201.0	298.0	319.1	306.9	280.6
Consortium of central banks			165.0	250.0	92.2	30.7	--
Deutsche Bundesbank	US$75		75.0	75.0	--	--	--
Netherlands Bank	US$35		35.0	35.0	15.8	6.8	--
National Bank of Belgium	US$25		25.0	25.0	11.9	5.8	--
Sveriges Riksbank	US$15		15.0	15.0	7.2	3.6	--
Norges Bank	US$15			15.0	7.2	3.6	--
Austrian National Bank	US$15		15.0	15.0	7.2	3.6	--
Danmarks Nationalbank	US$15			15.0	7.2	3.6	--
Swiss National Bank	US$55			55.0	35.7	3.7	--
Consortium of France and Switzerland				40.0	32.2	28.6	--
Bank of France	US$15			15.0	7.2	3.6	--
Swiss National Bank	US$25			25.0	25.0	25.0	--
Consortium of US$750 million				48.0	661.3	723.0	754.0
Norway	US$10			3.0	10.0	10.0	10.0
United States	US$300				300.0	300.0	300.0
Venezuela	SDR 19			15.0	24.5	24.3	24.8
Swiss National Bank	US$30			30.0	30.0	30.0	30.0
United Kingdom	US$20				20.0	20.0	20.0
Austrian National Bank	US$10				10.0	10.0	10.0
Netherlands	f. 50				25.4	24.6	26.5
Germany	DM 420				229.8	227.3	243.4
Sweden	Skr 50				11.6	11.7	12.0
Japan	¥ 19,800					67.1	77.5
Other		300.0	300.0	1,045.0	819.6	703.8	582.1
Swiss National Bank	US$50	50.0	50.0	50.0	--	--	--
Deutsche Bundesbank	US$250		250.0	250.0	151.8	71.6	--
BIS	US$745	250.0	500.0	745.0	667.8	632.2	532.1
Total		300.0	1,166.0	1,681.0	1,924.4	1,795.0	1,616.7

Source: Data supplied by the Portuguese authorities.

Table 14. Portugal: Net Foreign Assets

(In millions of U.S. dollars)

Stocks at end of period	Total	Bank of Portugal 1/	Treasury	Other Banks
1968	1,563	1,387	30	146
1973	3,012	2,789	55	168
1974	2,338	2,184	47	107
1975	1,324	1,158	53	113
1976				
I	974	738	56	180
II	517	340	46	131
III	494	273	45	176
IV	285	130	93	62
1977				
I	-64	-91	99	-72
II	-432	-313	79	-198
III	-710	-435	94	-369
IV	-720	-307	92	-505
1978				
I	-954	-363	100	-691
II	-1,012	-492	109	-629
III	-576	-195	209	-590
IV	-249	-103	157	-303
1979				
I	-192	-237	140	-95
II	-26	-185	121	38
III	877	65	416	396
IV	1,112	155	291	666

Source: Data provided by the Portuguese authorities.

1/ With gold stock valued at the official price of SDR 35 per ounce. Includes profits from sale of gold.

Table 15. Portugal: Official International Reserves

(In millions of U.S. dollars; end of period)

	Gold 1/	Foreign Currency	Reserve Position in the Fund	SDRs	Total Gross Reserves
1968	856	488	19	--	1,363
1973	1,163	1,641	35	--	2,839
1974	1,193	1,125	36	--	2,354
1975	1,136	390	--	8	1,534
1976	1,126	166	--	10	1,302
1977					
March	1,117	128	--	6	1,251
June	1,129	68	--	8	1,205
September	1,050	154	--	4	1,208
December	1,025	361	--	5	1,391
1978					
March	999	265	--	--	1,264
June	961	288	--	--	1,249
September	992	799	--	--	1,791
December	1,009	871	--	--	1,880
1979					
March	996	640	--	19	1,636
June	1,000	619	--	5	1,624
September	1,020	1,070	--	1	1,091
December	1,020	939	--	1	1,959

Source: IMF, International Financial Statistics.

1/ Valued at SDR 35 per ounce.

Office Memorandum

TO : Mr. Whittome

FROM : Saumya Mitra SM

DATE: July 31, 1980

SUBJECT : Portugal--Cooperation with the Bank

A Bank mission headed by Alan Roe, the economist for Portugal in EMENA, visited Lisbon between June 22 and July 15 in order to prepare a Current Economic Memorandum with accent on the question of domestic resource mobilization and medium-term planning. The mission held discussions with various Secretaries of State at the Ministry of Finance, with the head of the Research department and his colleagues at the Bank of Portugal and with a large number of individuals from banking, investment, planning and agricultural sectors. The Vice President of EMENA, who was in Lisbon for a few days principally on a public relations visit, saw the Prime Minister and the Minister of Finance. My role in the mission was to assist in the general economic work particularly in monetary and balance of payments matters and to examine the role and potential of the public enterprises sector in domestic resource mobilization. Thus, I attended meetings at headquarters of various public enterprises and at the Ministries of Finance and Transport.

The mission with the Bank was an instructive experience in particular in enlarging my knowledge of the real sectors of the economy, the investment performance and the requirements for future growth--subjects that are central to the concern of the Bank. However, the mission was not able to make a great deal of progress on the medium-term outlook for growth and investment chiefly because the Portuguese had themselves made little headway with their own medium-term plan. They had earlier received with enthusiasm the Bank's public investment report which should have been a useful guide to their own thinking, but their planning apparatus appears to be antiquated, weak, insufficiently motivated and possibly bedevilled by excessive politicization. Some sort of a document, perhaps the outline or the framework of a plan, is promised for the month before the elections but it seems to me unlikely that a carefully thought out and reasonably realistic proposal could be ready before spring 1981. This is disappointing to the Bank and to us: for the former, the public investment report, with which the Portuguese have no quarrels, could have been seized upon as the basis of a medium-term investment program against which the Bank would lend, and for us it could have provided a basis for the medium-term framework of an extended arrangement.

I learned much during the mission of the various sectors of the economy that Fund missions tend not to examine in depth, particularly planning methods in Portugal, agriculture, certain sectors of industry and the public enterprises, though the quality of information on the latter sadly falls short of what it should be. In return, I think I can safely say that the Bank found it useful to have someone with them who having participated in a recent consultation mission was au fait with current developments. I was able to assist on discussions on credit and monetary policy, exchange rate policy and flow of funds analysis for domestic resource mobilization. I am responsible for the public enterprises section of the report, which is a significant part of the analysis of the allocation of domestic savings.

On the short-term outlook, the mission's discussions confirm the dangers foreseen in our Staff Report. The major structural problems seem to center on domestic prices, investment bottlenecks and the state of public finances, including the public enterprises. The first is, in principle, susceptible to a fairly quick solution; the latter two are properly medium-term issues, and the extended arrangement could usefully be built around them. Our last mission was greatly concerned at the degree of artificially suppressed inflation in Portugal and discussions with the Bank mission have strengthened the view that in their determination to lower the nominal rate of inflation at any cost, the authorities have introduced serious price distortions in the economy. In spite of sharp increases in fuel and wage costs in the latter part of 1979 and thus far in 1980 the prices of various public utilities, particularly transport sector, have not been increased at all or have had inadequate increments. The domestic price of petrol and fuels have not fully reflected international developments, various food items are subsidized and a wide range of products are subject to direct or covert price control. In reflection of these policy steps, the Supply Fund that traditionally supplies food subsidies out of net petroleum tax revenues has been forced to rely on budgetary transfers this year. The public enterprises face immense financing difficulties as a result of the present tariff policy; their short-term indebtedness, already high and burdensome, will increase sharply this year thus preempting credit from the rest of the productive sector and leading to a further erosion of their capital structure from an already abysmal debt-equity position. It is widely acknowledged that a supplementary budget would be required after the elections in order to rectify the mis-estimates of the May budget in the areas of subsidy payments and transfers.

The intensification of price control has coincided with a substantial relaxation of credit policy in late 1979 and thus far in 1980. The authorities tolerated significant breaches of the ceilings in the first four months of the year and then raised the May ceilings to accommodate most of the past excesses. They now concede that even with the amended ceilings the banking system will continue to be above the limits until September. Together with a continued buoyancy in emigrants' transfers, the rate of growth of the money stock at 35 per cent is over twice the level of nominal inflation. It can be expected that the pent-up liquidity would lead to serious consequences for inflation and the balance of payments when finally released. A "corrective" once and for all increase in the price level appears to be imperative in order to sterilize domestic money balances and defend the balance of payments position, and the removal of the price distortions deliberately introduced should greatly assist this process. Recent figures show a striking increase in the volume of imports as well as a buoyant domestic economy; the export performance continues to be encouraging but a deceleration is all too likely over the next 12 months.

I have little to add to the analysis contained the Staff Report on investment bottlenecks that are evident particularly in agriculture and housing, but also in industry where the questions of compensation for nationalized assets, labor legislation, the sectors to be opened for private participation and poor management in the partly-nationalized institutions continue to sap confidence. The structural problems in the area of public finances center on the tax system, revenue and function sharing with the local authorities, expenditure monitoring and control, the special problems of the public enterprises and the funding of government debt by the nonbank public. The Ministry of Finance has set up a Committee on Indirect Taxes that is considering the establishment of a VAT in preparation of membership in the Common Market and a unitary income tax to replace the present system of schedular and forfait taxes is to be addressed in due course. These would help to improve the coverage of the tax system and its efficiency, buoyancy and equity--characteristics that are lacking at present. Details on the sharing of function with the local authorities in order to prevent a duplication of outlays remain to be worked out. The Minister has set up a study on expenditure control to rationalize the present rather arbitrary, ad hoc procedures. A beginning has been made this year on the sales of public debt and the Portuguese should be encouraged to set up a suitable market for public debt along the lines recommended by an expert from the Fed.

cc: Mr. Schmitt
Mrs. Ter-Minassian
Mr. Dhonte
Mr. Kopits

CC: SED

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DR. ANIBAL ANTONIO CAVACO-SILVA

MINISTER OF FINANCE

LISBON, PORTUGAL

A STAFF TEAM COULD VISIT LISBON FOR PRELIMINARY DISCUSSIONS FROM SEPTEMBER TENTH TO TWENTY-THIRD. IT WOULD BE LED BY MRS. TER-MINASSIAN AND INCLUDE MESSRS. [illegible], DHONTE AND MITRA. PLEASE LET US KNOW IF YOU AGREE.

BEST PERSONAL REGARDS.

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Lisbon, July 22, 1980

To the Managing Director
International Monetary Fund
WASHINGTON, D.C.

I do hereby notify the Fund that Portugal consents to the increase in its quota to Special Drawing Rights 258 million, in accordance with Board of Governors Resolution No. 34-2 on "Increases in Quotas of Fund Members - Seventh General Review".

Manuel Jacinto Nunes
Governor

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Office Memorandum

cc: Mr Schmitt

TO : Mr. Whittome

DATE: July 16, 1980

FROM : A. P. Nose

SUBJECT : <u>Mr. Sundgren's Report on his Visit to Portugal</u>

Attached for your information are two copies of Mr. Sundgren's report covering his visit to Portugal.

Attachments

INTERNATIONAL MONETARY FUND

Bureau of Statistics Central Bank Bulletin Project

Report on General Statistics Visit to Portugal

(May 5 - 16, 1980)

John E. Sundgren June 10, 1980

This visit was concerned with assisting the Bank of Portugal in evaluating the production, employment, earnings, price and foreign trade statistics used in the Bank's analytical work. The observations and recommendations made in the report are based on a series of discussions held with the Bank staff and with the staff of the National Institute of Statistics (NIS), which is the main compiler of general statistics in Portugal. It might also have been useful to discuss the general statistics with a few other data compilers or major users, such as the Ministry of Labor, the Ministry of Finance, and the Ministry of Foreign Affairs, but time constraints did not permit doing so during this visit.

The report is divided in two parts. Part I summarizes the observations and recommendations contained herein, and Part II reviews and assesses the general statistics compiled by NIS and offers recommendations for their improvement.

Part I Summary of Observations and Recommendations

I. General Comments

NIS is the central office for the compilation of statistics in Portugal and depends on the National Statistical Council and the Department of Planning. It appears that NIS has, for some time, given preference to the compilation of very comprehensive annual statistics at the expense of short term economic indicators. As a result, users of data are offered each year 18 annual publications, many of them voluminous, in various fields of statistics. These publications are available with a delay of one to two years and therefore mainly serve those users interested in the structural aspects of the Portuguese economy. It also appears that NIS intends to move further in this direction by making its annual surveys even more comprehensive with the aim of establishing a firm base for the detailed production accounts of national accounts statistics.

This emphasis on comprehensiveness has, unfortunately, had serious repercussions on the development of short term economic indicators needed in the work of policy makers in the Bank of Portugal and Ministry of Finance. The only monthly or quarterly series available to them are the series on consumer prices, industrial production, building permits and buildings completed, foreign trade values and business expectations, while current monthly or quarterly data on such important measures as producers prices, retail sales, employment, earnings, unit values and volumes of foreign trade, are not available. Furthermore, it should be pointed out that the currentness of the few available short term indicators is not always satisfactory; the industrial production index for example, should ideally be available with a six weeks instead of the present three month delay.

A balanced approach in developing the statistical system of a country should equally satisfy the needs of both short term and long term policy makers. If the development is in favor of the latter group, which appears to be the case in Portugal, the short term policy makers will be missing the vital set of monthly price and quantity measures on production, investment, consumption and labor they need for adjusting the economy. As a result they may not be encouraged to be very generous in the allocation of resources to the central statistical agency and may even undertake to take over the compilation of short term economic indicators. There is also great appeal among the informed public, and the press, for current short term indicators and these have a much greater appeal than "historical" annual data. More efforts in this area are therefore crucial in promoting the image of the central statistical agency as the primary source of most statistical information.

It is suggested that NIS assign a higher priority to the compilation of current short term economic indicators in the fields of production, employment, earnings, retail sales procedures, prices and unit value and volume indexes of foreign trade. As this work would require some reallocation of staff resources, NIS needs to make better use of sampling techniques in its various surveys of enterprises and establishments and in utilizing the administrative records of other government agencies. The NIS's attempt to attain census-type coverage, particularly in its annual surveys of the industrial sector, imposes too heavy a burden on its existing staff and computer resources.

Most of the suggestions offered in the report were discussed at the end of the visit with the officials of NIS and the Research Department of the Bank of Portugal. Their response was in general favorable, as they had previously reached similar conclusions on the steps to be taken to improve the general statistics of NIS. Some of their views have in fact been incorporated in the recommendations made in the following section. However, there were some differences of view with respect to the priorities to be assigned to the projects mentioned below. NIS seems to persist in giving preference to comprehensive annual surveys, but the emphasis given during the visit to the importance of having short term economic indicators was fully supported by the Bank of Portugal.

As a means of accommodating the two views on resource allocation, the report's suggestions on the introduction of more sampling, are aimed at releasing resources within NIS, which can be reallocated to the production of current short period data. This can be done without any serious repercussions on the quality of the annual statistics concerned, provided of course that efficient sampling techniques are used.[1/] In fact, this should result in an improvement in the availability, currentness and, probably, the accuracy of the data.[2/]

II. Specific Comments

1. Agricultural Production Statistics

a. The existing agricultural statistics are derived from a number of different sources that results in data of varying quality and currentness. A new and better designed sample survey that would include most of the data needed should be introduced. The sample frame can be developed this year from manually extracted results of the recent agricultural census. A request for a sampling expert should be forwarded to FAO and EUROSTAT.

b. To achieve greater accuracy in response, the survey data should be collected by personal visits, with the cooperation of the Ministry of Agriculture, and not by mail.

c. The weights of the producers price index for agricultural products need to be revised, and the index coverage should be expanded to include livestock products.

d. From a users' point of view, it would be important and helpful to have a summary table giving annual production estimates for major crops and livestock products published on a quarterly basis.

2. Industrial Production Statistics

a. The basic industrial surveys as presently conducted are too comprehensive and result in publication delays. Sampling methods should be introduced in the annual survey instead of the present attempt to cover all small establishments. The monthly surveys could be reduced to include about 1,000 representative establishments instead of 8,000 now covered and could mainly provide the basic data needed for the industrial production index. The

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1/ It is unfortunate that NIS employs only two sampling experts among its staff.
2/ Sampling allows for more intensive efforts in collecting and checking the data of the establishments selected.

surveying of 8,000 establishments could be carried out on a quarterly basis for the purpose of producing employment and earnings data.

b. The monthly industrial production index is due for a revision, which is planned for this year. An item on orders received could be added to the questionnaire.

c. A producers' price index for industrial goods could be constructed in parallel with the revision of the production index.

3. Statistics on Wholesale and Retail Trade

a. Statistics in this area are not yet regularly compiled but an annual sample survey has been designed for this purpose. It will cover about 15,000 establishments and will be launched in 1981.

b. It is suggested that the sample for the annual survey be reduced to about 8,000 establishments by excluding very small establishments, and that this year a quarterly survey be launched that would cover only the data on sales, employment and wages of the retailers selected for the annual survey.

4. Enterprise Statistics

a. Annual data on employment, revenues, costs, investments, stocks, etc., are collected from about 47,000 companies and published with a two year delay.

b. The currentness of this survey can be improved and the costs reduced if sampling methods are introduced.

5. Labor Force Survey

a. This semi-annual survey, which is the major source of data on total active population and total employment and unemployment, is based on an outdated sample and is now due for a revision. NIS plans to introduce a new survey in 1981, based on an area sample and to change some of the definitions used. This should be strongly supported.

b. It would be useful if survey results could be produced on a quarterly basis.

6. Labor Data in Industrial Statistics

a. This source could be more effectively used to produce quarterly employment and earnings data by activity groups and for the industry as a whole.

b. NIS intends to publish a monthly employment index this year for the industrial sector. It is suggested that this index be compiled on a quarterly basis in the future (see paragraph 2.a. above), and that an earnings index be compiled along with it.

c. As the 1971 weighting base of the forthcoming employment index is out of date, the index will be due for revision within a year or two.

7. Wage Indexes by Occupational Groups

a. These quarterly indexes, which refer to mainland Portugal, Lisbon and Porto, are based on samples of establishments that are too small for providing reliable results.

b. It is suggested that the compilation of these indexes be discontinued, and that NIS should provide instead annual wage data by occupational groups as derived from the administrative records of the Ministry of Labor (see paragraph 9 below). Quarterly wage data can be derived from other sources (see paragraphs 3b, 6b and 8a).

8. Wages in Construction

a. The quarterly wage data compiled by occupational groups and by regions are based on a relatively large sample in which very small establishments with low response rates are included.

b. It is suggested that the sample be revised with the aim of excluding establishments with less than 5 employees.

9. Labor Data in Administrative Records

a. Since 1977, the Ministry of Labor has collected for surveillance purposes detailed employment and earnings data referring to March of each year from about 140,000 establishments covering practically all activity groups. This material is also intended for statistical use, and NIS is responsible for the processing and publication of the data. The collection and processing of data are cumbersome, however, due to the great numbers involved, and 1977 results will not be available until the end of this year.

b. As this material will continue to be difficult to handle for statistical purposes, it is suggested that efforts be limited at this stage to the production of a complete and up to date register of establishments. Such a register would provide the framework needed for efficient sampling of establishments, for example in extracting data from the details collected through this same administrative process and in updating and revising the samples now in use at NIS.

10. Consumer Prices

a. This index on the base 1976=100 is very current and reasonably accurate. It excludes rent because of the difficulties encountered in the past in measuring this component.

b. The extraction of housing data from the ongoing household expenditure survey should be assigned highest priority. The data can be used as a base for designing a sample of dwellings to be covered in the collection of rent data for the existing consumer price index.

c. Later on, when the final results of the household expenditure survey become available, the index will be thoroughly revised.

d. In the future, more attention needs to be given to such maintenance problems as the substitution of items and the treatment of seasonal items and quality changes.

11. Wholesale Prices

a. The existing index is seriously outdated (original base 1948=100) and should be replaced with producers' price indexes for agricultural and industrial goods (see paragraphs 1.c., and 2.c. above).

b. The import component of the index should, however, be revised and expanded to form an import price index..

12. Export and Import Statistics

a. The compilation of regular trade data from Customs returns is based on the special trade system. It is well established and provides relatively current and accurate results.

b. A further refinement could involve a more complete recording that would cover the trade flows of bonded warehouses and free areas for the purpose of also arriving at trade data as defined in the general trade system. Customs have been requested to extend their procedures in this direction.

13. Trade Indexes

a. NIS is in the process of compiling quarterly indexes on the volume and unit value of exports and imports. Some additional work is required in the selection of substitutes for the heterogenous items appearing in basic trade data.

b. It is hoped that the indexes will become available this year and that unit value indexes compiled according to both the Laspeyres and Paasche formulae will be provided.

Part II. Review of the General Statistics compiled in NIS

I. Agricultural Production Statistics

a. Description

Agricultural production and related data are based on a number of sources of varying quality and currentness such as sample survey on major seasonal crops, input data of processing industries for a few other crops, rough estimates by Ministry of Agriculture agents for some seasonal crops, slaughtering data for livestock, data from agricultural associations for prices and wages, etc. Each of these sources are discussed below.

The most important source for seasonal crops is the NIS sample survey. The sample, which was drawn from the results of the 1968 agricultural census, is stratified according to the size of holdings and includes about 20,000 holdings, i.e., 2.5 per cent of the population in 1968. Very small holdings were excluded. Data on quantity of seed used, area planted and crops harvested are collected by mail from these holdings and cover eleven major crops. The farmers are approached twice during the crop season, i.e., questionnaires are mailed firstly at the time of planting[1/] and secondly at the time of harvesting.[2/] The response rate reaches about 80 per cent after reminders are mailed. The data reported, particularly for area planted, are so deficient that the estimates for this measure are based on the quantity of seed planted for each crop divided by an average ratio of seed used per hectar, as provided by the agents of the Ministry of Agriculture.

After verification, data are punched and processed and the results for the calendar year normally become available at the end of March of the following year. However, due to processing delays the data for the last two years have become available several months later than expected.

More current data on these eleven major crops and a few other crops are, however, provided by the Ministry of Agriculture. But these data, which are submitted to NIS on a monthly basis in the form of per cent changes, are based on rough estimates made at the district level by the Ministry's agents. The data can only be used as an indication of the direction in which the planting and harvesting activities develop during the crop season. The data are published with little delay in the form of index numbers in the Monthly Statistical Bulletin of Agriculture and Fishery of NIS, and they are continuously revised.

Production data on a few other seasonal crops of importance, which are mainly used as raw materials in industrial processing, are collected either through branch organizations (e.g., for wine and olive oil), or directly from the industrial establishments involved (e.g., for other vegetable oils and tomatoes). The coverage of these data varies from more than 90 per cent for olive oil to about 80 per cent for tomatoes.

For most vegetables and fruits, practically no data are available. NIS has tried to derive estimates for these products from scattered data on

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1/ In December for grains and in May for potatoes, beans, onions, etc.
2/ In July for grains and in November for other crops.

industrial inputs and private consumption but it has not succeeded in obtaining a satisfactory coverage.[1/]

The NIS data on livestock production are currently published in the Bulletin but the coverage is not always sufficiently complete. Production data on beef cattle, pigs, goats and horses are based on slaughtering statistics, which are collected monthly by mail from about 300 municipal slaughter houses. Veterinarians enter in the questionnaire the number and the weight of each kind of live animal slaughtered. In checking against consumption data from the 1973-74 household expenditure survey, it is known that the coverage of beef cattle is nearly complete while the coverage for the remainder, particularly for pigs, is incomplete due to slaughtering by the farmers themselves. For national accounts purposes, NIS therefore adjusts the incomplete data by a coefficient based on 1973-74 data on auto consumption by farmers which is further adjusted each year depending on the general prospects for the product in that year (e.g., the occurrence of diseases and changes in legislation are taken into account).

Data on the production of chickens and eggs are collected by means of a monthly mail survey of about 100 large chicken farms and a semi-annual survey of practically all chicken farms (i.e., about 2000 establishments). The NIS considers the coverage to be satisfactory as all commercialized production is included.

Producers' price data for crops and livestock products and wage data for agricultural workers are collected for each district via monthly questionnaires mailed to about 100 local agricultural associations. The response rate and the quality of the data received are, however, inadequate. The associations have shown little interest in the survey and the prices and wage rates they give are not based on direct inquiries but rather on subjective estimates made by the employees of the associations. The prices of wheat, rice and olive oil are controlled and can be obtained from government sources.

Price and wage data are published with a three month lag in the Monthly Statistical Bulletin of Agriculture and Fishery. Data are shown in the form of daily wage rates and price quotations and as index numbers. The 1968 based producers' price index is weighted with average quantities for 1963-68 and excludes most vegetables and all livestock products. The 1970 based wage index is weighted with the population census data of 1970.

b. Evaluation

The NIS system of producing and publishing agricultural statistics is unsatisfactory. The data on several crops and livestock products are incomplete or missing and even for those crops where complete estimates are available the quality of the data is questionable due to the use of mail

1/ Tomatoes, oranges, apples and figs are partly covered.

surveys, and of a sample which was drawn before the fundamental structural changes of 1973-74 occurred in the agricultural sector. Furthermore, the currentness and the form of publishing the NIS survey data on major crops needs to be improved. The NIS staff are aware of these problems and intend to resolve them insofar as resources permit.

Fortunately, there will soon be available a framework for introducing a new sample survey of the agricultural sector. In February 1980 NIS, in cooperation with the Ministry of Agriculture, embarked upon a census of agriculture. Data are at present collected through personal visits to all farmers. About 300 inspectors of the Ministry and 2,000 temporary employees are involved in this activity. It is anticipated that all the material, covering about 1 million holdings, will be collected by the end of June 1980. However, resources for punching this material will not be available before January 1981, and as this part of the processing is expected to last one and a half years, final results will not become available before 1983. The staff's proposal to extract manually from the questionnaires beginning in July, the ten items required (out of 300) for the purpose of establishing a sampling frame, is therefore strongly supported. Very small holdings will be excluded from this exercise.

With this sampling frame at hand at the end of this year, a new sample can be drawn[1/] and a more comprehensive sample survey launched which would cover data on fruits, vegetables, livestock products, prices and wages as well as data on production of major crops. At regular intervals data on major inputs and investments could also be sought. If an efficient statistical sample is designed, it should perhaps not be necessary to include much more than 20,000 holdings in the survey. The close cooperation with the Ministry of Agriculture established in the census work should continue, and its inspectors should be used for field collection of data on area planted, yield per hectare, livestock products, prices and wages.

As the holdings will be visited twice a year, the data on area planted, which are collected in the first visit, can be used to produce by mid-year, a preliminary production estimate for the whole year. Final production data should become available in the beginning of the following year. The data on prices and wages should, however, be collected by the Ministry's agents on a monthly basis, but this can be done from a relatively small sub-sample of holdings included in the annual survey.

The introduction of a new comprehensive sample survey implies that NIS will no longer have to rely on the scattered and rough estimates made during the crop season by the Ministry's agents and that NIS could discontinue the collection of price and wage data from agricultural associations. However, for a few highly commercialized crops (olive oil and wine), and livestock

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1/ NIS will probably need technical assistance in this field and should make a request to the European Community and FAO as soon as possible for a sampling expert.

products (chickens and eggs), it may be worthwhile to continue the system of collecting data now in use. This also applies to the gathering of monthly data from slaughter houses but these data should, of course, be adjusted on the basis of the results of the sample survey.

The producers' price index of NIS is also in need of revision at the present time. As the complete census results will not be available for some time, the revision could include livestock and a few other products that are missing, and the index could be re-weighted e.g., with 1975-77 average quantities. The new reference base of the index would be 1975. The monthly price quotations could be provided by the Ministry of Agriculture. It is suggested that NIS publish the new index beginning with the January 1981 issue of the Monthly Statistical Bulletin of Agriculture and Fishery and in more condensed form in the Monthly Bulletin of Statistics. Similarly, the weights and the reference base of the wage index for agricultural workers needs to be revised. The new weights can be derived from the results of the agricultural census, which includes data on the number of payed employees for each holding.

From the users' point of view, it is important to have annual production estimates tabulated and published quarterly in summary form. The estimates could be expressed as index numbers and all major crops and livestock products should be included. Weighted group indexes and a total index for the agricultural sector should be calculated. The annual estimates could be revised once or twice a year on the basis of the results of the sample surveys. This index should, as far as possible, have the same commodity composition and weights as the revised producers' price index mentioned above.

Due to the lack of current production aggregates for the agricultural sector, the Bank of Portugal has recently constructed such an index. Its base year is 1976=100 and it covers the major crops and livestock products that account for about 80 per cent of the total value of agricultural production. It is suggested that the Bank publish this index in its Annual Report and Quarterly Bulletin until the NIS index becomes available.

II. Industrial Production Statistics

a. Description

NIS has allocated considerable resources to the compilation and dissemination of industrial statistics. The Industrial Statistics Division, which has about 95 staff members, is involved in the collection, checking, coding and tabulation of monthly and annual data on production, employment, wages and hours worked, and of annual data on investment, materials and energy consumed, and inventories in mining, manufacturing, electricity, gas and water production, and in construction. In addition to these basic surveys the Division also compiles a monthly and annual industrial production index, quarterly data on business expectations,[1/] monthly data on building permits

1/ The quarterly survey on business expectations covers about 3,000 establishments.

and buildings completed, monthly price quotations on construction materials and a monthly construction cost index for Lisbon.

The data in all these surveys are collected by means of mailed questionnaires[1/] which are sent to more than 20,000 establishments in the annual surveys and to about 10,000 establishments in the monthly surveys. The final response rate is nearly complete for the annual surveys and is, after reminders are mailed, about 85 per cent in the monthly surveys. Data for missing establishments in each activity group are estimated by assuming that their rate of change is the same as the rate of the reporting establishments.

After review, the questionnaires are forwarded for computerized processing, which includes unit value and other validity checks besides a large number of final tabulations. From these tabulations the tables which appear in the various publications of the Division are prepared manually. The availability lag for data varies between three months for the monthly industrial production index and the quarterly survey of business expectations, to sixteen months for the annual industrial surveys. When available, the monthly data are published promptly in such regular publications as the Monthly Bulletin of Industrial Statistics, the Quarterly Information on Business Expectations and a leaflet on the Indexes of Industrial Production. The printing of the voluminous annual publications is, however, time consuming, and the latest available issues refer to 1977; the 1978 issues will be distributed in a month or two.

The Division has outlined programs for the introduction of new monthly statistics in the field of manufacturing employment, orders, investment plans, producers' prices and construction costs. But due to the heavy workload, particularly in the compilation of monthly industrial statistics, the work on these important projects has had to be postponed. This year the Division plans to revise the industrial production index and to start publishing a monthly manufacturing employment index on the base 1974=100.

b. Evaluation

In general it can be said that the Division has developed over the years a set of very comprehensive basic industrial statistics. Both in the annual and in the monthly surveys, an attempt has been made to cover as many establishments as possible. Compared to the industrial census results of 1971 the annual survey covers about 80 per cent of the employees in the industrial sector. It excludes a few minor activity groups and also establishments with less than ten employees in some activity groups where the number of small establishments is large. The monthly survey is somewhat less comprehensive, but it is still large when compared to most other European countries, leading to problems in the response rate. This desire for comprehensiveness has, of course, been pursued at the expense of currentness in industrial statistics. It has also engaged considerable resources in the collection and processing of

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1/ More than 150 varieties of questionnaires are used.

data which could otherwise have been used for the introduction of a system of short term price and quantity measures for the industrial sector as recommended by United Nations.[1/]

As it is unlikely that the Division will be able to expand its staff in the near future, a reallocation of existing resources is required if the Division is to launch the new projects it has outlined. This can be done mainly by changing the purpose and scope of the monthly surveys. Instead of comprehensiveness, the aim of the monthly surveys should be to cover the most important and representative products and their producers in Portugal and thus provide the basic data needed for the compilation of the monthly industrial production and producers' price indexes. For this purpose, about 1,000 important products and producers would need to be covered each month against 2,000 products and 8,000 producers in the existing survey.[2/] The annual survey would continue to provide the comprehensive and detailed data required.

The substantial staff resources released through this measure could assist in the preparatory work on the following projects:

(1) The revision of the monthly industrial production index. The existing index includes data on about 1,000 products collected from 600 industrial establishments which were selected on the basis of 1970 industrial statistics. Originally the products selected covered 64% of the total production value but their coverage has by now fallen below 60% due to the development of new industrial activities in Portugal. The work on the revision should include a careful scrutiny of all the products listed (at a six digit level of ISIC) in the latest available industrial statistics, with the aim of detecting and adding important new products to the existing sample,[3/] and deleting from it products that have lost their importance. The total number of establishments may have to be expanded somewhat, but there should be little need to raise the total number of products above 1,000.[4/] Furthermore, if a representative sample is obtained for the monthly production index, there will be no need to compile a separate annual index. As may be seen from the table in Appendix A, the movements in the existing monthly and annual indexes are already so close that it is questionable whether the compilation of the annual index is justified.[5/]

1/ See Guidelines on Principles of a System of Price and Quantity Statistics, Series M. No. 59 and Manual on Producers' Price Indexes for Industrial Goods, Series M. No. 66, United Nations.

2/ The surveying of 8,000 establishments could either be discontinued or, if needed for employment and wage data, carried out on a quarterly basis. The number of establishments covered could be reduced if sampling methods were introduced.

3/ The coverage of such product groups as machinery and transport equipment, and ship repairs needs to be improved.

4/ For example the indexes of Japan, Germany and Spain include 459, 470 and 545 products respectively.

5/ The differing levels of the mining indexes are due to the incomplete coverage of this sector in the monthly index.

As monthly production data need to be collected from only about 1,000 establishments instead of 8,000, it should be possible to improve the currentness of the index by nearly two months (e.g., April data would become available in mid June).

(2) The construction of a producers' price index for the industrial sector. The work on this project should be closely related to the revision work on the industrial production index particularly with respect to the selection of products and respondents, and the establishment of a weighting system.

(3) The introduction of order stock statistics in industries. This project should preferably form an integrated part of the above project on the revision of the industrial production index.

(4) The revision of the construction cost index. The existing index is outdated (1949=100) and refers only to Lisbon. An outline for a new index covering costs of labor and materials in construction for Portugal has been prepared but not yet implemented due to difficulties in establishing weights and to lack of resources.

As mentioned previously, the annual industrial statistics should continue to cover about 20,000 establishments. However, sampling techniques could be introduced in surveying small establishments with less than 10 employees in all activity groups where the number of small establishments is sufficiently large to allow sampling.1/ The considerable processing and publication lags in industrial statistics could be reduced by standardizing the tabulations made. The aim would be to publish only one volume of industrial statistics containing computer-generated tables by topic and activity groups. This implies that all the special tables now shown separately for each activity group could be deleted, resulting in the reduction of pages in the annual publications by one half.

III. Statistics on Wholesale and Retail Trade

a. Description

With the exception of a business expectations survey, there are no annual or monthly statistics available in this area. A census of wholesale and retail trade and services was taken in 1977 in which data on main activity, number of employees, and sales were collected from about 140,000 establishments. A register kept by the Ministry of Finance for taxation purposes was the basis for locating the establishments. The NIS agents collecting the data were also instructed to look for and to visit any establishment which was missing from the register.

1/ At present small esatablishments are excluded for some of these activity groups.

On the basis of the census results which became available in 1979, NIS designed the sample and the questionnaires to be used in the regular compilation of annual statistics on wholesale and retail trade. The sample of wholesalers covers all establishments with more than 9 employees, about 70 per cent of the establishments with 5-9 employees and about 30 per cent of those with less than 5 employees. The corresponding coverage for retailers is: all establishments with more than 19 employees, 60 per cent of those with 5-19 employees and about 6 per cent of those with less than 5 employees. A total of about 4,500 wholesalers (out of 7,400) and 10,000 retailers (out of 77,000) are included in the sample. The questionnaire to be used in this mail survey requests data on employment, wages, sales, costs, investments and stocks. The computer programs needed for processing the data have also been prepared and will provide annual data by activity and by size groups. The implementation of the survey has been postponed until April 1981 due to lack of staff. It is estimated that 19 persons would be needed to compile the data.

b. Evaluation

The survey design may, with a certain lag, meet, the requirements of national accounts statisticians in NIS but not the needs of policy makers in the Bank of Portugal or the Ministry of Finance who are particularly concerned with short term developments in private consumption, and would like to have a current indicator on which consumption estimates can be based. Both these needs can, however, be satisfied if a few changes are made in the survey design.

First of all, it is suggested that the sample size be reduced. This can probably be done with a minor loss of accuracy in results and a considerable gain in currentness. All establishments with less than 5 employees should be deleted from the sample since, in spite of their large number, they account for only 20 per cent of the total sales value, and most of these establishments would probably not respond.1/ This change would reduce the sample size to 3,200 wholesalers and 5,000 retailers. The sample size could be further reduced, perhaps by 1,000 retailers and 1,000 wholesalers, if the limit for complete coverage was raised to wholesalers with more than 19 employees, and if somewhat smaller sampling fractions were applied in the 5-19 size group in which the number of establishments is large. (For example a sample of 560 establishments out of 946 in activity group 62031 can probably be considerably reduced without a serious increase in the sampling error.)

The important advantage of a manageable sample is that it allows for the introduction of a quarterly (or monthly) survey on sales and on the number of employees in retail trade. Such a survey would provide the current data which policy makers need for estimating consumption and would therefore have a more

1/ Small establishments in commerce should actually be surveyed through area sampling and personal visits due to the high turnover rate in this group and to the poor condition of their accounts.

immediate use than the annual survey and a firmer justification for the expenses incurred. It would also increase the significance of the existing business expectation survey of retailers, which is too unspecific on its own to be of analytical value.

Rather than waiting until April 1981 for the quarterly survey, its launching is suggested for mid-1980 requesting data for the first two quarters of 1980. The results of the survey could be published in the form of index numbers for total retail trade and for its major activity groups. It may also be useful to provide a breakdown of cash sales and sales on credit.

IV. Labor Market Statistics

a. Description

The situation in the field of labor market statistics is rather complex and very confusing both from the compilers and the consumers point of view. There are three major sources for employment and wage data:

(1) Data that are based on special surveys in the field of employment and wages, i.e., the labor force survey, the establishment survey of wages by occupational groups, and the surveys of wages of agricultural and of construction workers.

(2) Data that form a part of ongoing establishment surveys, e.g., the annual and monthly or quarterly surveys of mining, manufacturing, electricity, gas, water and construction industries.

(3) Data that are produced from the administrative records of the Ministry of Labor, pension funds and the national social security system.

As duplication exists among the various sources of data, the problem for the compiler is to coordinate the compilation system and eliminate overlaps, while the problem for the user is to find the best source for the specific series he is interested in.

The time constraints during the visit did not make it possible to have discussions with the staff of the Ministry of Labor and the National Social Security Agency. The brief descriptions below of their statistics is therefore based on discussions with the NIS and Bank of Portugal staff.

<u>Labor force survey:</u> This semi-annual survey is at present the most important source for data on the total active population and total employment and unemployment. In designing the sample on the basis of the 1970 census results, 412 municipalities were first selected at random in proportion to size. All the households in these municipalities were grouped in units (segments) of seven neighboring households from which 3,800 units were selected at random. Half of this number of units was allocated to the survey for the first half of the year and the other half for the second part of the

year. The total number of households covered for each semi-annual period is thus about 13,300. More than 2,000 households are interviewed each month over the six months period by 24 NIS agents. As area sampling has only been used for low-income areas in Lisbon, the updating of the sample has had to be based on data on building permits issued.

Tabulations are made by computer and data on active population, employment and unemployment by activity and occupational groups are published in a separate publication with a delay of about six months. Results become available with a delay of 3-4 months.

NIS plans to revise in 1981, the methods used in this survey. The intention is to move to area sampling, which would solve the problems of coverage and of updating the sample. More than 30,000 households will be included in the new survey and data will refer to Portugal and not just to the mainland part of the country. Some changes will also be made in the definitions and questionnaires used with a view to narrowing existing differences with ILO and the European Economic Community standards. For example, the lower age limit for the active population will be raised from 10 to perhaps 13 years. It is also contemplated that results of the survey will be tabulated on a quarterly basis.

Labor data in industrial statistics: Data on employment, wages and hours worked are collected in the monthly and annual surveys of industry (including construction) described in Section II above. Totals are provided for each industry and for activity groups in the annual publications, but the monthly publications contain data for selected 5 digit activity groups only, and do not provide aggregates for 3 digit activity groups and for the industry as a whole. Average daily wages are calculated from wage bill and employment data and they are published on a quarterly basis in Escudos and in the form of index numbers (1968=100) for a few selected activity groups. The data become available with the same delays as industrial production data.

NIS has worked for some time on the construction of a manufacturing employment index on the base 1974=100. The basic data are obtained from the monthly industrial survey and the weights (number of employees) were derived from the 1971 industrial census. Monthly index numbers have been calculated for the period 1974-1979 and refer to 6 and 3 digit activity groups and the total manufacturing sector. The data compiled are at present under study and it is expected that the index will be published later this year. NIS also intends to revise the existing quarterly wage indexes for selected activity groups to include more activity groups and, perhaps, a total index for the manufacturing sector.

Wage indexes by occupational groups: Three separate quarterly indexes are calculated. Each index refers to a few important activity groups in manufacturing, construction and transportation and to the most representative occupational groups within these activities. The Lisbon index (1961=100) is based on a sample of 405 establishments, while the Porto index (1958=100) and the index for mainland Portugal (1968=100) include data for 232 and 745 establishments, respectively. For each index, total average daily wages are calculated using the number of employees as weights, but no such averages are provided for activity groups. Data are published in the Monthly Bulletin of Statistics with a three month delay. NIS is contemplating a revision of these indexes in 1980-1981.

Wages in construction: Hourly wages in construction are collected on a quarterly basis from a sample of 3,500 private and public establishments. The sample in use was drawn in 1971 from a register of establishments based on social security data. The establishments were stratified according to their size and selected in proportion to the standard deviation of each size group. The response rate is low for small establishments (with less than 5 employees) and results are usually based on data obtained from about 2,100 establishments. Data on hourly wages are published in the Monthly Bulletin of Statistics by districts and occupational groups, and they appear with a three month delay. The data are also used as an element in the construction cost index compiled for the Ministry of Public Works.

Employment and wage statistics based on administrative records:1/ In a combined effort, the Ministry of Labor, the social security agencies and NIS began work in 1975 on coordinating and improving the flow of employment and wage data supplied to the first two agencies by the establishments under their jurisdiction. The aim of the exercise was, besides surveillance, to set up a register of establishments and to compile statistics on employment, earnings, working hours and social security payments by occupational groups. The data would cover all establishments employing one or more employees. The only exclusions would be government employees and unpaid family members in family owned companies. The data would be collected at the end of March each year by the Ministry of Labor which would also be responsible for checking and coding the data. The questionnaires would then be forwarded to NIS for processing and publication.

A first attempt to apply this new system was made in March 1977. However, the response rate turned out to be low, particularly among establishments with less than 10 employees, and by February 1978 only 50 per cent of all establishments were covered. Due to delays in data collection, coding and verification and to many errors in the data received, it was decided to process only totals for each establishment and not the data on individual employees. It is expected that the tabulations will become available at the end of 1980.

The second attempt in 1978 resulted in a somewhat better coverage, i.e., 140,000 establishments, and fewer errors in the data. The processing of the data started at the end of 1979 and tabulations are expected at the end of 1980.

1/ The quarterly employment index compiled by the Ministry of Labor was not assessed during this visit.

Little progress has yet been made in applying statistical standards and routines to the monthly employment and earnings data collected through the social security system. Further work is envisaged in coordinating this effort with the employment registration routines of the Ministry of Labor, mainly by applying similar concepts and procedures for collecting, processing and publishing the data.

b. Evaluation

None of the existing labor market statistics are entirely satisfactory from an analytical point of view. The special surveys are based on more or less outdated samples, the data derived from industrial surveys do not cover the whole industry and the data that are a byproduct of administrative functions of the government are not yet available in a statistically usable form. There is also, duplication between several of the data sets, which leads to criticism by respondents and confusion among users. The following suggestions are offered to solve the major problems of coordination, accuracy and currentness in these statistics:

(1) Special Surveys: The main source for data on active population, employment and unemployment is the labor force survey of NIS. Unfortunately, the survey is not based on area sampling, which has created problems of updating the sample and resulted in a loss of coverage since the survey began in 1974. Furthermore, the criteria used for defining the concepts of active population and unemployment may have to be changed somewhat to align them more closely with international standards. A recent study on labor market statistics by the Bank of Portugal.[1/] shows that the NIS survey may overestimate the active population, particularly in the agricultural sector, and underestimate unemployment. The unemployment rate of NIS, for example, is 8-9 per cent in 1978, compared to the Ministry of Labor's rough estimates of 13-14 per cent, which are based on registration data adjusted to include new job seekers. Although the Bank relies on the NIS figures in its analytical work, the large differences with the Ministry of Labor data do confirm biased results in the NIS survey and suggests that it is now due for a revision. The proposal on definitional changes made in the Bank study[2/] should be considered by NIS when planning the new labor force survey.

It is suggested that the revision of the labor force survey be assigned the highest priority. Since it is important to have a sample that remains representative over time which is not too large to preclude its use in a quarterly survey, the possibility of technical assistance by a sampling export should be explored with ILO and Eurostat. The main objective of the survey should be to provide accurate and current estimates on the total active

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1/ See Rui Janes Cartaxo, Estatisticas de Desemprego em Portugal, Boletim Trimestral, Setembro 1979, Banco de Portugal.
2/ The seasonal and temporary workers and the active population need to be more rigorously defined, particularly for working family members in agricultural households.

population and the numbers of employed and unemployed, and to have reasonably good estimates for these measures on a district level. The existing breakdown by activity groups could be given a low priority as such data can be obtained, at least for employment, from the establishment surveys.

The two other special labor market surveys reviewed during the visit provide data on wages by occupational groups in industry , transportation and construction. The data, however, are based on deficient samples and they are also partly overlapping. The samples used in the wage indexes for Portugal, Lisbon and Porto are outdated and too small to provide reliable results. It is likely that these indexes underestimate wage increases due to incomplete representation of the newer and more dynamic establishments in the economy. However, it may not be worthwhile to introduce new quarterly sample surveys in this area, as short period data on wages by activity groups can be derived from existing industrial statistics and can be supplemented on an annual basis with wage data by occupational groups from the administrative records of the Ministry of Labor.[1/] It is suggested that NIS discontinue the existing wage indexes as soon as those data become available.

The quarterly survey on wages in construction will continue to be needed mainly as a component of the construction cost index. But the sample used in the survey needs revision. In order to avoid the current serious problems of response and to improve the currentness of the data, the new sample should exclude very small establishments (with less than 5 employees). The problem of updating the sample each year[2/] also needs to be solved but this depends on the availability of an up-to-date register of establishments (see paragraph (3) below). NIS also intends to computerize the processing of the data, which should contribute to an improvement in currentness.

(2) <u>Labor market data in industrial statistics:</u> This source could be much more effectively used for compiling current short period data on employment, wages and hours worked in mining and manufacturing. The publication later this year of the NIS employment index for manufacturing will be a useful step in this direction. It is, however, suggested that this index be compiled in future on a quarterly basis instead of monthly in order to reduce the heavy burden of collecting data from as many as 8,000 establishments (see also Section II above). It is also suggested that corresponding wage and hours worked indexes be compiled from the same sample of establishments and that the same weights be used as in the employment index. This could be done in 1981 when the employment index will be due for a revision.[3/]

1/ See paragraphs (2) and (3) below.
2/ A fraction of new establishments, created during the year, should be added to the sample to maintain the proportion between the sample and the population.
3/ The weights of the index refer to 1971 and do not reflect the structural changes that occurred in Portuguese industry in the seventies. The new weights can be derived from the latest available annual industrial statistics.

(3) Labor data from administrative records: Although some efforts have been made to improve this data source, the outcome has not been entirely satisfactory. The main obstacle to the compilation of useful statistics data from this material is the large amount of data involved. The coding, checking and processing of the data are slow even though only establishment totals have been used, and it is unlikely that these data will ever be reasonably current. The coverage of the data should, after the initial problems of enforcing the registration are solved, be nearly complete for most activity groups with the exception of agriculture and, to a lesser degree, the distributive trades and services where small family owned units are common. But this data base could, in the future, provide a very useful framework for verifying and improving the coverage of short term statistics based on establishments surveys, and for sampling. It is suggested that the main statistical aim of this project be the introduction of an up-to-date enterprise and establishment register.

V. Price Statistics

1. Wholesale Prices

a. Description

This Laspeyres' index is on a 1963 reference base and is a rebased version of the original index on the base 1948=100. The sample of 236 commodities included in the index and its weights were derived from production, import and export statistics of 1948 (with import data adjusted to include duties). Although the commodity composition of the index has remained the same over the years, the sample of varieties included has been revised. The last revision was made in 1972.

The price data are collected from wholesalers in Lisbon through visits around the fifteenth of each month. One to three price quotations are obtained for each commodity. The price data refer to the last transaction in bulk, i.e., the price charged by wholesalers for sales to retailers and producers. The index is calculated manually and is shown in the Monthly Bulletin of Statistics with a three month lag. Separate components for domestic and imported goods are shown.

b. Evaluation

The wholesale price index has become seriously outdated with respect to its commodity composition and weights and manufactured goods are particularly under-represented in the index. The monthly movements in the total index could, if the index were more current, provide an indication of future changes in the consumer price index as it seems that the wholesale price index anticipates such movements by a month or two. The detailed components of the index are not sufficiently reliable to provide deflators for the national accounts components.

It is suggested that the compilation of this index be discontinued as soon as the producers' price index mentioned in the section on industrial statistics becomes available. However, it would be useful to have the import component of the wholesale price index continued after its thorough revision to include representative items selected from recent import statistics and item specifications obtained by interviewing the major importers of the items selected.

2. Consumer Prices

a. Description

The 286 items and item weights selected for the 1976 based consumer price index were derived from a household expenditure survey carried out in 1973/74. The basket represents the consumption patterns of middle income households of 1 - 5 persons in 18 urban centers of Portugal. This group of households account for 64 per cent of the population of the urban centers selected, and 18 per cent of the total population of Portugal. As the household expenditure survey did not include sufficiently detailed questions on housing to provide a framework for a sample survey on rents[1/] and as no other basic material was available on housing, NIS has for the time being excluded the rent component from the index (its weight would have been 12 per cent).

Seventy NIS agents visit about 3,500 outlets monthly and collect 18,000 price quotations. Prices for perishable items are collected three times a month [2/] and prices on other food items in the last week of the month. Most other prices are collected on a quarterly basis, beginning with the northern region of Portugal in the first month of the quarter, and continuing with the central and southern regions in the second and third month of the quarter.

The index is calculated manually according to the Laspeyres' formula. Average item prices for Portugal are obtained by adding up the quotations for each urban center and dividing by the total number of quotations. These averages are in a sense weighted, as the number of quotations for each center is proportional to the population size of the center. The latest available price quotations for seasonal items are carried forward when an item disappears from the market. The substitution of items is rarely done.

1/ For sampling, the dwellings need to be stratified by location, size, age and quality of accommodation. This is particularly important in a market where prices have become distorted due to rent control over an extended period.
2/ Two of the three monthly quotations on perishables are mailed by the respondents.

Monthly data become available with a lag of two weeks and are published in a separate leaflet and in the Monthly Bulletin of Statistics.

A new household expenditure (and income) survey expected to extend through the year, covering about 11,000 households was launched in March 1980 and will provide a basis for the revision of the consumer price index. In this survey characteristics on housing are extensively covered and will allow stratification of the housing population for sampling purposes and for the inclusion of a rent component in the index. The staff envisages that the new index, which would also cover rural areas, will become available at the end of 1982. It is contemplated to add data on rent to the existing index in 1981, provided early results on the housing component of the expenditure survey can be obtained. Further plans for improvement of the new index include weighting of regional indexes with population figures to obtain the national index and the application of 12 month moving averages with varying monthly weights for seasonal items.

b. Evaluation

The system of collecting prices for the existing consumer price index and the methods used in computing it are basically sound and would provide reliable results if a rent component had been included.1/ But, due to the omission of rents, which are controlled, the index probably over-estimates the general rate of price increase in Portugal. It is therefore suggested that the processing of the housing data in the ongoing household expenditure survey be assigned a high priority so that preliminary results from this part of the survey can be used in designing a representative sample for a quarterly rent survey. The collection of rent data could begin in mid 1981 and these data could be used to adjust the total index back through 1977. It is also suggested that more attention be given to resolving the regular maintenance problems inherent in the existing index, e.g., the substitution of items and the treatment of quality changes in items.

The new index which is planned to be launched in 1982 will offer substantial improvements over the existing one. Further refinements to those envisaged by the NIS staff could cover:

(1) The inclusion of mortgage interest rates, property taxes and home insurance for owner-occupied dwellings to reflect homeowners' costs. It should also be explored whether data on rent can be collected through the labor force survey, for which a new sample of households will be drawn in 1981 (see Section IV above).

1/ It should be mentioned, however, that due to rent control and the resulting distortions in the housing market, the surveying of actual rents paid is a difficult task and requires a well stratified sample and vigilant interviewers.

(2) The weighting of the regional indexes in the national index with actual expenditure weights instead of population weights.

VI. Foreign Trade Statistics

1. Export and Import Data

a. Description

NIS receives on a daily basis export and import returns from Customs after clearance. By the tenth of the month over 90 per cent of the returns for the preceeding month are received and the returns can be forwarded for processing after checking and some coding (most of the coding is done by the exporters and importers). About 65,000 returns are handled each month. For checking purposes, lists are produced showing:

(1) the identification number of missing returns (returns are numbered by Customs in a descending order),

(2) erroneous returns, and

(3) unit values.

On the basis of this information, clarification is sought from Customs, and the preliminary data are then processed for publication. The normal publication lag is about six weeks, but was, at the time of the visit, about twelve weeks due to a strike last year in NIS and a recent change in the design of the returns. Monthly data are shown in the Trade Bulletin, classified according to the Brussels trade nomenclature and by country. Quarterly data are also tabulated according to SITC Rev. 2 and major groups of BEC. Each issue of the Trade Bulletin carries preliminary data for the latest month and revised data for the preceding month.

Portugal uses the special trade system, i.e., only trade flows which pass the customs border are recorded and are recorded at the time of customs clearance. However, re-exports are recorded although with little verification and only at the time of exit. But imports into free areas, where cars, television sets, etc., are assembled, are not recorded at all. The exports from these areas are recorded with little control (exporters are also requested to provide value figures on imported components in the goods exported). Imports from free areas into Portugal are, of course, subject to regular control. Government imports, which bypass customs clearance, are not recorded.

b. Evaluation

The NIS system of compiling trade data is efficient and accurate and can be used as a model for other NIS activities. Efforts are being made to return to the normal publication lag of six weeks and it is anticipated that this will be achieved within a month or so. NIS is also exploring the possibilities of having Customs record all trade flows of the free areas. The Bank of Portugal should support this effort as it would make it possible to derive trade data based on the general trade system, which are preferred in the compilation of balance of payments statistics.

The Bank adjusts imports to include relatively minor amounts of government imports, mainly defense imports, which are excluded from the NIS data. As this adjustment is based on Treasury data, for which the timing is the settlement of the transactions, NIS should explore the possibility of recording such imports on an arrival basis. Also exluded from trade statistics are the exports and imports of electricity. NIS should make an effort to obtain these data regularly from the National Electricity Company for inclusion in trade data.

2. Trade Indexes

a. Description

NIS discontinued the compilation of trade indexes a few years ago, and it is now in the process of constructing new indexes on the base 1977=100. The Bank of Portugal and the Ministry of Foreign Affairs are assisting in the planning of this work . The purpose is to produce quarterly and annual Laspeyres' volume indexes and Paasche unit value indexes for total exports and imports with a breakdown on major SITC and BEC groups. The working group also contemplates calculating monthly indexes at a later stage.

At the time of the visit, a first selection of the items to be included in the indexes had been made from tabulations listing the items in descending order of value within each SITC group. As a result of this exercise, all export items and the reasonably homogeneous import items, covering about 60 per cent of the total value of imports, were identified and data for these items were entered on tape, including annual data back through 1972 and monthly data back through January 1975. The heterogenous import items, which show erratic unit value movements over time, are still under study.

Some additional difficulties in the work have arisen because NIS changed to SITC, Rev. 2 in 1979 and some regrouping of the items classified according to SITC, Rev. 1 will be necessary in order to arrive at comparable time series over the period 1972-79. Computer programs for calculating the indexes have already been prepared and will soon be tested on the data stored. It is expected that the first tabulations will become available in August-September 1980 and will include calculations of unit value indexes according to both Paasche and Laspeyres' formulae.

b. Evaluation

This promising project will, in due course, fill a serious data gap in the analysis of the quantity and price components of foreign trade and of the terms of trade of Portugal. It is hoped that the indexes will become available according to schedule, and will be produced thereafter with no more than a lag of six weeks after the quarter under investigation.

In the remaining difficult task of selecting the series to be used for important heterogenous items, particularly in imports, it is suggested that the possibilities be explored for selecting a number of supplementary series as substitutes for the items provided in the detailed Customs data. The following four measures are often resorted to when a heterogenous item (mainly in the sections on machinery and transport equipment) produces erratic unit value movements:

(1) Unit values by country are calculated for the problem item and those which show reasonable unit value movements are selected (and assigned their trade weights).

(2) It may be feasible to obtain regularly from Customs, the invoices accompanying the returns of such items and from this material select more homogenous sub-items.

(3) The importers (or exporters) of such items can be approached for the purpose of identifying specific homogenous sub-items and of collecting price data from them to be used as a substitute for erratic unit values.

(4) As a last resort, the corresponding components of the trade indexes of major trading partners could be used, (e.g., the French export unit value index for aircraft) to estimate the corresponding import item for Portugal.

Although the intention of NIS is to construct a unit value index, this should not prevent the compiler from using specific prices as a substitute for erratic unit values as suggested in items (2) and (3) above. After all, a unit value index is a proxy for a price index.

NIS INDUSTRIAL PRODUCTION INDEXES, 1970 = 100

A = Annual Index

M = Monthly Index

	Total		Mining		Manufacturing		Electricity, gas	
	A	M	A	M	A	M	A	M
1972	116.6	122.1	106.4	102.0	116.7	122.7	118.9	122.1
1973	132.9	136.1	120.8	104.6	133.5	137.2	130.8	133.9
1974	139.5	139.8	119.2	100.1	139.8	140.3	143.2	146.2
1975	129.0	132.9	110.0	91.9	128.3	133.0	142.5	144.9
1976	136.7	137.7	98.7	83.3	137.3	139.8	141.5	132.9
1977	157.8	155.3	97.1	71.3	157.3	155.6	182.5	178.8
1978		165.4		72.3		166.1		186.8
1979		177.7						

EUR

INTERNATIONAL MONETARY FUND

Fiscal Affairs Department

Portugal: Technical Assistance Survey

Terms of Reference for Mr. Alan A. Tait

July 18, 1980

1. In response to a request from the Portuguese authorities, the Fund has agreed to send Mr. Alan A. Tait to Lisbon for a week in July 1980. He will discuss with the Value-Added Tax Committee their technical assistance needs in connection with the introduction of the value-added tax (VAT).

2. The Committee, in its "Preliminary Report and Program of Work," suggested the members should discuss:

(a) the taxes the VAT should replace;

(b) the consequent changes in other sales taxes (e.g., excises); and

(c) the consequent changes in income taxes (to compensate for any regressive characteristics of the VAT).

3. To achieve these objectives the Committee considers it will have to calculate the revenues and incidence of all taxes including the VAT under different assumptions about rates of tax, exemptions, and substitutions. Mr. Tait will discuss this outline in more detail with the Committee and consider the relationship of this study to the work already done by Messrs. Tanzi, de Wulf, and Abdel-Rahman.

4. The Committee considers it desirable to:

(a) model the effects of the tax substitution using an input-output matrix;

(b) push ahead with "fundamental questions" about the design and administration of the VAT with particular reference to small businesses and agriculture. Registering, filing, processing, and personnel requirements are to be estimated;

(c) estimate the effect of the tax substitution on relative prices (including final goods and services, capital goods, and agricultural production) and the general price level; and

(d) draft the law and regulations.

In all these matters Mr. Tait will try to identify the most appropriate way in which the needs of the Portuguese authorities can be met from the resources of both the FAD staff and the panel of fiscal experts, bearing in mind the necessary language requirements for experts working with the different levels of local technicians.

5. Problems of the transitional period before the VAT is introduced and while the turnover tax is still used are more properly the concern of the EEC, and Mr. Tait might emphasize the role to be played by the EEC secretariat in this area.

6. Mr. Tait will try to outline a timetable for the various projects. He may discuss, in broad terms, the possible combinations of technical assistance, and timing with the authorities, however, he will make it clear that any views or recommendations are tentative and subject to revision after discussion in Washington, D.C.

7. Mr. Tait will communicate by telex or telephone with headquarters at the end of his stay in Lisbon to give a summary of his findings. On his return to headquarters he will write a short report for the Director of the Fiscal Affairs Department.

cc: European Department
Administration Department

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MR. ANTONIO JORGE DE FIGUEIREDO LOPES
SECRETARY OF STATE FOR THE BUDGET
MINISTRY OF FINANCE
LISBON, PORTUGAL

THANKS YOUR TELEX OF JULY 8 RE TAIT VISIT TO LISBON. PLEASED INFORM YOU THAT FUND MANAGEMENT HAS GIVEN APPROVAL TO THIS. TAIT PLANS ARRIVE LISBON JULY 19 AT 0625 PER TW900 STAYING TIVOLI JARDIM. GRATEFUL SEND ANY DOCUMENTS IN REGARD TO ASSIGNMENT TO HOTEL. REGARDS.

LATHAM, INTERFUND

Special Instructions

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Mr. Tait

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Drafted by: RSLatham.mr
Department: FAD
Date: July 9, 1980

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Office Memorandum

TO : Mr. Dini

DATE: July 9, 1980

FROM : W. A. Beveridge

SUBJECT : Staff Survey of Portugal's Technical Assistance Needs

At the request of the Portuguese Ministry of Finance, Mr. Alan A. Tait (Assistant Director, Fiscal Analysis Division) is to visit Lisbon July 21-25, 1980. He will discuss with the "Value-Added Tax Committee" their technical assistance needs in connection with the introduction of the value-added tax in Portugal.

If you wish further information on this, Mr. Tait will be in headquarters until Friday, July 18, and will be happy to discuss the matter with you.

cc: Secretary's Department
European Department
Mr. Tait

7/9/80 cc: EUR
ADM

cc: SEB

Office Memorandum

TO : The Acting Managing Director

DATE: July 8, 1980

FROM : W. A. Beveridge

SUBJECT : Technical Assistance--Portugal

Following exploratory discussions in course of the recent Seminar on Budgeting and Expenditure Control with the Secretary of State for the Budget of the Portuguese Ministry of Finance, we have been asked to review the work program of a government working party set up to undertake the economic and other studies that are a prelude to the introduction of a value added tax, a step that would be consistent with accession to the EC. Following this review, we may be asked for further assistance.

I propose that Mr. Alan Tait, Assistant Director, Fiscal Analysis Division, a recognized authority on VAT matters, should visit Lisbon between July 21-25 for this purpose. Mr. Schmitt concurs on behalf of the European Department.

If you approve, the necessary administrative arrangements will be made.

Ok

cc: European Department
Administration Department

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Washington, D.C. 20431

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ADDRESS

MR. DOMINGOS OEHEN GONCALVES, DIRECTOR
GABINETE DE ESTUDOS E PLANEAMIENTO
MINISTERIO DAS FINANCAS E PLANEAMIENTO
LISBON, PORTUGAL

WE HAVE SENT THE FOLLOWING CABLE TO DR. ANIBAL CAVACO SILVA, MINISTER OF FINANCE AND PLANNING:

"REFERENCE TO MY LETTER OF MAY 22, 1980 PROPOSING A VISIT TO PORTUGAL BY MR. GUSTAVO ORTIZ OF BUREAU STAFF FOR TWO WEEKS BEGINNING OCTOBER 27, 1980 TO ASSIST IN COMPILATION OF GOVERNMENT FINANCE STATISTICS. NO REPLY YET RECEIVED. TO FINALIZE OUR SCHEDULES WOULD APPRECIATE REPLY ON PROPOSED VISIT AT YOUR EARLIEST CONVENIENCE."

APPRECIATE YOUR ASSISTANCE.

DANNEMANN

INTERFUND

Special Instructions

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Area Department
Executive Director
Mr. Dannemann
Mr. Levin
Mr. Dine
EUR

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Drafted by: JLevin/JDodsworth
Department: Bureau of Statistics
Date: July 3, 1980

Werner Dannemann
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MR.DANNEMANN

MR. JACQUES DE LAROSIERE
MANAGING DIRECTOR
INTERFUND
WASHINGTONDC

I HAVE THE HONOUR TO INFORM YOU, IN ACCORDANCE WITH ARTICLE IV OF THE IMF ARTICLES OF AGREEMENT, THAT THE MONTHLY DEPRECIATION OF THE EFFECTIVE EXCHANGE RATE OF THE PORTUGUESE ESCUDO WILL BE REDUCED FROM THE PRESENT 0.75 0/0 TO 0.50 0/0 WITH EFFECT AS FROM THE END OF JUNE 1980.

YOURS SINCERELY

RECEIVED
JUN 20 1980
TREASURER'S DEPARTMENT
OPERATIONS DIV.

MANUEL JACINTO NUNES
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INTERFUND WSH

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cc SED

Office Memorandum

TO : The Deputy Managing Director

DATE: June 3, 1980

FROM : A. Pfeifer

SUBJECT : Portugal - Cooperation with the IBRD

The IBRD are sending a mission to Portugal to prepare an updating report with special emphasis on resource mobilization to support a medium-term investment program. As the mission will more than usually deal with financial matters they are prepared to include a member of the Fund staff on their team. Mr. Whittome believes it to be in the Fund interest that we should cooperate and we are therefore proposing to send Mr. Saumya Mitra of this Department along. The mission will start work on or about June 23, and will remain in Lisbon for about two and a half weeks. May we have your approval?

OK

Thank you.

cc: ADM) after
SEC) approval

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OFFICIAL MESSAGE
INTERNATIONAL MONETARY FUND
Washington, D.C. 20431

cc: SED

TIME RECEIVED

ADDRESS

MR. ANIBAL CAVACO SILVA
MINISTER OF FINANCE
LISBON, PORTUGAL

Special Instructions

REFERENCE YOUR DISCUSSION WITH RECENT IMF MISSION ABOUT POSSIBLE TECHNICAL ASSISTANCE TO TAX COMMISSION. I HOPE WE CAN HELP. SUGGEST WE DISCUSS DETAILS OF EXPERTISE NEEDED, TIMING, DURATION, AND ARRANGEMENTS WITH MR. A. JA FIGUEIREDO LOPES, WHO WILL ATTEND SEMINAR ON BUDGETING AND EXPENDITURE CONTROL AT FUND HEADQUARTERS BEGINNING JUNE 9.

GOODE, DIRECTOR, FISCAL AFFAIRS DEPARTMENT, INTERFUND

Distribution

EUR

MESSAGE MUST END HERE

Drafted by: ~~RGoode.mr~~
Department: Fiscal Affairs I.O.
Date: May 16, 1980

Richardx Goode
NAME (TYPE)

SIGNATURE

NAME (TYPE)

SIGNATURE

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Mr. Goode

May 13, 1980

L. A. Whittome

Portugal--Technical Assistance

I understand from Mrs. Ter-Minassian, who recently led the 1980 Article IV consultation mission to Portugal, that the Finance Minister, Dr. Cavaco Silva, expressed a keen interest in obtaining the assistance of a fiscal expert for a commission he has recently set up to study a comprehensive reform of their system of indirect taxation, and in particular a shift from the existing transaction tax to VAT, in anticipation of Portugal's entry into the EC. He would hope that the assistance of the expert could be provided for a period of a few months. I understand that the Secretary of State for the Budget will be attending your Department's seminar on control of public expenditure in June. This could provide a suitable occasion to probe further into what exactly is required. However, in the meantime Dr. Cavaco Silva would very much hope that you would be able to give him a very general indication of your likely attitude. For our part we very much hope that you will be able to help.

cc: SED

May 12, 1980

MEMORANDUM FOR FILES

Subject: IBRD Report

I spoke today to Mr. Sri Ram Aiyer of the IBRD upon his return from Lisbon, where a team led by Mr. Karaosmanoglu had discussed with the Portuguese authorities the IBRD report on the public investment program of Portugal. He said that the report had been extremely well received not only by Dr. Cavaco Silva but also by the other Ministers responsible for the projects analyzed by the Bank. Except for a project on iron ore, for which a new feasibility study had been prepared recently, the recommendations of the Bank were generally heeded and would form the basis for an updated public investment plan to be presented in June. The IBRD team expected to begin shortly revising their report for release to the Executive Board by end June.

Mr. Aiyer indicated that the Bank team's complaints about Portugal's apparent inability to fulfill the schedules of projects financed by the Bank, which had led to the accumulation of large undisbursed loans, found a most sympathetic audience in Dr. Cavaco Silva, who was trying to enlist the support of other Cabinet members to deal with the problem. On the question of lending for structural adjustment, Mr. Aiyer said that it was his personal opinion that it could be linked to some investments planned in the energy field (especially in the electricity distribution network) but that there appeared to be some resistance on the part of senior Bank staff to call such assistance a structural adjustment loan. Finally, he indicated that a three-man Bank mission was planned for June to study in more detail the problem of resource mobilization, which had been barely touched upon in the report on public investment. He said he looked forward to a close collaboration with us in the weeks ahead.

T. Ter-Minassian T.T.M.

cc: Mr. Whittome
Mr. Schmitt (o/r)
Mr. Mitra

Mr. Whittome

CONFIDENTIAL

April 26, 1980

MEMORANDUM FOR FILES

Subject: Informal Meeting with Dr. Cavaco Silva

I met this evening for a private dinner with the Finance Minister, Dr. Cavaco Silva. I began by saying that I was grateful for the opportunity to meet informally with him and have the benefit of his views on the main economic policy issues at the present time. As our meetings had not yet covered in any detail the outlook for 1980, I was not in a position to present him our views at this time but hoped to meet him again toward the end of our visit to do so. He replied that, while he understood my position, he would welcome some preliminary reactions to his views. The conversation proceeded quite informally and covered a broad range of issues.

On the current economic outlook, he said that the official forecast was for a decline in the rate of growth of activity compared with 1979; some thought that growth might be as low as 2.5 per cent. However, when pressed, he admitted that there were signs that activity had been rising quite rapidly in the first quarter of the year, particularly in construction, and that some excessive pressure of demand might have been building up as a result of the marked easing of credit policy from mid-1979 onwards. He also recognized that the sharp increase in social transfers was likely to boost private consumption.

On wages he said that the fact that the Government had not imposed a ceiling did not mean that it did not have a wage policy. A guideline of no growth in gross real wage rates had been put forward and steps were being taken to ensure that it be observed in the public sector, including the public enterprises. These steps included the freezing of budgetary subsidies to the latter to the 1979 level and the announcement that they would not be allowed to pass on to prices wage increases in excess of 20 per cent. He recognized that, to secure broad compliance with the guideline by the private enterprises, which generally enjoyed a favorable profit position, a significant tightening of financial policies would be required. He admitted that some slippage might occur, compared to the target, but did not seem to believe that it would be major.

In the area of fiscal policy, he detailed some of the measures that were being taken to reduce evasion, including a substantial stepping up of selective audits, streamlining of collection procedures, publication of lists of delinquent taxpayers, refusal to grant budgetary subsidies to public enterprises which had not paid their taxes, and a temporary (two months) moratorium on penalties for taxpayers that were prepared to regularize their position. On expenditure, he said that he was hopeful of substantial success in containing the growth of public consumption, as he had the backing of the Prime Minister in his efforts to restrain the spending ministers. He was determined to resist pressures to increase subsidies to the public enterprises because he felt that utmost firmness was necessary to push them toward greater efficiency, as well as to secure restraint in their wage agreements. His main source of concern in the budget areas were the local authorities and the regional authorities. There he was acting to limit the transfers required by the law on local finance, through a restrictive interpretation of the latter, and to shift personnel and functions along with revenue. In general he said that, although some slippage may occur in the execution of the budget, he thought it important that a determined start was being made both in reversing the escalating trend of expenditure and in distributing more equitably the burden of taxation.

On financial policies he indicated that he shared my concern on the marked deterioration in the external position in recent months and recognized that it was at least in part related to the deterioration in the interest differential with abroad and to the excessive credit expansion since mid-1979. He said that he had taken firm steps to bring the latter under control by requiring the banks to return under the credit ceilings in the course of the next month. He was aware that this might affect adversely their profit position but felt that the latter remained comfortable, especially after a very good first quarter of 1980. On interest rates he said that he was pressing to secure the Cabinet consensus to raise them in the near future but that was encountering great resistance, especially since interest rates abroad had declined marginally in recent weeks. He indicated that some pressures on our part in that respect would not be unwelcome but that realistically he saw more hope for restraining credit than for raising interest rates. He also indicated that, to protect reserves, he was pressing the major public enterprises to seek external financing and had programed a $350 million loan for the Treasury. He was hopeful that, with these measures and the approaching tourist season, the loss in net foreign assets could be arrested at least until the fall, when political constraints to interest rate action would be eased. I stressed that the experience of the last few months had shown the fragility of the improvement in the external position. The deterioration in the current account, resulting from the downturn in external demand and the loss in the terms of trade, should not be aggravated by a worsening of the capital account. It was essential to maintain Portugal's creditworthiness and to avoid a repetition of the experience of 1976-77. I urged him to keep the situation under close control and press for prompt action on interest rates if it appeared that the trend of the past few months was not being reversed.

On exchange rate policy, he defended the revaluation on the grounds that its cost in terms of competitiveness was, in his view, outweighted by its favorable impact on inflation. However he recognized that further losses in competitiveness, at a time of downturn in world demand and sharp deterioration in the terms of trade, would be dangerous. Therefore he had refused to lower the depreciation rate, until there was more clear evidence that substantial progress was being made on inflation. He agreed with my view that exchange rate policy needed above all to remain credible, and that it was essential to avoid changes in the depreciation rate that the market would view as unsustainable over the longer run.

Finally we talked about the medium term outlook. He said that, despite the existing political uncertainties, the Government intended to proceed to prepare a medium-term development plan, working with the World Bank in defining an appropriate investment strategy. He expected to obtain some financial support from both the Bank and the EC, and wondered whether the Fund would be interested in negotiating an agreement to support such a program as well. I replied that in principle resources from both the EFF and the SFF (amounting to at least SDR 485 million) would be available to support an appropriate development program for Portugal. Indeed we saw such a program as the natural follow-up to a stabilization effort that was designed to ease the external constraint on growth. We would be glad to work with the Portuguese authorities in designing a consistent package of financial and other policies aimed at securing achievement of a higher but sustainable growth rate. Such a program, which would involve medium-term policies directed at mobilizing domestic savings, both public and private, and at attracting external savings through an appropriate debt management strategy, in our view would be a necessary condition for a sustained investment and development effort. On the question of timing, I indicated that funds from the SFF would have to be committed by February 1981. Dr. Cavaco Silva said that he expected the medium-term plan to be ready in the summer and thought that preliminary technical negotiations could start even before the elections, with a view to concluding an agreement after the latter. I said that, from our staffing viewpoint, it was difficult to give precise indications at present as to an appropriate time for commencing the negotiations, but that we would be in a better position to do so when the plan was presented.

In conclusion, Dr. Cavaco Silva indicated that he was planning to receive the mission formally toward the end of next week when we could give him a more specific presentation of our views.

T. Ter-Minassian

T. Ter-Minassian

cc: Mr. Hansen
Mrs. Mitchell
Mr. Mitra

Mr. Whittome

May 5, 1980

Aide Memoire

Financial Assistance Available to Portugal
Under the Extended Fund Facility
and the Supplementary Financing Facility

A member country which has entered into an arrangement with the Fund under the Extended Facility (EFF) for a period of up to three years, may draw up to 140 per cent of its quota. This amount may be supplemented by use of the "Witteveen Facility" (SFF) to the extent of an additional 142.5 per cent of quota. In Portugal's case the amounts available on the basis of the present quota (SDR 172 million) are SDR 240.8 million under the EFF plus SDR 245.1 million under the SFF, for a total of SDR 485.9 million (approximately US$630 million). On the basis of Portugal's new quota (SDR 258 million) after the VIIth General Review of Quotas comes into effect, the total amount available would be about SDR 720 million (approximately US$930 million). These amounts may be further increased through additional use of the SFF, in case of exceptional balance of payments need.

It should be noted that the SFF, which consists of a total of SDR 7.78 billion, to be allocated in order of successful application, is presently scheduled to expire on February 28, 1981.

The terms of the loans are as follows:

1. An initial service charge of 0.5 per cent of the total amount of the transaction applies to both facilities.

2. The interest rate on purchases outstanding under the EFF rises by 0.5 per cent per year from 4.375 per cent in the first year to 6.375 per cent after five years. Amounts drawn under the EFF must be repaid within ten years, starting after the fourth year.

3. The interest rate on purchases outstanding under the SFF is at present equal to the interest rate paid by the Fund to lenders (which is based on the average daily

yields on actively traded U.S. Government securities with a constant maturity of five years) plus a margin of 0.2 per cent per annum for the first three years of the loan, increased by one eighth of 1 per cent per annum thereafter. The loan must be repaid within seven years, starting after three and one half years.

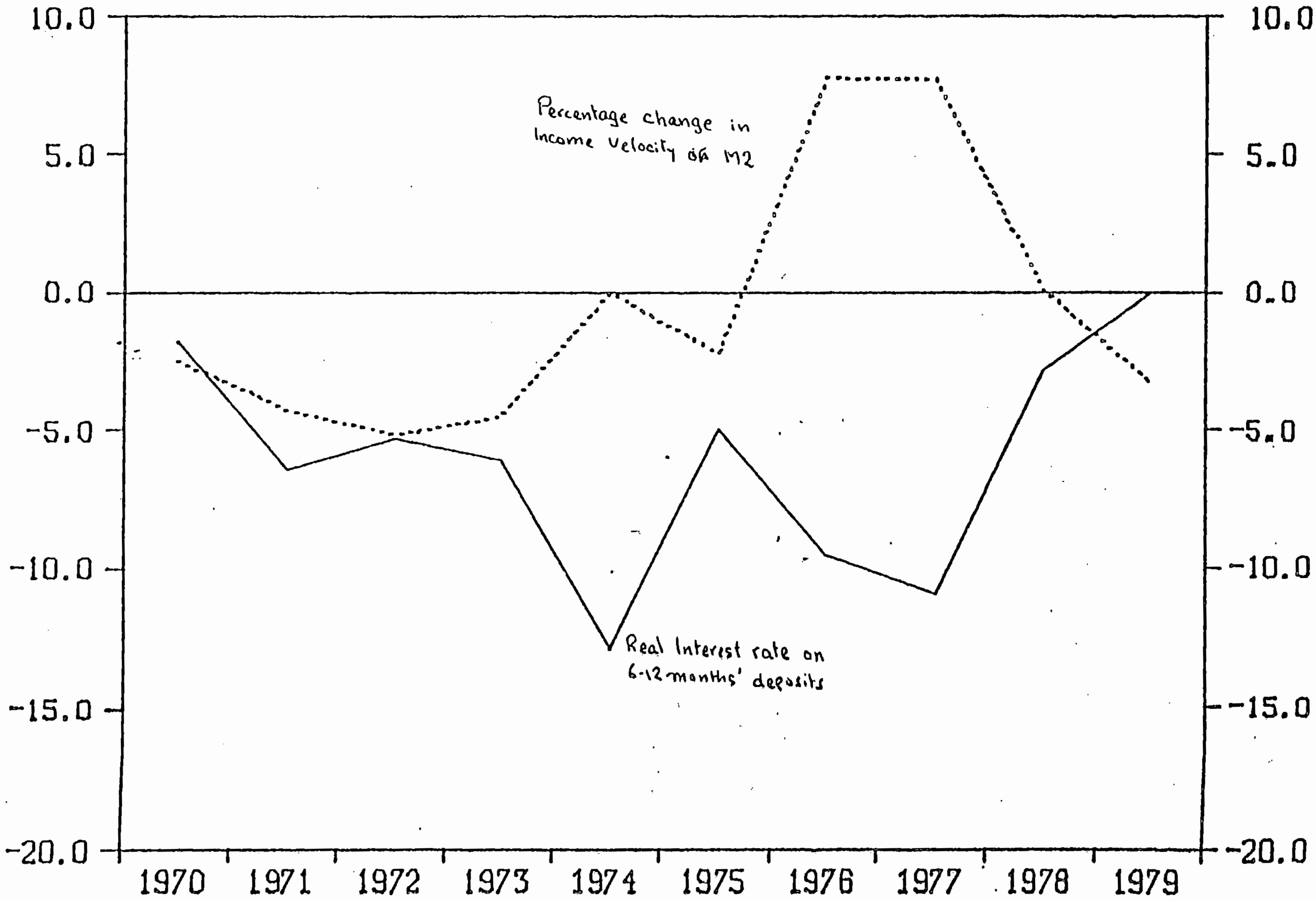
Chart 6

PORTUGAL

VELOCITY AND INTEREST

(Percent)

Fd Ex fets / G Rubmall



SOURCE IMF staff calculations and IFS

PORTUGAL

Mr Whittome

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

May 2, 1980

MEMORANDUM TO FILES

Subject: Portugal--Extended Fund Facility

Teresa told me yesterday over the phone from Portugal that the Minister of Finance looked to a resumption of discussions on the Extended Fund Facility in September. It would be his hope to put together a mutually satisfactory arrangement before the elections in October to permit quick agreement in November in the event they should be returned to office. Meanwhile the Portuguese would review their public investment program with the World Bank.

Today I met with Karaosmanoglu, Dubey and Aiyer of the World Bank preparatory to their departure for Lisbon this week-end. I reported the revived Portuguese interest in an EFF arrangement and the possible World Bank link. They explained that their forthcoming visit had two purposes, one to advance some operational matters and the other to discuss their draft report on the Portuguese public investment program. Karaosmanoglu then reported that he had gotten the green light on a Structural Readjustment Loan for Portugal but only on condition that total lending to Portugal would not exceed the overall limits previously placed on it. He would therefore leave the choice between project and Readjustment lending to the Portuguese.

We agreed that the macro-economic framework for the investment program specified in the Bank's draft report was outdated as it did not take recent increases in energy costs into account, nor the slowdown in the growth of the world economy that is now in prospect. I explained our own general approach to macro-economic programming to them and found broad understanding though not necessarily complete endorsement for it.

Hans Schmitt

cc: Mr. Whittome
Mrs. Ter-Minassian (o/r)

Mr. Whittome

Office Memorandum

TO : Mr. Syvrud

DATE: April 2, 1980

FROM : Hans Schmitt

SUBJECT : Lessons of Portugal

Attached please find a copy of a paper by Krugman and Macedo of the Economic Growth Center at Yale University.

The paper is highly supportive of some major provisions of Portugal's 1978 stand-by arrangement with the Fund. In particular it provides much of our own rationale for insisting on an exchange rate policy that would restore competitiveness by reducing real wages. We argued strongly at the time that this was a precondition for growth and development as much as for stabilization.

May I draw your attention in particular to the following quotes:

"The attempt to use the cause of disequilibrium to determine the remedy is a mistake." (p. 10)

"If a country finds itself oscillating between unemployment and balance of payments deficits this is an indication that the actual real wage exceeds the warranted." (p. 29)

"The austerity program agreed upon with the Fund in May 1978 had thus to be more stringent than would have been the case had it been implemented in the summer of 1976." (p. 37)

"The eventual direction of Portuguese policy has thus been determined by the logic of the situation." (p. 36)

cc: Mr. Whittome
Mr. Finch

Mr. Whittome

Office Memorandum

TO : Mr. Dini

DATE: April 2, 1980

FROM : Hans Schmitt

SUBJECT : Lessons of Portugal

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cc: Mr. Whittome
Mr. Finch

ECONOMIC GROWTH CENTER

YALE UNIVERSITY

Box 1987, Yale Station
New Haven, Connecticut

CENTER DISCUSSION PAPER NO. 326

THE ECONOMIC CONSEQUENCES OF THE APRIL 25TH REVOLUTION

Paul Krugman and Jorge Braga de Macedo

November 1979

Note: Center Discussion Papers are preliminary materials circulated to stimulate discussion and critical comment. References in publications to Discussion Papers should be cleared with the author to protect the tentative character of these papers.

Revised
October 1979

THE ECONOMIC CONSEQUENCES OF THE APRIL 25TH REVOLUTION*

Paul Krugman

Jorge Braga de Macedo

Economic Growth Center
Yale University

*This paper is based in part on presentations by the authors at the Washington Center for Foreign Policy Research, School of Advanced International Studies, The Johns Hopkins University, in April and May of 1979. An earlier draft was presented at the II International Meeting on Modern Portugal, University of New Hampshire, June 1979. We are grateful for comments received at both places.

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"Les à - coups d'accéleration de l'histoire marquent la vie des peuples comme les sacrements celle du chrétien. Ces periodes extra-ordinaires sont aussi la bibliothèque où, qui en a compris la grammaire, peut lire a livre ouvert les lois du changement social profond" Serge-Christophe Kolm, La Transition Socialiste--La Politique Economique de Gauche, Paris: Les Edition du Cerf, 1977.

"In the study of social phenomena, disorder is, it is true, the sole substitute for the controlled experiments of the natural sciences. But it sometimes happens that, in the midst of disorder, events move so rapidly that we are not able properly to observe them; disorder may be excessive even to the most detached of scientists." Frank D. Graham, Exchange, Prices, and Production in Hyper-Inflation: Germany, 1920-23, Princeton: Princeton University Press, 1930.

In the last few years, a unique combination of drastic internal and external shocks has turned Portugal into a testing ground for social and economic theories. But the ground is dangerous; nations are not laboratories where the effects of different factors can be studied in isolation. If there are lessons to be learned from Portugal's experience, they must be based on a theoretical framework which enables one to disentangle events in which several forces operated simultaneously.

In this paper we present an interpretation of the economic experience of Portugal since the revolution. We believe that the enduring consequence of April 25 has been the transformation of Portugal into what one might call a politicized market economy. In any market economy prices of goods and factors perform the dual role of allocating resources and determining the distribution of incomes. A politicized market economy is one in which the distributional role of prices becomes a justification for their manipulation, but in which the allocative role of prices is not replaced by a centralized allocation of quantities. Examples of the resulting dilemma are present even in relatively non-interventionist countries: e.g. the problems of EEC agricultural prices or U.S. oil prices. But in Portugal the dilemma has economy-wide consequences, for the crucial politicized price is the price of labor.

The real wage determines the distribution of income between capital and labor, yet it is also a price determining supply and demand. If the real wage is left to the market, it may not settle at a level which is regarded as just; if it is set politically, it will not fulfill its allocative role.

The paper is organized as follows. Section 1 gives some background on Portuguese economic development before the revolution. Section 2 develops an analytical framework based on two "strategic variables"--output and the real wage--whose evolution is analyzed in Sections 3 and 4 respectively. Section 5 contains a brief conclusion.

1. Background: Portugal before 1974

In 1973 Portugal's economy was fairly typical of the group of middle income nations sometimes referred to as newly industrializing countries or "nics".[1] These countries were able to achieve rapid economic growth during the 1960's and early 1970's via increased trade, exploiting their relatively abundant supplies of semiskilled industrial workers in textbook fashion: exporting labor-intensive manufactured goods, and also exporting labor directly in the form of emigrant workers. Portugal, with its 700,000 emigrant workers, relied more than most nics on direct export of labor, but substantial exports of textiles, electronic components, and other labor intensive manufactures had also emerged by the early 70's.

Table 1 presents some statistics on Portuguese economic growth before 1974, with comparable statistics of Spain and Greece for comparison. All three countries grew in somewhat similar fashion, so that these "soft

TABLE 1

Growth in Southern Europe Before 1974

	Portugal	Spain	Greece
Rate of Growth of GDP Per Capital, 1968-73	7.4	5.8	7.5
Exports/GDP, 1968	24.2	13.0	9.6
Exports/GDP, 1973	25.8	14.3	14.2
Imports/GDP, 1968	29.2	15.6	18.2
Imports/GDP, 1973	33.2	15.6	25.2

Source: International Financial Statistics underbelly" countries form a natural group. Several points stand out. First, growth was quite rapid, with real GDP per capita growing at rates which, if not up to South Korean or Taiwanese standards, were still much higher than less developed countries in general have managed. Second, growth was pro-trade biased; in all of the countries exports and imports rose relatively to gross domestic product; i.e., the economies became more "open" as they grew. In 1974-77 Portugal diverged from the others; Spain and Greece continued to grow more open, while Portugal did not.

In saying that Portugal achieved fairly rapid growth, we are not implying that all was for the best. One problem with the economic development of Portugal is suggested if we notice that in qualitative terms Portugal was moving into an economic relationship with respect to industrial Europe similar to that of Puerto Rico with respect to the mainland of the United States. In other words, Portugal was becoming a dependent economy. One need not interpret "dependence" in a Marxist way, certainly not in a way that suggests that what was happening was economically bad for Portugal. The problem was (and is) simply the fact that Portugal's economy is strongly affected by economic policy decisions of the industrial countries, decisions in which it has no voice.

The other problem with Portuguese growth was distributional. While it is probably true that nearly all Portuguese gained from growth, the gains were distributed unequally, both between city and countryside, and between the population at large and the elites which controlled economic and political life. There is little hard evidence on this, but Portugal by 1973 appeared to be a "dualistic" economy whose traditional sector had not shared fully in growth.

Despite these problems, it is difficult to avoid regarding the Portuguese economy before 1974 as a successful one. Portugal was still, in 1973, a poor country; but it was steadily catching up with the industrial west.

This qualified success story came to an abrupt end in the fall of 1973. The oil embargo had a particularly strong effect on Portugal, despite her claim on the abundant oil of Angola. In February 1974 inflation shot up to over 30 percent at an annual rate, supplies of some foodstuffs in Lisbon were disrupted, some white collar trade unions went on strike and it was in a political vacuum that an 'Armed Forces Movement'--of ambiguous economic ideology--took power on April 25.

Suddenly, then, the Portuguese economy was subjected to a unique combination of shocks. Political and social revolution at home, in addition to its direct effects, triggered a massive return of settlers from Africa. At the same time the crisis in the world economy raised the prices of imports, depressed the demand for exports, and provoked a return of emigrant workers.

We will, once again, attempt to isolate a few crucial aspects of these complex economic events. We now turn to an explicit discussion of the theoretical framework determining our choice of points to emphasize.

2. A Framework for Analysis

Our method in this paper will be to concentrate on two "strategic" variables, the real wage rate and the level of output; or more precisely, on output relative to potential and the real wage relative to its "warranted" level, a concept which will be explained below. Other aspects of Portugal's economy will be considered either as affecting these strategic variables or as being affected by them. In other words, we will attempt to sort out the tangle of events by first tracing the path of the strategic variables; then working backward to the major causes of changes in these variables; and finally moving forward to the effects of the changes.

The idea of concentrating on a few strategic variables is probably worth justifying, although this is not the place for an extended methodological discussion. Our basic suppositions are that, while the number of variables which have been subject to changes in recent years is large, the number of variables which are of crucial policy importance is fairly small. At the same time, we suppose that some of these crucial variables can be regarded as determined by the others, so that the structure of the economy looks something like this:

Exogenous and Policy Variables ⟶ Strategic Variables ⟶ Other Crucial Variables

where the strategic variables are thus both important in their own right and the intervening variables through which other important variables are determined. Among the exogenous and policy variables we would put oil prices, the exchange rate, government spending, and so on; the main crucial but not strategic variables are the balance of payments, unemployment, and the distribution of income.

The virtue of this scheme is that it lets us focus on a relatively limited number of channels of cause and effect. The defect is, of course, that it involves a simplification, and may give a somewhat misleading transparency to events. However, when there are a few shocks as drastic as those which Portugal has experienced, even very simple analysis can be enlightening.

Let us begin, then, by discussing the crucial relationships which we believe obtain in the Portuguese economy. First, and most obvious, is the relationship between output and unemployment. Other things equal, higher output will mean higher employment, and there is some level of output which corresponds to "full employment" (which includes allowance for some normal level of unemployment).

Less often emphasized but also crucial is the relationship between output and the real wage, on the one hand, and the current account of the balance of payments on the other. Clearly, increasing output will swell the demand for imports and, other things equal, worsen the balance of payments. Holding output constant, an increase in the real wage will normally involve increasing the price of domestic relative to foreign goods, so that there will also be a negative effect of the real wage on the balance of payments.

When, for simplicity, the level of output consistent with full employment is independent of the real wage, these relationships can be illustrated with a diagram like Figure 1.[2] In the diagram, one axis measures X, the level of real output, while the other measures the real wage rate W. The vertical line IB indicates the level of output consistent with full employment, while the line XB indicates the combinations of real wage and real output consistent with current account balance. The diagram shows that, given full employment output Y*, there is a unique level of the real wage W*, which is consistent with external balance. We will refer to W* and Y* as the "warranted" real wage and "potential" output respectively. They are the only levels of W and X which are consistent with equilibrium in both the labor and foreign exchange markets. Departures from these levels always involve a situation of disequilibrium--that is, a situation of economic or social stress.

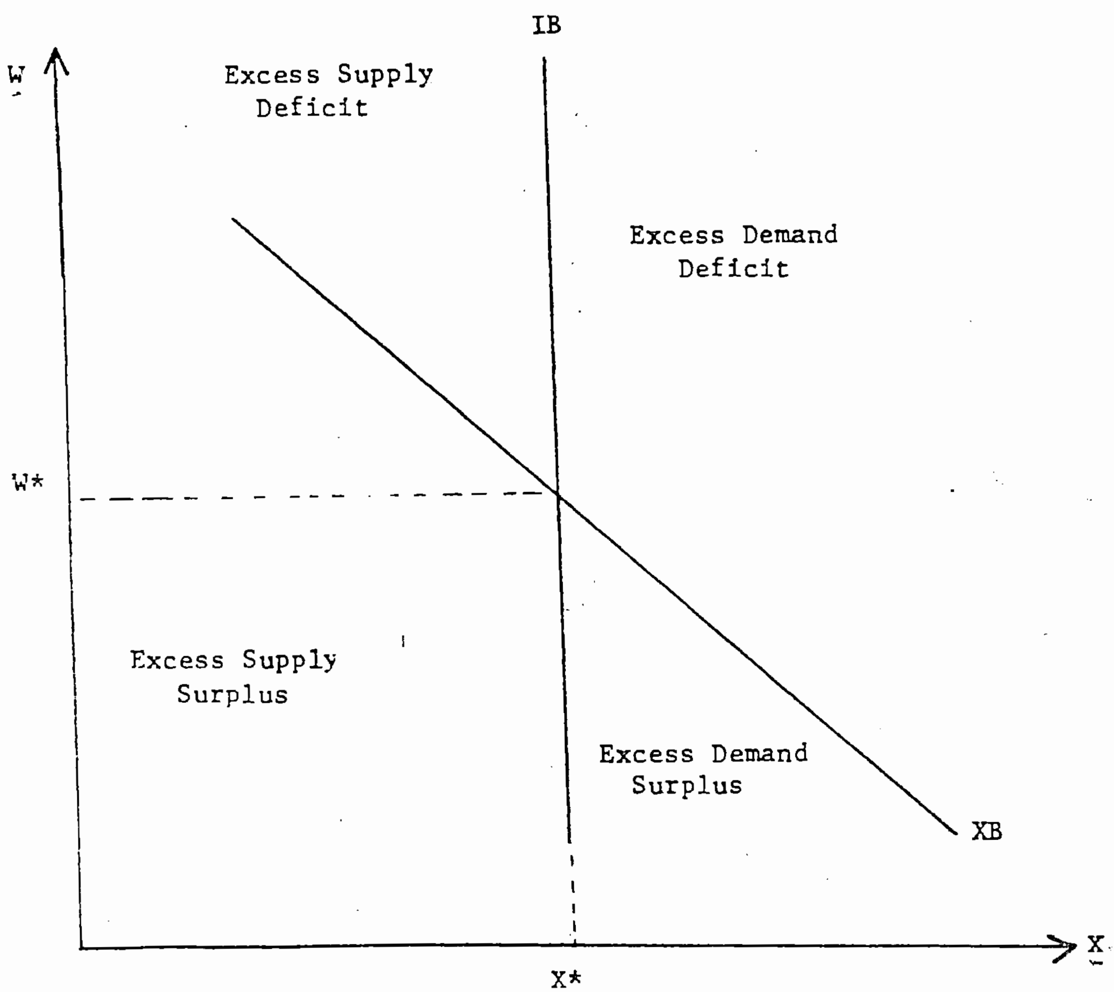
The possible kinds of disequilibrium are illustrated by the "zones of economic unhappiness" surrounding the equilibrium point. For each zone the state of the labor market and of the balance of payments are indicated. On the eve of the revolution Portugal was in a situation of tight labor markets and payments surplus, i.e., it was in the southeastern zone of the diagram. Since late 1974 the characteristic state of the economy has been more like that in the northwest zone--persistent unemployment and current account deficits.

While a diagram like Figure 1 is of considerable diagnostic use, it has some defects if one tries to use it to discuss events in Portugal. The problem is that the schedules have undoubtedly shifted drastically. For example, the arrival of the returnees must, by increasing the supply of labor, have increased potential output and reduced the warranted real wage. In order to trace out the path of the economy one would not only have to keep track of W and X but of the shifting IB and XB schedules as well. This would destroy the simplicity of the scheme.

What we will do to avoid this problem is replace W and X as our variable by W/W* and X/X*: that is, by the actual values relative to their equilibrium values. To a first approximation, one would expect the XB and IB schedules to remain unchanged when drawn in this space. Thus the effect of, say, a rise in oil prices--reducing the warranted real wage--would be to raise W/W* for a given W, not to shift the XB curve. The variables W/W* and X/X* become our strategic variables, and the starting point of our analysis is a story about their path over time which

Figure 1

The "Zones of Economic Unhappiness"



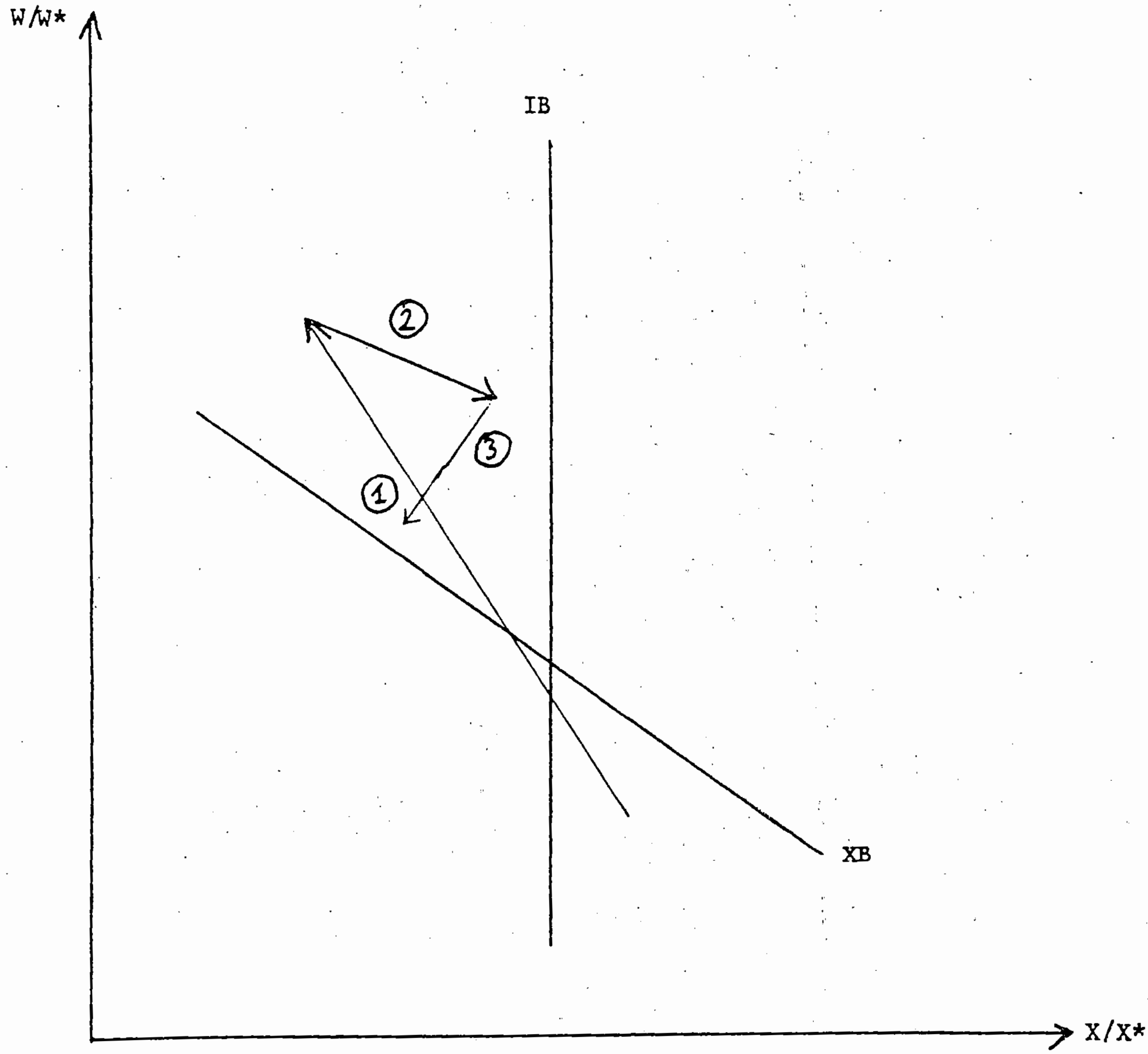
makes sense of the observed economic developments.

This may be an appropriate place to say something about the "structural" aspect of Portugal's economic difficulties.[3] It is often argued that conventional macroeconomic analysis is not applicable to Portugal because the problems are not primarily due to increases in real wages or domestic demand, but are rather the result of real shocks such as the rise in oil prices and the loss of the colonies. What this amounts to saying is that in our Figure 1 the schedules have shifted; or, equivalently, in Figure 2 the movement of the economy has been due primarily to changes in W* and Y*. In fact, we would agree that such "structural" changes have been large and important. But the attempt to use the cause of disequilibrium to determine the remedy is a mistake. Suppose that external shocks--such as an oil price increase—were to lead to a combination of balance of payments deficit and unemployment, the real wage having remained unchanged. Even though real wage increases would not be the cause of disequilibrium, it would still be the case that the real wage would have to fall to achieve internal and external balance. Whatever the cause of disequilibrium, conventional macroeconomic analysis can still be used to determine the way back to equilibrium.

Returning to the analytical framework, in Figure 2 we indicate schematically the course we believe Portugal has followed since 1973. In 1973 the Portuguese economy was in a situation of tight labor markets, as shown by the low unemployment rate, and was running a current account surplus; thus our starting point, as shown in Figure 2, is one of disequilibrium. There followed a series of events which we would divide into three phases, shown in our schematic as 1, 2, and 3.

Figure 2

Three Phases of Macroeconomic Adjustment



(i) Phase 1 (1974-75): There was a rise in real wages and a slump in output (in 1975 only). Unemployment increased and the current account moved into deficit. Because of the oil price increase, the world recession, and the increase in Portugal's labor force, the warranted real wage dropped considerably. The last factor may also have increased potential output. Thus we suppose in Figure 2 that 1974-75 was marked by a sharp rise in W/W*, as the numerator rose and the denominator fell, and also by a decline in X/X*.

(ii) Phase 2 (1976-77): Under pressure from wage controls, devaluations, and the overhang of unemployed, real wages fell. But an explosion of credit produced rapid growth in output. The effect of output expansion was enough to worsen the external balance in spite of the decline in real wages.

(iii) Phase 3 (1978-): Real wages continued to decline; but this was now accompanied by tightened credit, producing slower output growth. As we show in Figure 2, the effect has been to move Portugal close to external balance.

To explain why Portugal has followed this path requires a more detailed examination of events. This is done in the next two sections: Section 3 analyses the course of expenditure, output, and the capacity of the economy; Section 4 discusses movements in real wages and their relationship to changes in the equilibrium real wage rate.

3. Output

The evolution of output in Portugal since 1973 is summarized in Table 2. Until 1977 real gross domestic product in 1975 prices grew on an average at a rate of 2.4% p.a., much less than the growth rates of the late 60's and early 70's but still above the comparable EEC figure of 1.8%. As is apparent from the table, however, the variability of Portuguese output was also higher.

The figures for 1977 and 1978 are still first round official estimates and some earlier figures are included to show the precarious nature of these estimates. First-round official estimates of 1973-75 output available in mid 1976 were substantially revised twice and led to underestimating the strength of the 1976-77 recovery. Forecasts have been even less reliable. The best 1976 forecast for 1977 was a supposedly "optimistic" one which assumed a 10 percent increase in investment, regarded as extreme at the time. Yet output growth was less than forecast.

The Plan forecast of growth for 1979 is 2.8 percent; given the rise in oil prices and the downward revisions in estimates of OECD growth, this is probably over-optimistic.

Chart 1 shows that the decline in the growth rate in 1974 and 1975 was also accompanied by a sharp fall in the share of output devoted to investment. This obviously tended to reduce the rate of growth of potential output. And the investment figure--which is in any case highly unreliable[4] --understates the problem. A large part of capital formation in the post 1973 period has gone to public sector projects of questionable productivity, particularly the immense Sines project. The decline in private investment is thus far larger than these numbers would suggest. In 1976, for instance,

TABLE 2

Output Estimates
(million Contos)

	1973	1974	1975	1976	1977	1978	1979
1. Current prices GDP f.c.	254.2	309.0	342.1	422.6	563.8	715.4	874.8
2. GDP m.p.	281.1	338.4	376.2	467.6	622.2	781.9	953.0
3. GDP m.p. 1975 prices Estimated in							
3.1 1979	388.8	393.2	376.2	402.0	423.4	437.1	
3.2 1978	389.3	393.7	376.7	406.7	426.6		
4. Forecast in							
4.1 1976	377.8	389.0	373.5	390.3	408.0A 414.4B		
4.2 1977				383.3	397.4A 402.5B		
Growth rates % p.a.							
5. Portugal	11.9	1.1	-4.3	6.9	5.3	3.2	2.0
6. EEC average	5.9	1.6	-1.5	5.0	2.3	2.8	3.2

Sources:
1. a) 1973-76 Instituto Nacional de Estatística (except for construction in 1976, source 1b)
   b) 1977-78 Banco de Portugal and Departamento Central de Planeamento
   c) 1979 DCP forecast in Grandes Opções do Plano, 1979

2. a) 1973-78 same as above
   b) Adjusted for 1978 collected indirect taxes and 1979 budget with own estimate for subsidies based on same ratio to indirect taxes as 1977.

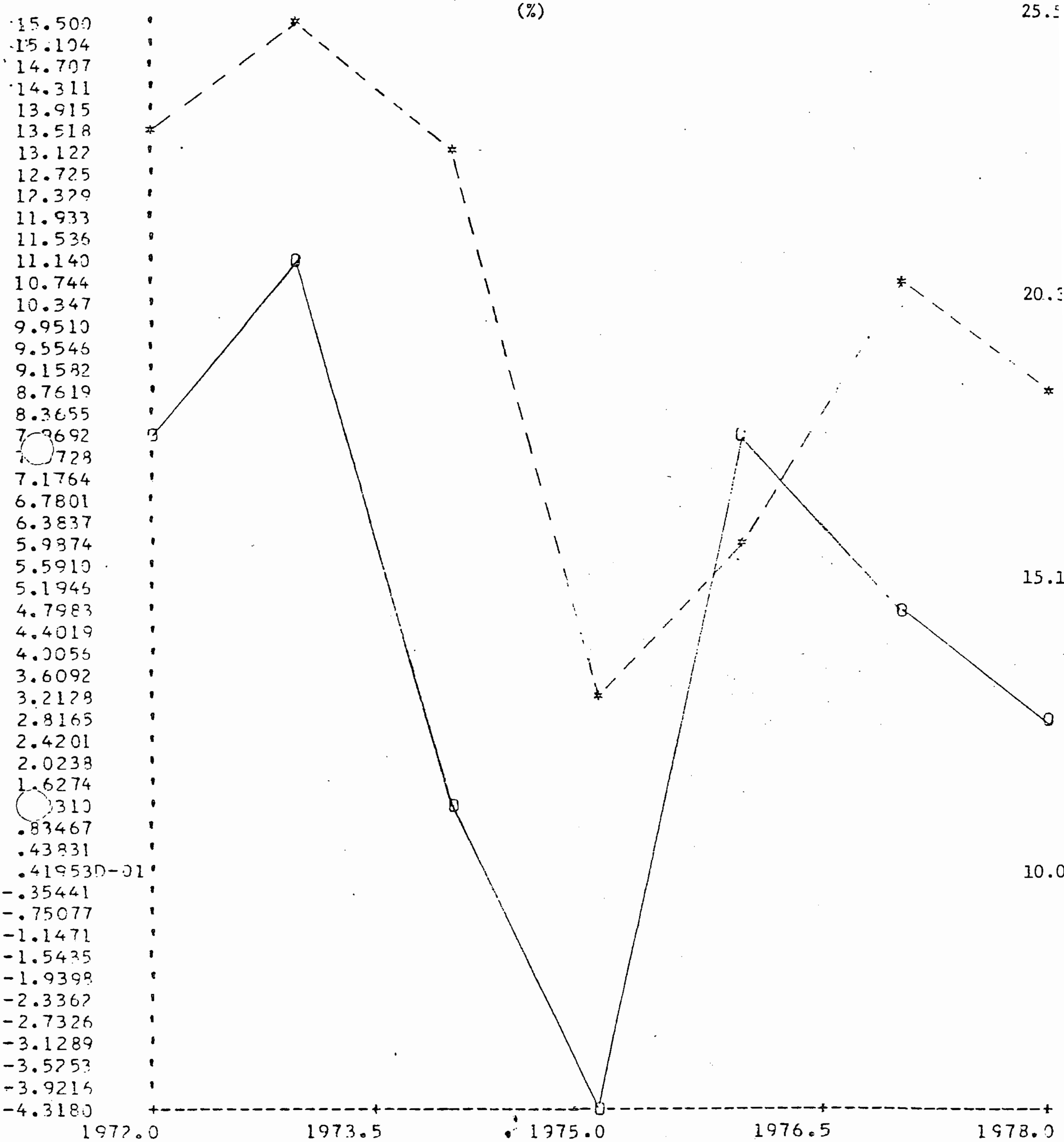
3. IFS (line 99b.p) same as 2. with numbers from 1978 Banco de Portugal Report for the 1979 estimate (corrected in August 1979 issue of IFS) and 1977 Report for the 1978 estimate.

4. Based on DCP numbers for 1973-75 and projection from model in Abel et al. (1977) for 1976 forecasts and Abel and Beleza (1978) for 1977 forecasts. Forecast A (pessimistic) assumes constant investment, B (optimistic) assumes 10% increase.

5. From 3.1; 1979 OECD (1979c) forecast

6. OECD (1979c)

Chart 1
Real Growth Rate and the Investment Share
(%)



—Annual Growth Rate of Real GDP (left scale)

--Real Investment Share in Real GDP (right scale)

Source: Same as Table 1, Line 3

public (state) investment increased by 19 percent, whereas housing declined by 6 percent and "productive" investment (itself mainly in the nationalized firms) declined by 6.7%, giving rise to the total decline of 3.4%. In 1977 the 12% increase was more evenly spread between "productive" (13.3%) and public (14.6%) but housing continued to lag at 5.5%. Plan figures show very little growth in investment in 1978-79.

The effect was, apparently, a sharp reduction in the productivity of investment. A crude but suggestive indicator of this decline is the gross incremental output-capital ratio, which was .41 in 1969-73 but only .13 in 1974-5. We should note, however, that this measure of the productivity of investment has declined world-wide. For example, in Japan it declined from .29 in the period 1967-73 to .12 in the post 73 period. In the U.K. the decline was from .17 to .05.

The swings in output in Portugal were also reflected in the crucial balance of payments. Table 3 shows the changes in that balance since 1973. In 1973, as we have already mentioned, Portugal was in surplus. The deterioration in the external environment produced an abrupt deterioration in the trade balance. Slump in 1975 temporarily reduced the demand for imports, but the boom of 1976-77 led Portugal into a severe deficit and forced the adoption of austerity measures.

The dramatic reversal of the external deficit in 1978 was a definite surprise. A major part of the improvement was a surge in emigrants' remittances, and it is possible that this was in part dishoarding of accumulated savings held abroad as confidence in Portugal's political stability returned and nominal interest rates on deposits were raised. If this is the case, remittances will fall again, so that part of the improvement will turn out to be only temporary. However, exports have also surged, indicating that

Table 3

THE BALANCE OF PAYMENTS

(in millions of dollars)

	(1) TRADE	(2) CURRENT ACCOUNT	(3) NON MONETARY TRANSACTIONS
1973	-914	351	345
1974	-2002	-829	-638
1975	-1674	-819	-1016
1976	-2115	-1246	-1179
1977	-2533	-1500	-1437
1978	-2300	-775	157
1979	-740*	-276*	723**

Notes: * Jan.-June
** Jan.-August

Sources: 1973-1977 OECD

1978 Banco de Portugal

1979 Banco de Portugal and Cardoso (1979) there has been a fundamental improvement in competitiveness.

The external current account is related to national saving by the identity saving = investment + current account. It is natural, then to consider along with the current account the public sector deficit, which is a major source of dissaving, as is evident from Table 4. In fact, since investment has been so predominantly undertaken by the public sector, the overall deficit of the public sector is the appropriate measure of the gap between private savings and private investment, where nationalized firms are included in the private sector.

Chart 2 shows a remarkably close relationship between the external current account and the public sector borrowing requirement, measured in dollars. The surprising turn of the external account in 1978-9 is again evident there, since the available evidence suggests a substantial worsening of the public sector deficit.

In output and expenditure, then, Portugal experienced some sizeable fluctuations. These fluctuations were somewhat larger than those of other European countries, and the balance of payments problem has been severe. Nonetheless, Portugal has not been too far out of line with the experience of other semi-industrialized countries. What makes the Portuguese experience unique is the developments in the labor market.

Portugal in 1973 was a country with an unusually high proportion of its population working outside the country. Emigrant workers were 17.5% of employed Portuguese in 1975. When recession came to Europe, emigration halted and partially reversed. At the same time, the returnees began

Table 4

PUBLIC SECTOR ACCOUNTS

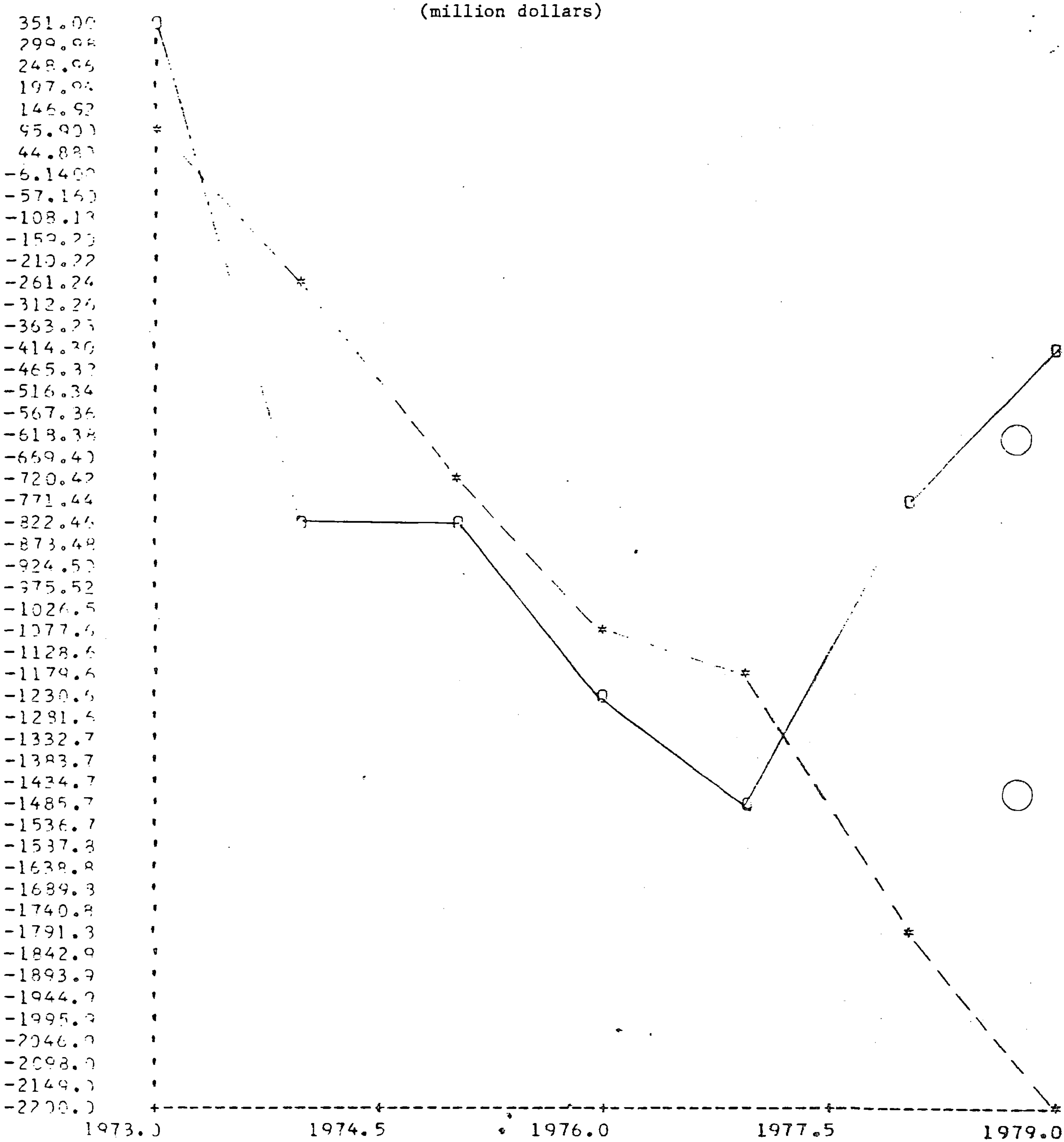
(in million contos)

	(1) Current Balance	(2) Overall Balance	(3) Central Administration Budget (OGE)	(4) Balance (CGE)
1973	9.0	2.6	5.2	-2.4
1974	1.2	-7.0	8.1	-9.7
1975	-9.3	-18.5	-13.9	-25.4
1976	-13.0	-32.9	-31.8	-38.7
1977	-12.6*	-45.5*	-59.9	-49.0*
1978	-28.5*	-79.3*	-60.5	-76.6*
1979** A	-12	-62	-66.0	n.a.
B	n.a.	-113.0	-120.0	n.a.

* Estimates
** Forecasts

Sources: 1973-76 Estatisticas das Finanças Publicas
1977-78 Banco de Portugal using data from Ministerio das Financas
1979: A OECD (1979b, p. 54).
B Revised official forecast for (3) Expresso, 10/13/79 and June ratio (2)/(3) as in B.

Chart 2
Current Account and Public Sector Deficit
(million dollars)



Current Account Deficit, Table 2, col. 2

Overall Deficit of the Public Sector, Table 3, col. 2
converted into dollars at average exchange rate from <u>IFS</u>

arriving from Africa. The result is shown in Table 5: there was a huge growth in the labor force, some 13 percent from 1973 to 1977, according to the only available estimate (source A).

Because of the growing labor force, and because employment grew only slightly, unemployment rose to very high levels. (We are not confident in these figures, for reasons discussed in Section 4). A gap thus emerged between actual and potential output. We make an effort to measure potential output and the output gap in Table 6. Several assumptions are made. First, we assume that potential employment is 97 percent of the labor force: i.e., that the 3 percent unemployment of 1973 represents "full employment". Second, we assume that the ratio of the marginal productivity of labor to average productivity is one-half, based on the 1973 labor share. Thus we compute "full-employment" employment as 97 percent of total labor force, and assume that the additional workers would have one-half of the average product of those already employed.

The numbers produced by this rough calculation show a large output gap, only slightly narrowed by the 1977 boom. While the output gap is large, however, even closing it completely would still leave the growth rate of per capita GDP since 1973 quite low. In other words, potential output has grown slowly given the rise in the population. The chief reason for this is the slow growth in productivity. From 1973 to 1978 GDP per employee rose 10%, an annual growth rate of only 1.9%. This is, of course, the counterpart of the low output-capital ratio already mentioned.[5]

On balance, then, averaging over the fluctuations, output has failed to keep up with potential, while potential output has in turn grown disappointingly slowly.

Table 5

EMPLOYMENT AND UNEMPLOYMENT
(Thousands)

	(1) Employment			(2) Unemployment			(3) Civilian Labour Force		
	A	B	C	A	B	C	A	B	C
1973	3046	n.a.	n.a.	99	n.a.	n.a.	3145	n.a.	n.a.
1974	3061	3767	3621	180	86	47	3241	3853	3668
1975	2980	3735	3714	396	222	133	3376	3957	3847
1976	3005	3820	3759	504	276	244'	3509	4096	4003
1977	3097	3781	3787	455	326	291	3552	4107	4078
1978	n.a.	3809	3736	450*	348	319	n.a.	4157	4055

Note: (1) = (3) - (2)

Sources: A - Gabinete de Estudos, Planeamento e Organização, Ministry of Labour as reported by Banco de Portugal

B - INE, 1st. semester survey as reported in Banco de Portugal

C - INE, 2nd. semester survey as reported by Banco de Portugal

*as reported in BPA, Conjuntura, n°12.

Table 6

UNEMPLOYMENT RATE AND THE OUTPUT CAP

		1973	1974	1975	1976	1977	1978
1.	Unemployment(%)	3.1	5.6	11.7	14.4	12.8	13.0*
2.	Output Gap (%)	.05	1.88	4.93	6.66	5.62	5.75
3.	Potential Output (million contos)	389.0	400.6	394.7	428.8	447.2	462.2

Sources: (1) - 1973-77: Table 5, Source A (1- (2)/(3) x 100.

1978: reported in OECD (1979b) from Source A.

(2) (((1) - 3.0)/(100-(1))) x .5

(3) ((3) from Table 2, line 3.1.) x (1 + (2)/100)

3. Real Wages

The movements in the real wage rate in Portugal, and the changes in the distribution of income which accompanied these movements, are perhaps the most striking feature of economic developments since 1973. As is shown in Table 7, Portuguese real wages rose sharply in the first eighteen months following the revolution, then began an extraordinary decline which left them, by 1978, well below their pre-revolution level. (There are-once again-problems with the figures, as discussed below). The labor share in national income paralleled this movement, although the rise in the labor share from 1973 to 1975 was much larger in percentage terms than the rise in real wages, so that in 1977 the labor share was still substantially above its 1973 level.

As we have already suggested, however, the crucial variable from the point of view of achieving internal and external balance is not the wage rate *per se* but the wage rate relative to its "warranted" or equilibrium level. While the warranted real wage rate is not directly observable, there can be little question that it fell sharply in the first two years following the revolution, for reasons discussed below. Thus, the ratio of the actual to the warranted real wage must have risen more steeply than the real wage itself. Where that ratio now stands is a difficult question which we will postpone to the end of this section.

Let us begin by discussing the factors affecting the movement of real wages since 1973. We will then turn to a consideration of the factors which must have affected the warranted real wage, making an effort to put at least an order of magnitude on the movements in this variable. Finally we will discuss the implication of the movements in both variables.

Table 7

REAL WAGES AND THE TERMS OF TRADE

	1973	1974	1975	1976	1977	1978
1. Real Wage (1973 = 100)	100	106	109	101	91	89
2. Labor Share in Income (%)	51.6	57.0	68.9	66.6	60.0	56.4
3. Terms of Trade (1973 = 100)	100	89.9	76.8	73.2	74.9	76

Sources: 1973-77: 1: IFS
2,3: World Bank (1978).
1978: 1: INE, Boletim Mensal
2,3: Banco de Portugal

Causes of Changes in Actual Real Wages

Since 1973 wages in Portugal have been largely a political phenomenon. The political climate affects wage settlement directly through its impact on bargaining and on public sector wage decisions. At the same time, government policy plays an important role in determining real wages through wage and price controls, taxation, and exchange rate policy. Market forces do have some effect, especially in the small-business sector. But the principal way that economic pressures affect real wages is by inducing the government to take action to push real wages towards a level which it regards as appropriate.

In 1974-75 the internal situation in Portugal naturally made for intense pressure for real wage increases, while the "war chest" of foreign exchange and gold left by the old regime allowed the successive governments to ignore external constraints for the time being. One can easily draw up a sizable list of factors making for wage increases. First, there were large increases in the minimum wage. Second, wages paid by the government--both in the traditional public sector and in newly nationalized firms--were sharply increased. Third, legal restrictions which were placed on dismissals _de facto_ forced firms to continue paying the wages of striking workers, with obvious effects on the balance of power in wage bargaining. Even the threat of bankruptcy was not much of a limitation, since loss-making firms were often able to get low-interest loans--in effect subsidies--to cover their wage bills. Finally, the political climate itself made for worker militancy and employer timidity.

We should note that in addition to a redistribution of income from capital to labor there was a redistribution within the labor force to the less well-paid. In particular, changes in the tax system would have made it necessary for higher-paid workers to have received much larger percentage wage increases to keep up with inflation than those with lower initial wages, as shown by the figures reproduced in Table 8.

The fact that nominal wage increases were in part translated into real increases, instead of merely being dissipated in inflation, was also largely due to policy. For one thing, many prices were controlled under an elaborate system instituted in 1974. This system kept cost increases from being fully passed on in many areas, especially in rents. Price controls were supplemented by subsidies used to keep down the prices of some consumption staples. And import prices were kept down by the Bank of Portugal's support of the escudo.

With all of these forces working to raise real wages, it is somewhat surprising that the real wage index reported in Table 7 did not rise more. In part this may reflect the unreliability of the statistics,[6] but there were also some factors working to depress real wages, notably increases in taxation and the worsening of Portugal's terms of trade. These factors are considered in our discussion of movements in the warranted real wage, below.

From 1976 on many of the policies which had fostered real wage increases in 1974-75 were reversed. A catalogue of major actions would include the following:

(i) Ceilings were placed on wage increases.

(ii) Controlled prices were raised.

(iii) The escudo was repeatedly devalued.

(iv) Subsidies were reduced and taxes increased.

(v) Labor laws were changed so as to allow dismissals.

Table 8

CONSTANT REAL TAKE HOME PAY

Equivalent nominal gross wage (contos/month)		% share in increase	
1974	1979	Inflation	Tax
4	12.2	86.5	13.5
8	25.8	79.8	20.2
15	55.7	65.3	34.7
30	267.7	22.3	77.7

Source: Banco Português do Atlantico, Conjuntura, 12, July 1979

Note: See also Cadilhe - Costa (1978)

(vi) The interest rates on loans to loss making firms were increased.

In addition to these policy actions, there was pressure on the wage rate from the overhang of unemployed workers, swollen by returnees from Africa and the halting of emigration to Western Europe.

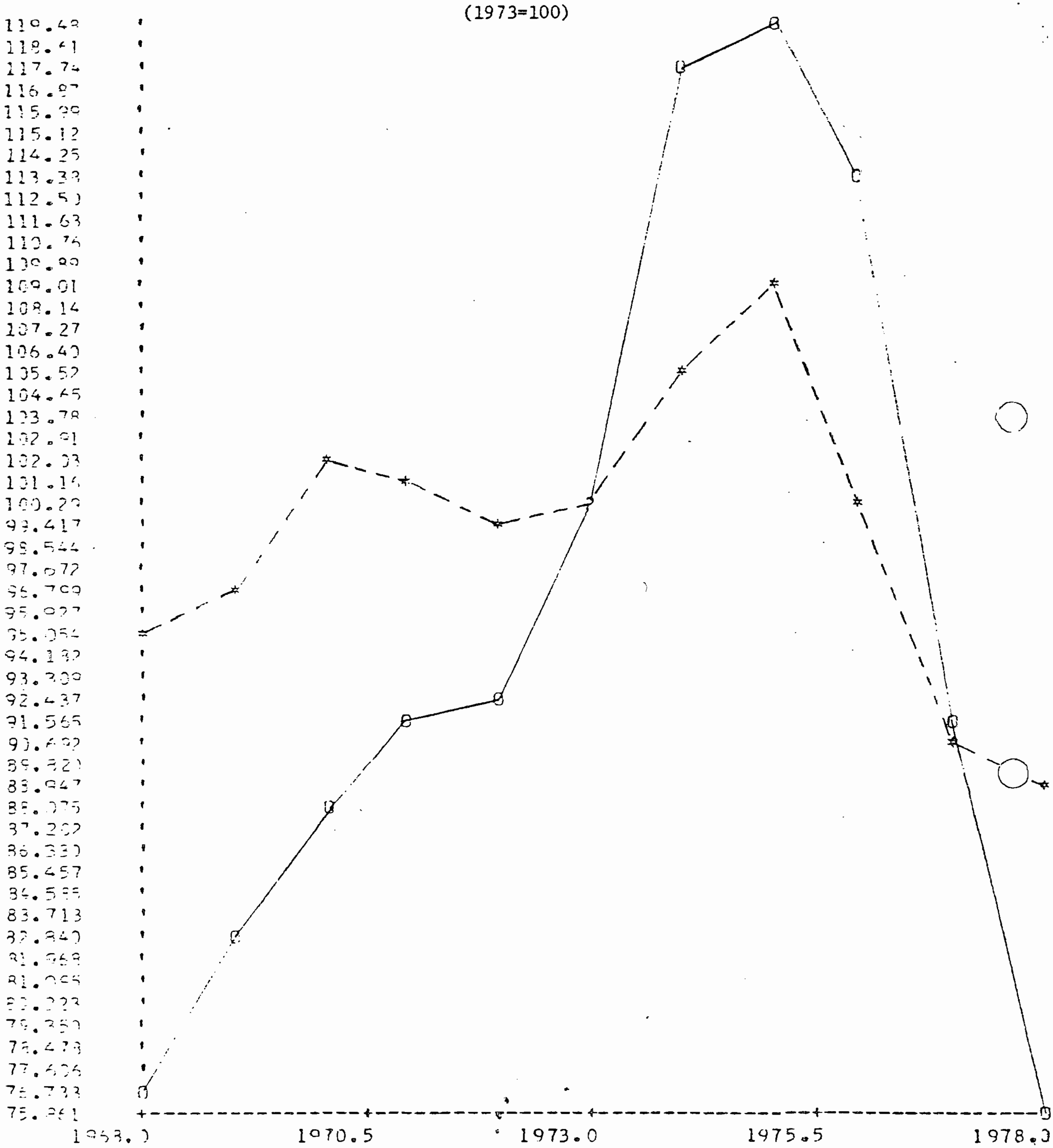
The most obvious way in which policy affected the real wage rate is, of course, through devaluation. Devaluation--if it is effective--has the effect of lowering the wage rate in terms of external prices. This in turn implies a fall in the real wage in terms of imports and other tradable goods. Chart 3 shows the Portuguese real wage in terms of external prices, as measured by a weighted average of the four principal trading partners, and in terms of the domestic CPI. It is clear that the large decline in the "external" real wage must have played an important role in the decline of real wage in terms of consumption goods.

What is surprising about the post-1976 period is how severe the decline in real wages has been.[7] The greater part of this decline took place under a socialist government, in a country where trade unions remain powerful. To make sense of the remarkable decline, we must consider the factors affecting the warranted real wage.

<u>Causes of Changes in the Warranted Real Wage</u>

Since we cannot directly observe the warranted real wage, it is necessary to attempt to infer it from indirect evidence. This can be of two kinds. First, the nature of the disequilibrium a country finds itself in can be an indication of the position of the actual relative to the warranted real wage. If, for example, a country finds itself oscillating between unemployment and balance of payments deficits, this is an indication that the actual real wage exceeds the warranted. Second, one can attempt to

Chart 3
Internal and External Real Wage
(1973=100)



—— Based on the escudo CPI of four main trading partners from IFS weights from Macedo (1979, p. 263)

--- Based on the Lisbon CPI including rent, Table 7, line 1 take account of the main factors which are likely to have affected the warranted wage. We will concentrate first on the second approach.

The factors affecting the warranted real wage may be divided into two groups. The more important group is the set of "external" shocks in 1973-75 which were not under the control of policy: the rise in oil prices, the onset of economic stagnation in industrial countries, and the growth in the labor force. Probably less important but still significant were policy actions: increases in indirect taxes and in Social Security contributions.

Let us start with the external shocks. The worsening in the international environment had the effect of reducing the real income of the Portuguese nation as a whole, and therefore presumably of reducing the warranted real wage. The size of this effect was quite large: as shown in Table 7, Portugal's terms of trade worsened by 24 percent from 1973 to 1978, which given the 1973 import share in GDP of 33 percent implies a reduction in real national purchasing power of about 8 percent.

At the same time, returnees and returning emigrant workers from Western Europe swelled the labor force by about 13 percent. Since the capital stock was not increased accordingly--indeed, the period since the revolution has been marked by low investment--the fall in the capital-labor ratio must also have acted to depress the equilibrium real wage.

Along with these external shocks came certain government actions which acted to further lower the warranted real wage. The most easily measurable of these were the increases in indirect taxes, from 13 percent of expenditure in 1973 to 15 percent in 1978, and the increase in Social Security payments from 11 to 15 percent of labour income. Both of these widened the "wedge" between the price of output and the remuneration received by factors of production.

Can we estimate the impact of these factors on the warranted real wage? There are a number of obstacles to any such calculation. First, there are the measurement difficulties: not one of the crucial numbers can be considered reliable. Second, there are technical difficulties arising from possible changes in the equilibrium share of wages in factor payments. If imports are a better substitute for capital than labor, the worsening in the terms of trade would tend to raise the equilibrium labor share (and conversely); the extent to which an increasing labor force lowers the equilibrium real wage depends on the elasticity of substitution between capital and labor.

The best we can do is to make a hypothetical calculation, which will give some indication of the order of magnitude of the effects. Such a calculation is presented in Table 9. We must emphasize that the assumptions on which the calculation is based are extremely shaky; the true number could easily be considerably more or less than our number. So as not to give a spurious impression of precision, we deal only in round numbers.

The first entry is the effect of the decline in the terms of trade. Here we assume that the proportional reduction in the warranted real wage is the same as the proportional reduction in real national purchasing power as a whole. The entry which follows is the effect of the 13 percent increase in the labor force. Two assumptions are made here: (i) The elasticity of substitution between capital and labor is taken to equal one, so that the equilibrium share of labor did not change;[8] (ii) We use the 1973 labor share of one-half as a measure of the elasticity of output with respect to labor input. The result, then, is an estimate of 6 percent for the effect on the warranted real wage. The effects of tax increases, shown by the remaining entries, add a further 6 percent.

Table 9

HYPOTHETICAL CALCULATION OF DECLINE IN WARRANTED REAL WAGE, 1973-78

Decline in terms of trade	8 Percent
Labor force growth	6 Percent
Increase in indirect taxes	2 Percent
Increase in Social Security payments	4 Percent
Total	20 Percent
Less: Productivity increase	10 Percent
Equals: Decline in warranted real wage	10 Percent
Decline in actual real wage from Table 7	11 Percent

What is immediately apparent is that, without any deliberate inflation of the figures, we are able to come up with a quite large number for the decline in the warranted real wage. In fact, if we are concerned with the ratio of the actual to the warranted wage, this calculation suggests that the decline in the denominator of W/W* was more important in 1973-75 than the rise in the numerator. We must repeat, however, that what we have done here is purely a suggestive calculation, not something which can be treated as a reliable estimate.

The shocks we have considered must have led to a once-for-all decline in the equilibrium real wage. One would expect this to be offset over time by the normal, secular growth in the equilibrium real wage. There are some reasons for being pessimistic about this in Portugal's case, however. First, the years since 1973 have been marked by low productivity growth worldwide. Second, Portugal has had lower growth in investment since 1973 than before--and much of the investment has, as discussed in Section 3, been devoted to public sector projects of doubtful productivity. Finally, the institutional changes brought by the revolution have probably had at least the initial effect of hindering productivity growth. This is certainly true in agriculture, and may also be true for the nationalized firms.

We can get a rough estimate of the actual secular growth in the warranted real wage by looking at actual labor productivity. Our preferred estimate in Section 3 was that GDP per employee increased 10% from 1973 to 1978. But we suspect this may be too high. Official data on employment are "very heterogeneous and partially contradictory" (as generously described by the OECD). Growing employment in family enterprises, self-employment, and public administration has surely been understated.[9] Unless GDP is comparably understated (which is also possible) the productivity growth is exaggerated. In any case, even if we use the 10% estimate, we find that secular growth is much less than the impact decline in the warranted real wage.

The implication of this is that the warranted real wage is probably still, in 1979, below its 1973 level; 10 percent below, by our estimate. What this means for the appropriateness of the actual real wage is the next question.

The Current Situation

Data for 1978 shows a real wage in Portugal down about 20 percent from its 1975 peak. At the same time, the disequilibrium state of the economy seemed to suggest that the real wage was still above its warranted level. That is, there was still some balance of payments disequilibrium (perhaps more than the current account indicated, since as pointed out in Section 3 some of the surge in emigrants' remittances may be temporary), together with high unemployment.

As we have seen, given the size of the shocks which have affected Portugal, it is possible that the real wage is still too high to allow simultaneous balance of payments equilibrium and full employment. It is too soon to judge, however; we may be witnessing delayed effects of the earlier period of high real wages.

In any case, there is no reason to believe that the real wage is currently very far from its warranted level. Indeed, if one compares our estimate of the decline in the warranted real wage with the estimated actual decline one sees that the two are almost exactly equal. Given the roughness of our methods, however, this seeming exactitude is a mildly embarassing coincidence.

5. An Assessment

In the years since April 25th, the realistic alternatives available to successive Portuguese governments have all been unpleasant. For the short run, the choice has always been between cutting real wages, increasing unemployment, and running a balance of payments deficit. As reserves have been drawn down and foreign indebtedness has grown, the last option has become increasingly difficult to manage. So the last five years have been marked by a narrowing of already binding constraints.

The eventual direction of Portuguese policy has thus been determined by the logic of the situation. Recent improvements in the external balance notwithstanding, the balance of payments constraint still precludes any sustained increase in either real wages or employment.

Given the constraints on policy, details of demand management are not of central importance. The actual record on stabilization is mixed. In 1974-75, although the slump in Portugal was deeper than in the rest of Europe, this is not surprising given the severity of the internal and external shocks. In fact Portugal did remarkably well: the actions of the government, even though not consciously planned, acted to support demand and limit the initial damage.

That in 1976-77, the demand expansion, and in particular consumption and public investment surge, were larger than in the industrial countries, despite the overhang of the 1974-75 disturbances, was also in part the result of lack of a consistent policy, but this time was clearly inappropriate. Indeed this expansion dissipated the remnants of the "war chest" and pushed Portugal deeper into debt, eliminating the country's remaining room for maneuver. More seriously, the implementation of poorly conceived investment projects in the public sector did not improve the country's prospects for long term growth.

The austerity program agreed upon with the IMF in May 1978 had thus to be more stringent than would have been the case, had it been implemented by the first constitutional government in the summer of 1976. Also, with rising private savings, the diversion of these savings to financing the rising deficits of the public sector and state the enterprises has probably become a major cause of continuing inadeqacy of private investment; an inadequacy which is an important brake on the growth of potential output and of the warranted real wage.

Real wages are at the heart of Portugal's experience in recent years. In 1974-75 a huge gap opened between the actual and the warranted real wage. Then an extraordinary decline in real wages set in. probably closing this gap. The downward flexibility of real wages in post-revolution Portugal is remarkable; the far smaller declines in the early 1970's may have been a cause of the revolution. However, the fall of the 4th constitutional government in June 1979 has been linked to the announcement of an extraordinary tax on labor income, which suggests that the downward flexibility may have a floor.

What can be learned from Portugal's experience? Perhaps the main lesson is in the "narrow limits of the possible" when one tries to redistribute income in a market economy. The allocative effects of disequilibrium real wages, manifesting themselves in a critical balance of payments problem, forced governments of pro-worker sympathies to engineer a steep decline in workers' standard of living. The dilemma of the politicized market economy could only have been eliminated by going over to a centrally planned economy. But this would have other and we believe far worse political and economic consequences.

FOOTNOTES

[1]OECD (1979a) lists as members of the group of newly industrializing countries the following nations: Greece, Portugal, Spain and Yugoslavia in southern Europe; Brazil and Mexico in Latin America; and Hong Kong, Singapore, South Korean and Taiwan, in Asia. Note that the grouping together of these countries is not meant to deny the significant differences in the growth process between, say, the "Gang of Four" in Asia and the southern European nations.

[2]This diagram draws on the well-known analysis by Swan (1960), as well as the recent discussion by Modigliani and Padoa-Schioppa (1977). Allowing for a positive effect of the real wage on output would not change the analysis.

[3]Stallings (1979) emphasizes this aspect.

[4]Portuguese estimates of fixed investment are based on sales of construction materials. Since administrative backlogs led to lax enforcement of building codes in this early post-revolution period, the composition of these sales changed, making estimation a hit-or-miss affair. Changes in stocks are estimated by even less reliable guesswork.

[5]Productivity calculated in this way diverges from the estimates reported by the Banco de Portugal. In the 1977 Report, the growth, productivity for 1976 and 1977 above was 11%. The 1976 figure, however, was 7.1% in the 1977 Report and 3.4% in the 1976 Report. See further estimates in Macedo (1979, p. 232, note 61).

[6]Thus the official figures for 1978 wage and price inflation are based on average annual earnings in manufacturing including social security payments and the new price index on the Continent whereas the series used in Table 7 line 1 and Chart 3 are the old indices of hourly wages and the Lisbon CPI including rent reported in IFS. The 1978 increase in the latter wage and price indices is 11% and 13% respectively, whereas the increase in the former is 18% and 21% respectively. The use of the Lisbon industrial wage index underestimates return to labour because both the Oporto industrial wage index and the agricultural index are higher, on the other hand the use of the Lisbon CPI including rent underestimates inflation. A weighted average of real wages in agriculture, men and women, Lisbon and Oporto using the respective CPI's (without rent) just about matches the one in Table 7, except in 1976 and 1977 where the values are 4 and 3 percentage points higher respectively.

[7]The levelling-off of growth in the internal real wage before 1974 suggests a "rising expectations" story of the Portuguese revolution, a hypothesis which has been advanced in the psychology and politics literature, namely by Davies (1962) and Gurr (1970). The inverted J shape of the real wage series after 1974 is used by Kolm (1977) Figure 1 p. 35 as a revelation of the effects of a political victory

of the right following a political victory of the left in the cases of Chile and Portugal. The effect of the external shocks is however crucial. Notice that the external real wage has a much more pronounced J pattern.

[8] Estimates of the elasticity of substitution between capital and labor have been made for Portugal by Sousa (1977) and Barbosa (1977). Sousa's estimate was 0.6; Barbosa's 0.8. In assuming a value of 1, we are biasing our results toward an understatement of the decline in the warranted real wage.

[9] (1979b, p. 10). The three sources indicated in Table 5 are not comparable with each other. Sources B and C, which are now the only ones used by Banco de Portugal begin in 1974 (See INE, Boletin Mensal, 1979 no4, supplement) and the values of source A for 1978 are not directly available. These values are close to the ones indicated by Moura (1979, Table 4) which include agriculture and public sector even though (OECD 1979b, p. 11 footnote 10) claims that the Ministry of Labour poll excluded these sectors.

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Office Memorandum

TO : Mr. Whittome

DATE: April 1, 1980

FROM : Hans Schmitt

SUBJECT : Portugal and GATT

Attached please find a paper that has been prepared in this division in support of Portugal's consultation with the GATT's Economic Committee. Upon your approval this paper should be returned to this division.

Mr. Gerhard's (ETR) comments on the first draft of this paper have been taken note of.

1) UN
2) Portugal

Office Memorandum

TO : Mr. Whittome

FROM : Hans Schmitt

SUBJECT : UN on Portugal

DATE: March 31, 1980

Attached a memo reporting on an ICC meeting at the UN in which we are reported as having made a hit with the Portuguese business community. I guess by putting a private enterprise economy back on its feet we will automatically cheer those who run it. Have we got any similar experience with the functionaries of an honestly socialist one?

Attachment

[illegible] in one box for this good Port — a plague may be going a little too far. SN

Office Memorandum

cc: Mr. Schmitt, EUR

TO : Mr. Finch RRS

DATE: March 25, 1980

FROM : R. R. Selby

SUBJECT : ICC-UN, GATT Economic Consultative Committee Meeting, March 20-21, 1980

The Thursday afternoon and Friday sessions of the 11th annual meeting of the ICC-UN, GATT Economic Consultative Committee in New York City were not productive of new or startling thoughts on its theme, economic development and the business community. These sessions heard the views of, among others, Daniel Parker, former head of AID, Klaus Fuehrer of the OECD/OAC, Klaus Sahlgren of the Transnational Center, Bradford Morse of the UNDP, and comments from a broad spectrum of prominent businessmen. Their conclusions were, expectedly, that economic development in the LDCs required continuing flows of capital, and technology and managerial skills and that to sustain this growth at anything like acceptable levels would require a large, even overwhleming, role for the private business sector at least in the near term. However, with respect to the first, a note of caution was expressed by speakers from the financial sector on whether present levels of international lending could be maintained by the private banking community without changes in institutional arrangements. The need for continuing trade liberalization was also emphasized.

The International Chamber candidly agreed that at the national level, at least, in the LDCs, Chambers of Commerce needed a great deal of strengthening if their views were to be taken seriously by local governments.

The Managing Director would have been pleased to hear the unanimously favorable commentary on his observations at the Thursday morning session on the need for coherent rules in the conduct of development policy (a rare experience at the UN in New York). Especially eloquent testimony came from Bernardo Mendes de Almeida, Conde de Caria, President of EMINCO SARL and Vice Chairman of the Portuguese National Committee of the ICC who stated that IMF help had restored the Portuguese economy "in a fashion that had exceeded the fondest hopes of the business community."

Banco de Portugal

Governador

Nº 103/ROI

T-M

Pl let me have a draft connecting you as mission chief

LAW 17/3

Lisbon, March 6, 1980

Dear Mr. Whittome,

Very many thanks for your letter of February 13 and for your kind wishes in my post as Governor of the Banco de Portugal.

Since the very beginning of our membership in the Fund, Portugal has always received the most valuable and friendly cooperation from your part and it is a great privilege for the Banco de Portugal and for its Governor to occupy the special place they detain in this relationship. I am happy that this had afforded me the professional as well as personal relations that I am delighted to maintain with you.

Yours sincerely,

Manuel Jacinto Nunes
Governor

Mr. L. A. Whittome
Director
International Monetary Fund
1818 H Street, N.W.
Washington D.C. 20431
U. S. A.

MM/RF

cc SED

MAR - 6 1980

Sir:

This will acknowledge and thank you for your dated February 5, 1980 addressed to the Managing Director, advising the Fund of the following appointments by your government:

Governor of the Fund:	Prof. Dr. Manuel Jacinto Nunes Governor, Banco de Portugal
Alternate Governor of the Fund:	Dr. Emilio Rui da Veiga Peixoto Vilar Vice-Governor, Banco de Portugal

Very truly yours,

Leo Van Houtven
Secretary

Dr. Anibal Antonio Cavaco Silva
Ministro das Financas e do Plano
Avenida Infante Dom Henrique
Lisbon 2, Portugal

CC: MD
DMD
MR. DINI
EUR
SEC

MDennison:mc
March 5/80

Office Memorandum

TO : Mr. Whittome

FROM : Hans Schmitt

DATE: March 5, 1979

SUBJECT : Portugal: A cautionary tale

Some of the currently fashionable critiques of Fund policy prescriptions were in fact taken seriously in Portugal in 1976 and 1977, with disastrous consequences. Most notable of these is the proposition that not only stabilization but development are best promoted by policies aimed at promoting "supply" rather than restricting demand even in the short run. This is simply not so for either objective.

The attached draft for a first section of the Portuguese paper you asked me to do is still a rough draft. I thought it useful, nevertheless, to rush it to you for what help it may be in backing up the claims just made. Does it approach plausibility? Does it make you want to read more, or less?

Attachment

DRAFT
3/5/80

INTERNATIONAL MONETARY FUND

European Department

A Stabilization Program for Portugal

Prepared by

March , 1980

I. Introduction

Following a decade of rapid growth with external equilibrium, the Portuguese economy suffered a series of major shocks. Even before the Revolution of April 1974 the increase in world petroleum prices had sharply raised the import bill, and by deepening recession elsewhere, was to reduce export earnings and remittances from abroad. The independence of the former overseas territories, though a major impetus to the Revolution, meant a loss of export markets and brought a major reflux of settlers home. Domestically the Revolution, nevertheless, achieved a substantial redistribution of income in favor of workers both in the factories and on the farms. Although the rate of economic growth slowed down, however, it now generated external deficits so large as to be unsustainable.

The problem of how to manage economic growth with a balance of payments constraint was new to Portugal. The authorities responded with progressively tighter austerity measures, culminating in May 1978 in a stabilization program that was supported by the Fund. The main purpose of this program was to strengthen the balance of payments while maintaining a positive rate for the economy as a whole. A monthly rate of depreciation was fixed for the escudo together with a matching set of interest rates on bank deposits. The former would make the economy more competitive by reducing costs while the latter was to ensure that savings would not only increase but be placed at home. For safety, a limit was placed on domestic credit expansion. And to protect the productive sector credit to the public sector was rationed within the total.

The approach taken in the stabilization program was vigorously debated in Portugal and also abroad. The first concern was that credit restraint would rely too exclusively on reducing demand to correct external deficits, rather than on increasing supply. The second was that exchange depreciation would entail too costly a reduction in real incomes before any significant easing of the external constraint could be expected from it. The last concern was that an excessive preoccupation with external adjustment would undermine prospects for economic growth and development. This paper reviews the Portuguese experience with these issues in mind. Section II examines the economic background; Section III the context of the stabilization program; and Section IV the prospect ahead.

II. The Economic Background

Beginning in 1974 Portugal's rate of economic growth slowed down. Nevertheless, the balance of payments, which had traditionally been in surplus, moved into substantial deficit. In relation to GDP an external current account surplus equivalent to 3 per cent in 1973 was turned into deficits of 6 per cent in 1975 and 9 per cent in 1977. The overall balance on nonmonetary transactions changed from a surplus of US$328 million to deficits of US$1,013 billion and US$1,430 million over the same years (Table 8). As a result, a net foreign asset position of the banking system of US$2,937 million at the end of 1973 was changed to a net foreign liability position of US$1,243 million at the end of 1977, taking gold at the official price of SDR 35 per ounce. The background can be quickly sketched.

1. Rapid expansion

In the five years to 1973 real GDP growth in Portugal averaged 7.4 per cent. This very high rate of growth was supported mainly by exports, including particularly manufactured exports, which expanded at an average annual rate of 8.5 per cent in real terms over the same period. The main thrust of the export drive was diverted toward Western Europe which provided, in addition to expanding markets, also a steady stream of tourists, and employment to a growing number of migrant workers. As the nine countries of the European Community increased their share in Portuguese exports from 41 to 49 per cent, that of the African territories dwindled from 24 to 15 per cent, thus eroding the economic basis for the costly effort to keep them Portuguese.

Despite the impressive performance of exports, it was mainly emigrants remittances that produced the surplus in the external balance on current account in 1973. Remittances apart, a deficit on goods and nonfactor services equal to 5 per cent of GDP in 1968 and widened to 7 per cent, as the increase in imports outpaced that of exports alone. Fearing increasingly keen competition from imports of manufactures as well as of agricultural products if the exchange rate were to appreciate, the authorities held it firmly fixed in effective terms throughout the period. Even so, by 1973 commodity exports covered only 49 per cent of imports of goods and services, gross tourist receipts some 15 per cent, and workers remittances fully 30 per cent, a situation that was thought to be precarious.

While Portugal had long exported labor as well as goods, gross emigration accelerated sharply in the mid-1960s, so that by 1973 some 14 per cent of the combined Portuguese labor force were employed in the European Community, leaving less than 2 per cent unemployed at home. The possibility of emigrating to better paying jobs elsewhere put upward pressure on wages in Portugal. Even without additional help from currency appreciation, real wage increases put increasing pressure on the least productive sectors of the economy such as agriculture, where value added by 1973 had dropped below its 1968 level. Nevertheless, at 3 per cent per annum by the end of the decade, wage increases still fell substantially short of the rate of growth for the economy as a whole.

Though a stable exchange rate policy sustained the competitiveness of the Portuguese economy for a while, it could be maintained only by adding substantially to gross official reserves. These doubled between 1968 and 1973 to a level that covered over 12 months' imports (Table 13). The consequent increase in bank liquidity permitted domestic credit expansion to accelerate from just over 10 per cent of the initial money stock in 1968 to no less than 25 per cent in 1973. Real GDP growth accelerated to more than 11 per cent, spurred by an increasingly speculative boom in construction and stockbuiild-ing, as the rate of price inflation more than doubled to 13 per cent while interest rates remained close to their traditionally low levels.

The acceleration of economic activity stretched labor markets as much as product markets. The increase in money wages lagged that of prices nevertheless. Real wages had not in any case kept up with productivity, skewing the distribution of income increasingly against labor, but now actually fell by 2 per cent between 1970 and 1973. As workers had no right to form independent trade unions, and the right to strike was severely circumscribed, their dissatisfaction could only take political expression. To raise the standard of living of workers and small farmers as quickly as possible, thus became one of the primary objectives of the Revolution in 1974. The other objective was to put an early end to the colonial wars in Africa.

2. The wage explosion

The Potuguese revolution coincided with a crisis in world energy markets. A fourfold increase in the price of petroleum contributed to a ___ per cent deterioration in the Portuguese terms of trade between 1973 and 1975. Given that imports equalled 33 per cent of GDP in 1973 this meant a ___ per cent reduction in the real purchasing power of the national income. Domestic developments nevertheless followed their own momentum. By the end of 1975 about 23 per cent of the cultivable land excluding forests was nationalized, largely among the large estates that characterized the south of the country. In the cities, major industries accounting for 27 per cent of GDP, 50 per cent of investment, and 20 per cent of the labor force, were also expropriated.

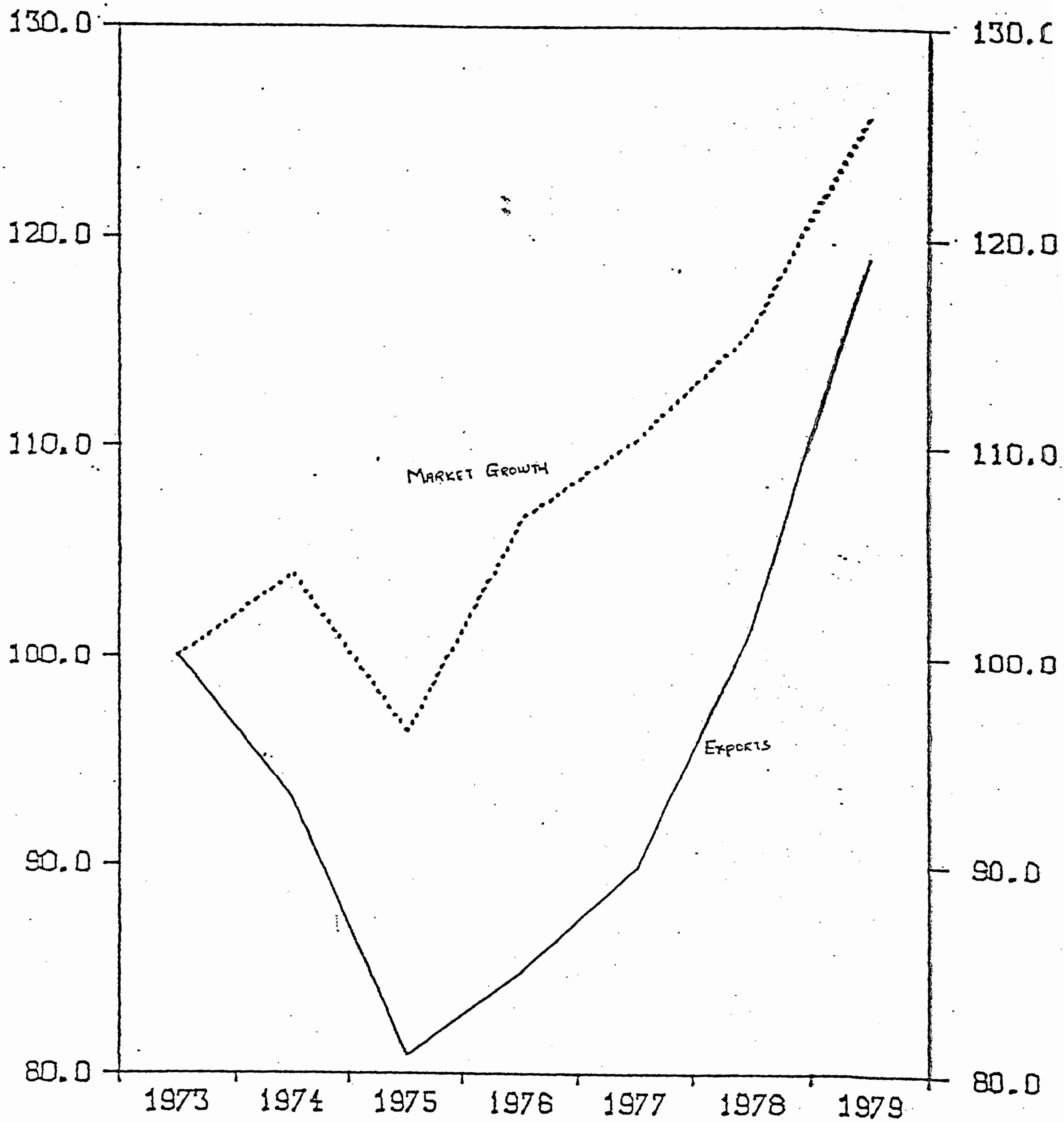
Once the political barriers had been removed real wages jumped--by 25 per cent in the two years to 1975 if we take annual earnings per man in manufacturing for the country as a whole. The energy-induced recession in world markets would have slowed Portuguese exports in any case. There was also a major loss of market shares, however (Chart A), and though disruptions in the productive process may have been a factor at first, their loss did not begin to be corrected until cost competitiveness was eventually restored, and even now falls short of the Greek or Spanish performance (Balassa, 1980). The sharp drop in tourist receipts and workers remittances also went beyond what recession abroad could have accounted for.

The catch-up in real wages also produced a major shift in the distribution of income, raising the share of labor in the national income from 52 per cent in 1973 to 69 per cent in 1975. Associated with this was a rise in public and private consumption from 82 per cent of domestic expenditure to 96 per cent. Investment particularly in the private sector fell precipitously, by

CHART 8: PORTUGAL

INDEX OF EXPORT VOLUMES AND MARKETS

(1973=100)



SOURCE IMF staff calculations and Bank of Portugal, Annual Report more than domestic saving at full employment, and real GDP dropped 4 per cent below its 1973 level (Table 3). The rise in real consumption nevertheless kept aggregate demand high enough to produce a deficit on external current account equal to 6 per cent of GDP in 1975. Excluding remittances, the deficit on goods and nonfactor services alone nearly doubled to 12 per cent.

By making much existing capital uneconomical to operate, and by reducing the margin for investment required to replace it, real wage increases reduced employment opportunities in Portugal. 1/ The excess labor supply would normally have been added to the flow of workers abroad. However, in consequence of the energy-induced recession abroad, the flow of migrant workers to the European Community virtually dried up; on top of this, the end of the colonial wars were bringing an inflow of of settlers that added ___ per cent to the labor force and raised the overall unemployment rate to well above 6 per cent (Table 1). Thus, just when wage increases were being realized the conditions for them had already disappeared. To absorb the increased labor force while maintaining balance of payments equilibrium significant reductions rather than increases would have been called for (Krugman and Macedo, 1979).

Instead, employment was to be maintained through fiscal deficits despite the external deficits on current account to which they would give rise. The social goals of the Revolution and the inflow of returnees, in any case, required a considerable expansion of public sector activities. To be sure, tax rates and social security contributions were progressively raised. Nevertheless, the financial position of the public sector deteriorated markedly (Table 5). Its overall balance swung from a surplus equivalent to 2 per cent of GDP in 1973 to a deficit equivalent to 11 per cent in 1975. Since much of

1/ "Portugal enjoys unexpectedly good economic health." Dornbusch et. al. (1976).

this deficit went to finance additional increments to consumption, and to subsidize faltering enterprises, borrowing abroad to cover it proved impractical.

Increased fiscal deficits had, therefore, to be financed by money creation at home despite the loss of net foreign assets that this entailed for the banking system (Table 6). The deficit in the external balance on nonmonetary transactions was not the only drain on their liquidity, however. There was, in addition, a flight from bank deposits into cash on the part of the public reflecting the same confidence factors that kept workers remittances away. The increase in the government deficit was not by itself sufficient to make up for both. The monetary authorities responded by suspending reserve requirements and drastically expanding their rediscounting facilities. For lack of demand, however, domestic credit expansion still slowed to ___ per cent of the initial money stock in 1974, and to ___ per cent in 1975.

By the end of 1975 the stock of official international reserves had, nevertheless, dwindled to 46 per cent of its end-1973 level. 1/ At this level gross reserves still covered the equivalent of six months' imports even with gold valued at its official price, and were thought adequate to support an economic recovery for some time at least. The exchange rate had been held steady, to protect high wages rather than low this time. But it was thought prudent in May 1975 to introduce an import surcharge which, when expanded in ________ 1976, would raise effective protection to a range from 40 to 60 per cent (Macedo, 1980). To minimize domestic price effects, controls continued at the turn of the year to be applied to some 60 per cent of items in the consumer price index.

1/ "This is to be viewed as perfectly normal for a country in Portugal's position." Dornbusch, et. al. (1976).

3. The crunch

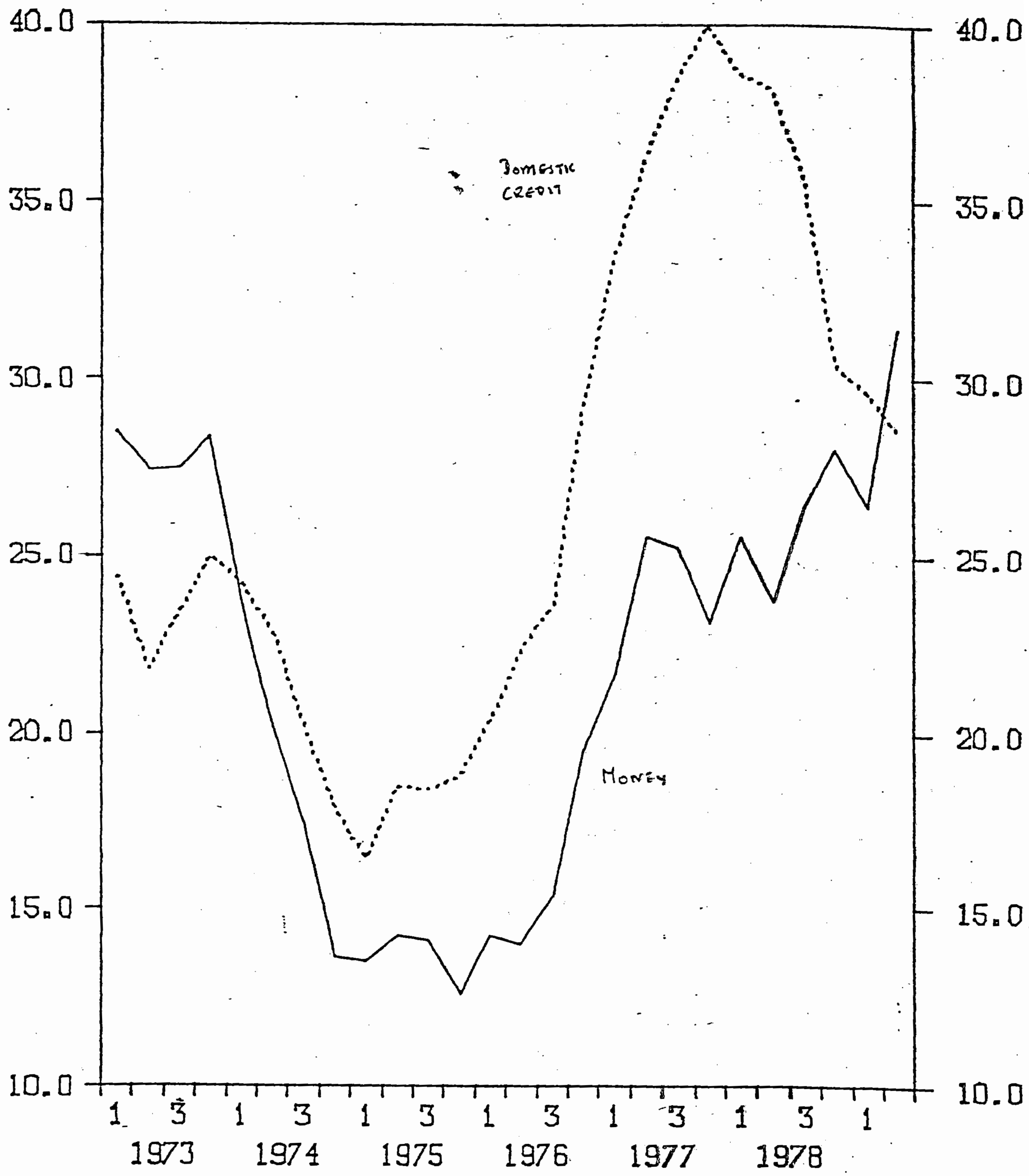
Launched on an uncompetitive base, the economic recovery of 1976 and 1977 was directed mainly to domestic rather than to foreign markets (Table 3). The initial impetus came from policies designed to expand production in the private sector which had remained the main source of employment as well as of exports (Cardoso 1980). The nationalizations of the preceding two years had concentrated on industries producing intermediate goods. Consumer goods and export industries that give rise to intermediate demand were largely left in private hands. To restore their profitability, the new Government that was elected in early 1976 initiated the first steps toward decontrolling prices combined with a ceiling on nominal wage increases.

It also opted for rapid credit expansion. By reducing constraints on output, unrestricted credit would reduce the external deficit along with unemployment, even without substantial changes in the exchange rate (Cardoso 1980). Low interest rates would also contribute to a recovery of output particularly in construction. Apart from providing needed housing for returning settlers and demobilized military personnel, construction would provide increased unemployment, at little cost in foreign exchange. Domestic credit expansion did indeed rise to unprecedented highes as a result. It reached 26 per cent of the initial money stock in 1976 and 39 per cent in 1977 (Chart B). For speculative reasons, however, the demand for money balances lagged as that for goods and foreign currency balances drained the reserves.

The increase in bank liquidity that permitted credit to expand was now fed from rising government deficits rather than from external payments surpluses as it had before the Revolution (Table 7). However, the expansion of output that it fuelled was no less associated with rapid price increases than

CHART 8.

PORTUGAL
MONEY AND CREDIT
(Annual movements as percent of initial money stock).



SOURCE Data supplied by Portuguese authorities.

before; they reached 27 per cent in 1977. Real wages again lagged. They were stabilized in 1976 and fell 9 per cent in 1977. The labor share of income, after reaching a peak of 69 per cent in 1975, also fell back to 61 per cent by 1977. Even so, employment benefited little from an expansion that took an even more capital-intensive turn than it had before. The unemployment rate continued to rise in both 1976 and 1977 contributing to further downward pressure on wages.

Investment did show some of the desired improvement. However, because of low interest rates and increasing inflationary expectations it took mainly the form of speculative stockbuilding not least of imported goods rather than of fixed capital (Table 4). The revival of construction was also disappointing. Housebuilding was held back not only by continued rent control and the unavailability of sites, but also by increasing competition of stocks and foreign currency holdings as hedges against inflation (Cardoso 1980). While imports boomed as a result, exports continued to lag. Though profits were improving on domestic sales, they did not on sales abroad as long as exchange rate remained stble. Remittances from Portuguese workers abroad were also very slow to recover.

Accordingly, the deficit on external current account widened rapidly to the equivalent of 8 per cent of GDP in 1976 and 9 per cent in 1978. 1/ Some unannounced depreciation of the escudo took place in the opening months of 1976 to reduce what after all was an evident policy bias against exports. But with an unchanged monetary policy, depreciation only fanned destabilizing speculation, and was therefore soon discontinued. A discrete devaluation of 15 per cent in early 1977 failed for the same reason (Cardoso 1980).

1/ "A disregard for external financing constraints" had been urged on the Portuguese authorities. Dornbush, et al (1976).

By the end of 1977 the country's foreign exchange reserves had long been exhausted, nearly 50 per cent of a dwindling gold stock had been pledged against short-term loans, and the net foreign liability position of the banking system had reached its maximum.

Table 1. Portugal: Population and Employment

(In thousands; end of period)

	1968	1973	1974	1975	1976	1977	1978	1979
Population			8,650	8,947	9,123	9,168	9,204	
Civilian Labor Force			3,853	3,957	4,096	4,107	4,157	
Employment			3,767	3,734	3,820	3,781	3,809	
Unemployment 1/			86	222	276	326	348	
Unemployment rate 2/			2.2	5.6	6.7	7.9	8.4	
Memorandum items:								
Annual per cent changes in:								
Annual earnings in manufacturing			40.0	37.9	17.1	15.5	11.9	
Consumer prices excluding rents		11.5	28.0	20.4	18.0	27.3	22.1	
Real earnings in manufacturing			9.4	14.5	-0.8	-9.3	-8.4	
In thousands per annum:								
Net immigration 1/			-34.3	-6.6	-19.2	-10.7		
African returnees			199.4	339.6	--	--	--	--
Military manpower			195.0	108.0	65.0	70.0		

Sources: Bank of Portugal, Annual Report, 1978.

1/ Excluding African returnees.
2/ As per cent of civilian labor force.

Table 2. Portugal: National Product Accounts

(In prices)

	1968	1978	1968/73	1974	1975	1976	1977	1978	1979
	In per cent of total		Real annual per cent change						
Agriculture 1/				-2.1	-1.9	-1.5	-10.0	4.0	2.5
Mining				14.8	2.9	-14.3	15.3	1.2	
Manufacturing				3.1	-9.7	4.5	9.4	3.3	
Electricity, gas, and water				13.9	3.2	0.3	20.0	6.5	5.5
Construction				3.5	-15.8	5.0	11.0	5.0	-2.5
Private services				-4.5	-5.3	7.7	5.8	1.7	
GDP at factor cost less public administration				0.5	-6.0	4.6	5.4	3.0	2.1
Public administration				15.0	30.9	18.6	7.0	6.0	
GDP at factor cost				1.8	-2.7	6.1	5.6	3.4	2.6
Memorandum items:									
In escudos billions at current prices:									
GDP at factor cost			281.5	338.4	376.2	476.6	622.2	781.9	
Annual percentage changes:									
Industrial production index				2.3	-4.8	3.2	13.2	6.8	
Output per employed worker									
Output per head of population									

Source:

1/ Includes forestry and fisheries.

Table 3. Portugal: National Expenditure Accounts

	1968	1978	1968/73	1974	1975	1976	1977	1978	1979
	In per cent of total		Real annual percentage growth						
Private consumption					-0.9	3.5	0.6	1.0	0.2
Public consumption					6.6	7.0	9.3	5.6	5.0
Investment					-45.3	29.7	29.5	-4.6	-1.4
Fixed capital					-11.3	0.8	12.0	4.0	-1.0
Stockbuilding 1/					-8.5	3.8	3.7	-1.3	-0.1
Domestic expenditure					-8.9	7.2	6.9	0.3	0.5
Exports of goods and services					-15.6	--	5.9	13.9	15.0
Imports of goods and services					-25.2	3.4	12.0	-1.0	3.0
Gross domestic product at market prices					-4.3	6.9	5.3	3.2	2.6
Memorandum items:									
Contributions to growth rate: 1/									
Domestic expenditure					-10.2	7.9	7.6	0.4	
Stockbuilding				-0.1	-8.5	3.8	3.7	-1.3	
Foreign balance					5.9	-1.0	-2.3	2.8	
Percentage changes in:									
Partner countries' real GDP 2/				1.1	-1.5	3.7		3.1	
GDP deflator		9.6		19.4	16.2	16.3	26.4	21.8	

Source: Bank of Portugal, Annual Report, 1978.

1/ Change as per cent of previous year's GDP.
2/ Trade weighted.

Table 4. Portugal: Saving and Investment

(Per cent of GDP at market prices)

	1968	1973	1974	1975	1976	1977	1978	1979
Investment		26.3	24.9	16.4	20.8	25.4	23.1	
Gross fixed capital formation		20.4	19.7	19.7	19.0	20.2	20.0	
Housing						(3.6)	(3.6)	
Productive sector						(13.7)	(13.6)	
State sector						(2.9)	(2.8)	
Stockbuilding		5.9	5.2	-3.3	1.8	5.2	3.1	
Saving		26.3	24.9	16.4	20.8	25.4	23.1	
External saving			6.2	5.6	8.0	9.2	4.3	
Remittances from abroad (net)			8.3	7.0	6.4	6.9	9.3	
Private domestic saving			10.0	6.3	9.2	11.3	13.1	
Public sector saving			0.4	-2.5	-2.8	-2.0	-3.6	
Memorandum items:								
Labor share in national income (net)				66.3	68.7	60.7	56.4	
Savings out of disposable income (net)								

Sources: Bank of Portugal and Central Planning Department.

Table 5. Portugal: Public Sector Accounts

(National accounts basis, in billions of escudos)

	1968	1973	1974	1975	1976	1977	1978	1979 Budget Proposal
Current receipts		63.8	77.8	93.2	131.4	168.0	210.8	265.1
Direct taxes		28.8	36.1	47.1	60.7	80.9	103.2	125.8
Indirect taxes		30.4	37.0	41.8	61.7	79.3	97.4	118.9
Other		4.6	4.7	4.3	9.0	7.8	10.3	20.4
Current expenditure		54.8	76.6	102.5	144.4	180.6	239.3	293.2
Goods and services		37.1	49.1	58.0	66.1	88.2	111.8	140.7
Subsidies		2.9	7.6	7.5	17.1	20.9	30.9	40.8
Transfers		13.6	18.4	34.3	56.1	60.9	73.9	83.5
Interest payments		1.2	1.5	2.8	5.1	10.6	22.7	28.2
Current balance		9.0	1.2	-9.3	-13.0	-12.6	-28.5	-28.1
Capital receipts		3.8	4.5	5.0	2.4	3.6	3.5	3.9
Capital expenditures		10.2	12.7	14.2	22.3	36.5	54.3	69.8
Investments		5.8	6.8	9.1	12.8	25.1	33.9	42.2
Transfers		2.5	3.4	6.1	7.7	8.7	9.3	11.6
Net lending		1.9	2.5	-1.0	1.8	2.7	11.1	16.0
Capital balance		-6.4	-8.2	-9.2	-19.9	-32.9	-50.8	-65.9
Overall balance		2.6	-7.0	-18.5	-32.9	-45.5	-79.3	-94.0
Memorandum items:								
Ratios to GDP:								
Current revenues		22.7	23.0	24.8	28.1	27.0	27.0	26.7
Current balance		3.2	0.4	-2.5	-2.8	-2.0	-3.6	-0.5
Overall balance		1.4	-2.3	-4.9	-7.0	-7.3	-10.1	-7.2

Source: Bank of Portugal, Annual Report, 1978

Table 6. Portugal; Monetary Survey

(Stocks in billions of escudos, end of period)

	1973	1974	1975 1/	1975 1/	1976	1977	1978	1979
Net foreign assets	77.8	63.3	38.9	39.1	5.0	-33.5	-18.9	
Net domestic credit	248.5	303.0	359.8	406.6	518.3	702.6	874.9	
Private sector 2/	249.5	293.8	326.3	365.9	442.8	579.3	703.2	
Public sector	-1.0	9.2	33.4	40.9	75.5	123.3	171.7	
Per cent of total	(-0.4)	(3.0)	(9.3)	(10.1)	(14.6)	(17.5)	(19.6)	
Monetary liabilities	301.3	342.3	385.4	394.9	460.8	567.4	726.6	
Money supply	165.6	182.5	227.2	227.7	246.3	274.8	314.9	
Currency in circulation	(38.3)	(69.7)	(109.8)	(111.7)	(110.4)	(113.3)	(121.4)	
Demand deposits	(127.3)	(112.8)	(117.4)	(116.0)	(135.8)	(161.2)	(192.9)	
Quasi-money	135.7	159.8	158.2	167.2	214.5	292.6	411.7	
Other items, net	25.0	24.0	13.3	50.8	62.5	101.6	129.4	
Memorandum items:								
Percentage changes in:								
DCE over initial money stock	25.0	18.1	16.6	--	25.8	39.0	30.4	
Money stock over year earlier	28.4	13.6	12.6	--	16.7	23.1	28.0	
Income velocity (M2/GDP)	1.05	1.07	1.04	--	1.11	1.18	1.18	
Real interest rate 3/	-6.1	-5.3	-5.0	--	-9.6	-11.0	-2.7	

Source: Bank of Portugal, Annual Reports, and information supplied by the Portuguese authorities.

1/ Change in series.
2/ Including bad debts.
3/ Annual average on 6-12 month deposits.

Table 7. Portugal: Monetary Base

(Stocks in billions of escudos, end of period)

	1968	1973	1974	1975	1976	1977	1978	1979
Base money				130.8	139.6	147.3	169.5	
Currency in circulation				111.7	109.2	113.3	121.4	
Reserves of other banks				19.1	29.2	33.7	47.5	
regional						(25.8)	(42.3)	
excess						(7.8)	(5.2)	
Other monetary liabilities				0.0	1.3	0.3	0.6	
Financing				165.4	169.9	202.2	240.7	
Net claims on abroad				32.0	3.1	-13.4	-4.9	
Net credit to public sector				33.8	59.5	112.2	158.5	
Net credit to other banks 1/				86.1	99.7	92.4	73.8	
Net credit to nonbank public 2/				13.5	7.6	11.0	13.3	
Other items net				-34.6	-30.3	-54.9	-71.2	
Memorandum items:								
Currency to deposit ratio (M2)				0.39	0.31	0.25	0.20	
Reserves to deposit ratio (M2)				0.07	0.08	0.07	0.08	
Money multiplier				2.4	3.3	3.9	4.3	

Sources:

1/ Excluding the Societate Financeira Portuguese.
2/ Including noncollectible items.

Table 8. Portugal: Balance of Payments

(In millions of U.S. dollars)

	1968	1973	1974	1975	1976	1977	1978	1979
Exports		1,843	2,288	1,936	1,824	2,001	2,410	3,235
Volume change in per cent 1/			-6.8	-12.6	4.8	5.9	13.5	18.0
Price change in per cent 1/			33.0	-2.7	-10.2	5.2	6.5	14.0
Imports		2,753	4,277	3,606	3,925	4,533	4,791	5,853
Volume change in per cent 1/			8.4	-23.5	17.8	12.7	-2.0	
Price change in per cent 1/			43.0	7.3	-4.4	2.1	4.6	
Trade balance		-910	-1,989	-1,670	-2,101	-2,532	-2,381	-2,618
Per cent of GDP			-15	-11	-13	-15		
Nonfactor services			-74	-170	20	82	275	419
Investment income			129	-14	-131	-179	-329	-445
Private transfers		1,097	1,111	1,037	963	1,134	1,635	2,194
Current balance		341	-823	-817	-1,249	-1,495	-800	-450
Per cent of GDP			6	6	8			
Overall balance		328	-633	-1,013	-1,125	-1,430	160	
Memorandum items:								
Per cent change in export markets			3.9	-7.2	10.5	3.6	4.7	8.8
Per cent change in effective exchange rates						-20.9	-19.1	
Per cent change in relative unit labor cost						-22.2	-14.7	
Terms of trade 1/								
Dollars received per tourist night		97	115	108	89	67	89	(98)
Dollars received per migrant worker		564	529	446	484	617	867	

Source:

1/ Customs basis.

Table 9. Portugal: Exports by Destination

(In per cent of total)

	1968	1973	1974	1975	1976	1977	1978	1979
EEC	40	49	48	50	52	52	55	
Of which:								
United Kingdom	20	24	23	21	18	18	18	
Old escudo zone	25	15	11	8	5	7	6	
United States	12	10	10	7	7	7	7	
Japan	1	2	2	1	1	1	1	
Planned economies of Eastern Europe and China	--	1	1	2	5	4	3	
Oil exporting countries	1	1	1	2	2	2	1	
Rest of world	21	22	27	30	28	27	27	
Memorandum item:								
EFTA (excluding the United Kingdom)	13	17	14	15	16	15	15	

Source: IMF, Direction of Trade.

Table 10. Portugal: Imports by Economic Category

(Annual per cent rates of change in 1970 prices)

	1973 Proportions	1963-73	1974	1975	1976	1977	1978	1979	1978 Proportions
Equipment goods 1/				-35.0	16.0	24.2	-0.4		16.4
Capital goods				-35.0	14.9	22.1	1.9		15.3
Transport goods 1/				-43.8	37.2	56.9	-26.1		1.0
Ships and planes				-32.9	-14.1	-70.8	49.9		0.6
Intermediate goods				-22.5	21.8	20.1			58.6
Primary products 2/				-0.3	19.5	21.8	0.6		17.4
Finished products				-30.7	22.8	20.3	-4.7		41.2
Fuels and lubricants				-7.5	6.7	-1.5	10.6		15.4
Consumer goods				-25.8	17.8	-22.0	-24.6		8.1
Food products				-25.2	28.0	-21.1	-36.0		2.8
Other nondurables				-21.2	16.0	-5.9	-2.7		2.6
Semidurables				-30.3	3.8	-21.5	-33.2		0.9
Durable goods				-26.9	12.4	-36.5	-17.4		1.8
Total 3/				-22.3	19.2	13.6	-2.6		98.5
Total				-23.5	17.8	12.7	2.0		100.0

Source: Data provided by Portuguese authorities.

1/ Except ships and planes.
2/ Except diamonds.
3/ Except diamonds, ships, and planes.

Table 11. Portugal: Financing the External Current Account

(In millions of U.S. dollars)

	1963	1973	1974	1975	1976	1977	1978	1979
Current account balance	29	356	-824	-816	-1,249	-1,495	-800	
Medium-term and long-term capital, net	117	-146	272	-107	26	95	758	
Government	21	-108	56	-86	11	76	509	
Government guaranteed								
Other private								
Bank liabilities					41	90		
Bank assets					--	-4		
Basic balance		210	552	923	1,223	1,400	-42	
Residual flows		138	-82	-89	98	-30	202	
Short-term financing								
Errors and omissions								
Overall balance		348	-633	-1,013	-1,125	-1,430	160	
Monetary movements		-348	-633	-1,013	1,125	1,430	-160	
Treasury					-18	-13	-63	
Other banks			6	-10	153	567	-201	
Bank of Portugal			590	687	990	876	104	
IMF		--	--	33	179	83	-53	
Compensatory borrowing, net		--	--	303	665	421	197 1/	
Gold sales		--	--	--	--	403	--	
Direct intervention, net						-31	-40	

Source:

1/ US$589 Paris credits less repayments to BIS (US$89 million) and other central banks (US$309 million).

Table 12. Portugal: Net Foreign Assets of the Banking System

(In millions of U.S. dollars)

	Bank of Portugal 1/	Other Banks	Total
Stocks at end of period:			
1963 2/	838	95	933
1973 2/	2,721	216	2,937
1974 2/	2,221	296	2,519
1975 2/	1,165	258	1,423
1976 3/			
I			
II			
III			
IV	110	96	206
1977 3/			
I	-164	-45	-209
II	-411	-170	-581
III	-638	-344	-982
IV	-738	-505	-1,243
1978 3/			
I	-942	-691	-1,634
II	-1,192	-628	-1,821
III	-910	-590	-1,500
IV	-783	-303	-1,086
1979 3/			
I	-916	-95	-1,011
II	-863	16	-848
III			
IV			

Sources: IFS; and data supplied by the Portuguese authorities;

1/ With gold stock valued at the official price of SDR 35 million per ounce and cumulative profits from the sale of gold counted as a liability beginning in September 1977.
2/ Old series
3/ New series.

Table 13. Portugal: Official International Reserves

(In millions of U.S. dollars; end of period)

	Gold 1/	Foreign Currency	Reserve Position in the Fund	SDRs	Total Gross Reserves
1968					
1973	1,163	1,641	35	--	2,839
1974	1,193	1,125	36	--	2,354
1975	1,136	390	--	8	1,534
1976	1,126	166	--	10	1,302
1977					
March	1,117	128	--	6	1,251
June	1,129	68	--	8	1,205
September	1,050	154	--	4	1,208
December	1,025	361	--	5	1,391
1978					
March	999	265	--	--	1,264
June	961	288	--	--	1,249
September	992	799	--	--	1,791
December	1,009	871	--	--	1,880
1979					
March	996	640	--	19	1,636
June	1,000	619	--	5	1,624
September	1,020	1,070	--	1	1,091
December	1,020	939	--	1	1,959

Source: IMF, International Financial Statistics.

1/ Valued at SDR 35 per ounce.

Table 14. Portugal: Outstanding Compensatory Debt Incurred by the Bank of Portugal

(End of period)

Creditor	Initial Amounts In millions	1975	1976	1977	1978	1979 1st half	1979 1/
		Outstanding amounts (In millions of U.S. dollars)					
IMF	SDR 245		201.0	298.0	319.1	306.9	275.0
Consortium of central banks			165.0	250.0	92.2	30.7	--
Deutsche Bundesbank	US$75		75.0	75.0	--	--	--
Netherlands Bank	US$35		35.0	35.0	15.8	6.8	--
National Bank of Belgium	US$25		25.0	25.0	11.9	5.8	--
Sveriges Riksbank	US$15		15.0	15.0	7.2	3.6	--
Norges Bank	US$15			15.0	7.2	3.6	--
Austrian National Bank	US$15		15.0	15.0	7.2	3.6	--
Danmarks Nationalbank	US$15			15.0	7.2	3.6	--
Swiss National Bank	US$55			55.0	35.7	3.7	--
Consortium of France and Switzerland				40.0	32.2	28.6	--
Bank of France	US$15			15.0	7.2	3.6	--
Swiss National Bank	US$25			25.0	25.0	25.0	--
Consortium of US$750 million				48.0	661.3	725.0	749.1
Norway	US$10			3.0	10.0	10.0	10.0
United States	US$300				300.0	300.0	300.0
Venezuela	SDR 19			15.0	24.5	24.3	24.3
Swiss National Bank	US$30			30.0	30.0	30.0	30.0
United Kingdom	US$20				20.0	20.0	20.0
Austrian National Bank	US$10				10.0	10.0	10.0
Netherlands	f. 50				25.4	24.6	24.6
Germany	DM 420				229.8	227.3	227.3
Sweden	SKr 50				11.6	11.7	11.7
Japan	¥ 19,800					67.1	91.2
Other		300.0	800.0	1,045.0	819.6	703.8	582.1
Swiss National Bank	US$50	50.0	50.0	50.0	--	--	--
Deutsche Bundesbank	US$250		250.0	250.0	151.8	71.6	--
BIS	US$745	250.0	500.0	745.0	667.8	632.2	582.1
Total		300.0	1,166.0	1,681.0	1,924.4	1,795.0	1,606.2

Source:

1/ Exchange rate of June 30, 1979.

February 13, 1980

Dear Dr. Silva Lopes,

Thank you very much for your kind letter telling me of your decision to resign from the position of Governor of the Bank of Portugal.

During the long series of discussions and contacts which the Fund has had with Portugal during recent years two things have always stood out in our minds. First that there was every reason to have faith in the economic future of Portugal not least due to the inate wisdom of its people and secondly that Portugal was fortunate indeed to have people of the calibre of yourself at the center of the decision-making process. I think when you look back you should draw great strength in the knowledge of the contribution which you have made to your country.

I am much encouraged by the possibility that you will join us for up to a year. We have a few formal details to be completed and either Mr. Schmitt or I will write to you as soon as this has been done.

With best wishes.

Yours sincerely,

L.A. Whittome
Director

Dr. José da Silva Lopes
Bank of Portugal
Lisbon, Portugal

cc: SED

Banco de Portugal

Governador

cc SED

Nº. 31 /ROI

Lisbon, January 23, 1980

Dear Mr. Whittome,

I should like to inform you that I have decided to resign from my post of Governor of the Banco de Portugal.

On this occasion I wish to express my sincere appreciation of the kind cooperation you have given to me and the Banco de Portugal over the years. I realize how much this has been due to your personal involvement, and for this I am particularly grateful.

My successor will be Prof. Manuel Jacinto Nunes whom you know very well. I am sure that the Portuguese authorities will assess correctly, as they have done in 1978, the value of the advice and assistance that they may get from the IMF and that your institution will show the same willingness as in the last few years to help us in meeting the economic difficulties which might appear in the future.

With kindest personal regards,

Sincerely yours,

José da Silva Lopes

José da Silva Lopes

Mr. L. A. Whittome
Director
European Department
International Monetary Fund
WASHINGTON, D.C.

JM/MA

February 13, 1980

Dear Mr. Governor,

You have a habit, if I may say so, in Portugal of moving a small group of able and dedicated people around the posts of real economic importance. It does seem to me that this is an approach which has a very great deal to commend it for too often people are narrowly frozen by the requirements of their institutional work into a set pattern of thinking. Now you have again been appointed to the post which you held with such distinction earlier. I and my colleagues are extremely pleased that this has happened and send you most sincerely our very best wishes and our assurance that if at any time we can be of use to your country or the Bank of Portugal we are ready to do all that we can.

Yours sincerely,

L.A. Whittome
Director

Governor Jacinto Nunes
Bank of Portugal
Lisbon, Portugal

cc: SED

February 13, 1980

Dear Mr. Governor,

You have a habit, if I may say so, in Portugal of moving a small group of able and dedicated people around the posts of real economic importance. It does seem to me that this is an approach which has a very great deal to commend it for too often people are narrowly frozen by the requirements of their institutional work into a set pattern of thinking. Now you have again been appointed to the post which you held with such distinction earlier. I and my colleagues are extremely pleased that this has happened and send you most sincerely our very best wishes and our assurance that if at any time we can be of use to your country or the Bank of Portugal we are ready to do all that we can.

Yours sincerely,

L.A. Whittome
Director

Governor Jacinto Nunes
Bank of Portugal
Lisbon, Portugal

cc SEP

File

Office Memorandum

TO : Mr. Pfeifer

DATE: February 12, 1980

FROM : Saumya Mitra SM

SUBJECT : Portugal

Portugal's balance of payments position registered a strong improvement in 1979 and it can no longer be considered to be a country in acute payments difficulties. The most recent estimates show a current account surplus of about US$100 million in 1979 (versus a deficit of US$800 million in 1978) and an overall surplus in excess of US$1 billion. In 1980 the current account is projected to be in deficit to the tune of US$700-900 million, but Portugal is expected to attract sufficient capital inflows and to be able to borrow with ease and on good terms to bridge this financing requirement. Recently the escudo was revalued un tantum by 6 per cent. The authorities will continue the downward crawl of 0.75 per cent per month in effective terms of the escudo in order to protect the competitiveness of Portugal's exports. However, the stubbornly high rate of inflation (24 per cent in 1979) and a weakness in public finances are causes for concern.

Total reserves, with gold valued at near-market prices, stand at US$14 billion.

cc: Mr. Schmitt

0728 02/11

INTERFUND WSH

16554C BAGAL P

11.2.80 12.26

cc: SED

RECEIVED
I.M.F.

1980 FEB 11 AM 8:53

CABLE
ROOM

403955

ORIG: EURO
CC: MD
DMD
MR. DINI
LEG
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BUREAU OF STAT.

MR. JACQUES DE LAROSIERE
MANAGING DIRECTOR
INTERFUND
WASHINGTON D C

SPECIAL DELIVERY CABLE

I HAVE THE HONOUR TO INFORM YOU, IN ACCORDANCE WITH ARTICLE IV OF THE IMF ARTICLES OF AGREEMENT, OF THE FOLLOWING EXCHANGE ARRANGEMENTS WHICH THE PORTUGUESE AUTHORITIES HAVE DECIDED TO APPLY AS FROM THE 12TH FEBRUARY:

''THE PORTUGUESE ESCUDO IS REVALUED BY 6 PER CENT IN TERMS OF THE EFFECTIVE EXCHANGE RATE.
WITH A VIEW TO ENSURING THE EXTERNAL COMPETITIVENESS OF PORTUGUESE GOODS AND COUNTERING ANY SPECULATIVE MOVEMENTS AGAINST THE ESCUDO THE CRAWLING PEG SYSTEM SHALL BE MAINTAINED AT THE RATE OF 0.75 PER CENT PER MONTH WHILST A RELATIVE ABATEMENT OF INFLATION IS NOT APPARENT''

THIS ACTION IS PART OF A PACKAGE OF MEASURES ANNOUNCED BY THE GOVERNMENT TO FIGHT INFLATION

YOURS SINCERELY

MANUEL JACINTO NUNES
NGOVERNOR
BANCO DE PORTUGAL-LISMON

cc: Hans,
Pl check with Dini's office & the Secretary. This should be circulated to EDs
/ [illegible] 11/2

INTERFUND WSH

16554C BAGAL P
REPLY VIA WUI

Western Union International, Inc. International telex

Ofício nº 350
Procº 38

cc: SED

FEB 19 1980

MINISTÉRIO DAS FINANÇAS

GABINETE DO MINISTRO

466241

Lisbon, -5. FEV. 1980

Orig: SEC
cc: MD
DMD
Mr. Dini
EUR

Dear M. de Larosière,

I have the honour to inform you, for the purposes of the Article XII, Section 2 (a) of the Articles of Agreement, that I have appointed Prof. Dr. Manuel Jacinto Nunes, Governor of the Banco de Portugal, to serve as Governor of the International Monetary Fund for Portugal and Dr. Emílio Rui da Veiga Peixoto Vilar, Vice-Governor of the same Bank to serve as Alternate Governor.

With kind regards.

Yours sincerely,

Mr. Jacques de Larosière
Managing Director
International Monetary Fund
WASHINGTON, D.C. 20 431

U.S.A.

1980 FEB 20 AM 11: 14
COMMUNICATIONS
DIVISION

Office Memorandum

TO : Mr. Whittome

FROM : Hans Schmitt

SUBJECT : Letter from Silva Lopes

DATE: February 1, 1980

The attached letter which I received from Dr. Silva Lopes on the occasion of his resignation from the Bank of Portugal may be of interest to you.

Banco de Portugal

Governador

Nº. 28 /ROI

Lisbon, January 23, 1980

Dear Mr. Schmitt,

I should like to inform you that I have decided to resign from my post of Governor of the Banco de Portugal.

I wish to express my sincere appreciation of your work for Portugal in the last few years. The success of such work is clearly shown by its contribution to the solution of some of our most pressing economic problems. I consider that our discussions about the choices of the appropriate economic policies for Portugal in recent years were very constructive and highly stimulating.

My successor will be Prof. Manuel Jacinto Nunes whom you know well. I hope that you will maintain your interest for Portugal.

With kindest personal regards,

Sincerely yours,

José da Silva Lopes

José da Silva Lopes

Mr. Hans Schmitt
Assistant Director
European Department
International Monetary Fund
WASHINGTON, D.C.

JM/ MA

Mr. Rose

January 25, 1980

MEMORANDUM FOR FILES

Subject: Portugal--Dr. Constâncio

Replying to the economic program presented by the Minister of Finance in the Assembly last week, the Deputy Governor of the Bank of Portugal, Vitor Constancio, who is a Socialist member, characterized the economic program as inadequate on both the "technical and ideological" planes. The new Government was taking office at a time of healthy growth, investment and balance of payments, while the first Socialist Government (in August 1976) found a declining national product, a sharp fall in investment and a large external deficit with a very difficult climate for borrowing. However, the program, at the technical level, was vague and imprecise. As stated it tended to obscure the policies the Government intended to follow and it revealed little of how the Government was going to deal with national problems. Moreover, the clear ideology that it embedded was defective; no modern, civilized, intelligent society could be based on it. The planned alteration of the division between the public and private sectors implied the abandonment of constitutional perspectives on the control of private economic power and privilege. Dr. Constancio opposed particularly the revision of laws permitting free enterprise in banking and insurance as it was not likely to lead to greater investment in the economy, and also laws for agrarian reform and rural rents. These revisions would enhance the power of the privileged (sic) classes. Dr. Constancio concluded by saying that Portugal faced difficult structural problems in the 80s to which a liberal economic system was not capable of offering a satisfactory resolution.

Fairly strong stuff from a present Deputy Governor and former head of the EEC negotiating team, but clearly avoided putting forward any specific economic policies on the grounds that Dr. Cavaco-Silva's program was too vague. But such a fundamental attack must mean that Dr. Constancio's days at Rua do Commercio are numbered.

SM

Saumya Mitra

cc: Mr. Rose
Mr. Schmitt
Mrs. Ter-Minassian
Mr. Dhonte

Copies (All Sent)

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

January 24, 1980

Dear Dr. Silva Lopes,

I should like to convey my very best wishes to you on leaving the Governorship of the Bank of Portugal. I hope very much that we shall have the opportunity of remaining in touch with you whatever new responsibilities you may assume.

With best personal regards.

Very sincerely yours,

Hans Schmitt

Hans Schmitt
~~European~~ Department

Dr. Jose da Silva Lopes
Bank of Portugal
Lisbon, Portugal

INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

CABLE ADDRESS
INTERFUND

January 24, 1980

Dear Governor Nunes,

I should like to congratulate you on resuming your old position as Governor of the Bank of Portugal. We here on the staff of the Fund look forward to continuing the positive relationship that we have had with you and your colleagues in the past. As you know, we always stand ready to be of service to you when we can.

Very sincerely yours,

Hans Schmitt

~~Hans Schmitt~~
European Department

Governor Jacinto Nunes
Bank of Portugal
Lisbon, Portugal

January 23, 1980

Dear Antonio,

It was with pleasure that I heard of your recent promotion. I would like to congratulate you and to wish you the best for the future. I look forward to continuing with you the very stimulating relationship that we have had in the past.

Very sincerely yours,

Hans Schmitt
European Department

Mr. Antonio Fazio
Bank of Italy
Rome, Italy

January 15, 1980

MEMORANDUM FOR FILES

Subject: Portugal

Mr. Schmitt told me yesterday that he had heard from Governor Silva Lopes who had said that the Minister certainly did not wish to rule out the use of the Fund's financial resources during 1980. The Minister would take the matter up with the Cabinet and we hoped to have a decision in good time before March. There remain three possibilities, either a straight Article IV consultation or a normal one year stand-by or an EFF program. Mr. Schmitt and I agreed that the last of these is the most improbable but if nevertheless the Portuguese would wish to pursue this course then he himself should head the mission. If either the other two courses were followed then Mrs. Ter-Minassian should head the mission. This is understood by all concerned.

/LAW/

L.A. Whittome

cc: SED

CC: H.S

Office Memorandum

1) DOC
2) [illegible]

TO : Mr. Whittome

FROM : P. de Fontenay

DATE: January 10, 1980

SUBJECT : Visit by Mr. van Lennep to Portugal

Julius Rosenblatt called to say that Mr. van Lennep was planning a visit to Portugal on March 15 and he was anxious that his visit did not coincide with a Fund mission. I told Julius that, as far as I knew, no date had yet been decided for the next staff visit to Portugal but that I thought we could have Mr. van Lennep's concern in mind in our scheduling. Julius did not know the length of Mr. van Lennep's visit and will cable the exact date(s) when he expects to be in Portugal.

cc: Mr. Schmitt

HS When you have fixed a date pl let Mr. Rosenblatt know.
AW 9/1

INTERNATIONAL MONETARY FUND

January 7, 1980

To: Mr. Whittome

For your information.

A. P. Nose

Mr. Whittome CC: SEO

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

JAN 7 1980

Dear Mr. da Silva Lopez:

I am writing to explore the possibility of a staff visit to Portugal to review the general statistics in the Bank of Portugal *Boletim Trimestral* and to offer ideas and suggestions for improving the Bank's assembly of statistics on prices, production, employment, wages and external trade.

It is envisaged that the work program for such a visit would require the close cooperation of the National Institute of Statistics and should bring together the staff of the Bank and the compilers of the data in the National Institute of Statistics in mutually beneficial discussions. The program could provide assessment of the quality and currentness of the general statistics and resolve problems in the application of methodology for compilation of these data.

The proposed visit would be a continuation of the earlier staff visits under the program in areas of balance of payments and financial statistics. If a visit would be useful for the Bank, we could arrange to have Mr. John Sundgren, Assistant Chief of the General Statistics Division, visit Portugal for two weeks beginning March 17, 1980. I would appreciate your cable reply as to whether the proposed visit and its timing are agreeable to the Bank.

Very sincerely yours,

W. Dannemann

Werner Dannemann
Director
Bureau of Statistics

Mr. Jose da Silva Lopez
Governor
Bank of Portugal
Lisbon, Portugal

Office Memorandum

DEC 10 1979

TO : Managing Director

DATE: December 7, 1979

FROM : L. Dini

SUBJECT : Portugal - Foreign Exchange Sales Restrictions

You may recall that Portugal maintains certain restrictions on foreign exchange sales for remittances of profits and dividends (as described in SM/79/304), the retention of which was approved by the Executive Board until December 31, 1979 (Decision No. 6028-(79/14), adopted January 24, 1979).

The Portuguese authorities have asked me to request extension of Fund approval for maintenance of such restrictions until December 31, 1980. In this regard, they wish to bring to the attention of the Fund that under the present regime: (a) Remittances of profits and dividends in excess of U.S. dollars 250,000 are authorized up to a limit of six monthly instalments; in case the final remittance is lower than U.S. dollars 100,000, it may be effected jointly with the previous one. (b) Upon authorization by the Bank of Portugal, remittances may be effected at once. (c) The waiting period for obtaining the authorization from the Bank of Portugal is on average three to four weeks; such waiting period is the time required for the processing of applications and does not depend on foreign exchange availability.

These restrictions are maintained because of the continuing balance of payments difficulties faced by Portugal and the considerable uncertainty that surrounds developments in this field.

The Portuguese authorities will, however, keep the matter under constant review and will consider removal of the above-mentioned restrictions as soon as possible, in light of external developments.

orig. to HOS 12/17

Mr Schmitt,

I presume we should go along c process? If so would you put the machine in motion.

17/12

Reply via RCA, call 212-248-7000

SPECIAL DELIVERY CABLE

1979 DEC -6 PM 1:08

397486

CABLE ROOM

MR. HANS SCHMITT
ASSISTANT DIRECTOR
EUROPEAN DEPARTMENT
INTERFUND
WASHINGTON DC

REFERENCE YOUR TELEX OF NOVEMBER 8 WE INFORM YOU THAT:
(I) REMITTANCES OF PROFITS AND DIVIDENDS IN EXCESS OF US DOLLARS 250,000 ARE AUTHORIZED UP TO A LIMIT OF 6 MONTHLY INSTALMENTS. IN PRINCIPLE MONTHLY REMITTANCES SHALL NOT BE LOWED THAN US DOLLARS 250,000: SHOULD THE FINAL REMITTANCE BE LOWER THAN US DOLLARS 100,000 IT SHALL BE EFFECTED JOINTLY WITH THE PREVIOUS ONE.
(II) UPON AUTHORIZATION BY THE BANCO DE PORTUGAL, THE RELEVANT REMITTANCE MAY BE EFFECTED AT ONCE.
(III) THE TIME LIMIT FOR OBTAINING AUTHORIZATION FROM THE BANCO DE PORTUGAL IS ON AVERAGE 3/4 WEEKS. THIS IS THE TIME REQUIRED FOR THE PROCESSING OF APPLICATIONS AND DOES NOT DEPEND ON EXCHANGE AVAILABILITY.
REGARDS.

JOSE DA SILVA LOPES
GOVERNOR
BANCO DE PORTUGAL/LISBON

248331 IMF UR
165544 BAGAL P

248331 IMF UR

Valerie
~~pl. find out (a) what telex is referred to (b) why it was sent — and in any case cc ETR (McLenaghan?)~~

I have talked to Mr. McLenaghan and have sent him a copy of the telex; will take the matter up in due course.

BR

cc: Mr. Mitra

Reply via RCA, call 212-248-7000

Reply via RCA, call 212-248-7000

Mr. Whittome
2

November 28, 1979

MEMORANDUM FOR FILES

Subject: Portugal--The Economic Policies of The Socialist Party

In a press interview conducted on November 19, 1979, Vitor Constancio, Vice-Governor of the Bank of Portugal and a leading Socialist candidate in the December 2 general elections, stated that a Socialist Government would reduce direct taxes, particularly the professional tax and the complementary tax, and would adopt an economic policy stance more expansionary than that seen at present. These tax reductions could take place as early as next year as the balance of payments position permitted room for stimulatory policies. A reduction in the rate of depreciation of the escudo would also be considered.

For the near future, Dr. Constancio ruled out an agreement with the Fund as it would be likely to thwart the preferred economic policies of the Socialists. Further, the balance of payments deficit was well within bounds and easy to finance in the international credit markets.

SM

Saumya Mitra

cc: Mr. Whittome (o/r) ✓
Mr. Rose
Mr. Schmitt (o/r)
Mrs. Ter-Minassian (o/r)

Mr. Whittome

Mr. Karaosmanoglu November 19, 1979

Hans Schmitt

<u>Portugal--Joint Financing</u>

Attached please find copies of three memoranda on Portugal for your easy reference. I would like very much to discuss our next steps with you at this point. Can we meet this week sometime? I am scheduled to leave town on Sunday. Many thanks.

Attachments (3)

cc: Mr. Whittome
Mr. Dubey

Mr. Whittome

CONFIDENTIAL

November 13, 1979

MEMORANDUM FOR FILES

Subject: Portugal - IBRD

Basil Kavalsky called me today concerning a possible IBRD program loan to Portugal. The amount might be some US$200 million, based on the same investment program they have been preparing in support of a possible EFF cum SFF package from us, which would add another SDR 485.9 million or about US$600 million. We agreed that the sum of the two would not exceed Portugal's financing needs, and indeed hoped together that we might draw in an EIB contribution to make the total add to US$1,000 million over three years. Such a sum, especially from the three institutions jointly, would provide additional incentive to the Portuguese to put their development efforts on a sustainable basis.

Mr. Kavalsky was worried, however, that the management of the IBRD might be reluctant to tie themselves to Fund conditionality. I explained to him that under a joint arrangement we would defer to Bank standards on the content of the Portuguese investment program; we would want to be assured that we were not underwriting waste. In turn we would be concerned with ensuring that the investment program was accompanied by macro-economic policies that placed it on a sustainable basis. The rapid expansion of the Portuguese economy in 1976 and 1977 had manifestly not been sustainable. A repeat of that performance would surely not benefit Portugal in future either.

Asked what specifically conditionality would entail under an EFF for Portugal, I sketched the following approach. We would in the first instance be concerned with stabilizing the external debt service ratio at a sustainable level for the medium term. Along with reasonable export projections this would give us annual ceilings for external borrowing gross and net. Comparing these with the investment program certified by the IBRD would yield a required domestic saving effort on public and private account. If this effort was regarded as excessive, the investment program would have to be cut. If not, the saving effort would be translated into ceilings on domestic credit to the public and private sectors.

Mr. Kavalsky accepted the general approach and planned to inform his superiors of it. He was also scheduled to go to Lisbon in the near future, and I urged him to raise with the Portuguese, if he could, the possibility of joint financing with the Fund, based on the same investment program and supporting policy package. I would advocate the same approach within the Fund.

Hans Schmitt

cc: Mr. Whittome
Mrs. Ter-Minassian
Mr. Mitra
Mr. Dhonte

H.S

Talked with Benjenk. We would clearly favor such an approach and would be full of admiration if you could pull it off.

LAW 13/11

cc: Mr. Schmitt (chron)

Office Memorandum

TO : Mr. Dubey

DATE: November 16, 1979

FROM : Hans Schmitt HS

SUBJECT : Portugal - IBRD Draft Report

The draft report entitled "Portugal: Priorities for Public Sector Investment", is of great interest to us as you know. We need an outside view on the Portuguese public investment program in the context of a possible EFF arrangement. Augmented by the SFF this could involve disbursements of up to SDR 485.9 million, or roughly US$600 million over a three-year period. Against this background, we would like to offer the following broad comments on the draft as it presently stands.

There are two questions we bring to the report. The first is, what size of investment program can be built up in Portugal on a project by project basis. The second is, what sort of supporting policies are required to make it sustainable. The two answers are, of course, logically interlinked.

We are very pleased by the way that the first question, having been clearly stated first, has in fact been systematically addressed in the report. We are gratified by the way that an "implicit" program has been shaken down to produce a "core" program. We defer to others in determining the adequacy of the criteria that have been applied in the choice of projects for this core program. We would, however, like to know more about the choice of projects for inclusion in the "expanded" program. We can conceive of expanding a program by adding projects of higher capital intensity or longer gestation periods if saving can be increased to finance them. An increased domestic saving effort is tantamount to a lower social discount rate, which lowers the cut-off point on permissible rates of return on projects to be included in the program. But this sort of logic is not much in evidence in the macro-economic framework in which the "expanded" program is embodied.

We are a bit disappointed that the second question, regarding the type of supporting policies required, is not explicitly stated or pursued in the present draft. For us, the first requirement of a sustainable program would be that it should stabilize the external debt service ratio at some appropriate level. Given reasonable export forecasts, this requirement would fix annual ceilings on external borrowing gross and net. With this external financing constraint firmly fixed, the viability of the program depends on the domestic savings effort. The draft report simply assumes that this effort will be adequate on both public and private account, without specifying the very serious policy issues that must be addressed to make it so.

The present draft provides two alternative macro-economic scenarios associated with the two alternative investment programs. Moving from the "core" program to the "expanded" program produces a path for the economy that yields (i) a much higher level of per capita consumption by the end of the plan period; (ii) a much lower fiscal deficit in relation to national income; and (iii) a balance of payments not much worse in relation to income than before. Superficially, one gains the impression that the only major policy requirement for achieving this improved prospect is not to save more, but rather to spend more, and that on projects whose intrinsic merits were inadequate to qualify them for inclusion in the "core" program. Clearly other assumptions were changed between the two scenarios. It might be more illuminating for policy purposes to keep those changes to the bare minimum necessary.

It is our impression that a sharper focus on policy issues would show a lot of the detail in your macro-economic projections to be unnecessary. For the few remaining forecasts, however, it would be useful if the underlying assumptions were more clearly specified. We would be particularly interested in how you split exports and imports by volumes and values, how you relate export volumes to market growth, and import volumes to domestic demand. Your debt service projections seem low to us; what have you assumed regarding grace periods? We do not feel very secure about public sector current expenditures growing by only 2 per cent, or about using historical elasticities for tax yields. Finally, how sensitive are your results to deviations from your inflation forecast?

Details apart, the basic problem is, of course, to find a way of linking project specific investment programs to the macro-economic framework into which they are to fit, in a way that is both simple and sensible. We feel very encouraged by your explicit recognition of this problem during this morning's meeting. We hope that our specification of the two main questions we ourselves bring to the report, may be of some use to you in the next iteration and revision of the report. We are looking forward to it, as you can imagine, with great expectations.

cc: Mr. Whittome
Mr. Sadove
Mr. Kavalsky

Office Memorandum

TO : Mr. Schmitt

DATE: October 22, 1979

FROM : Pierre Dhonte P. Dh

SUBJECT : Portugal - External Debt: Long-Run Perspectives

The World Bank projections which you circulated under your October 12 memorandum are not specific enough to provide a basis for an external debt projection. It may, however, be useful at this stage to sketch a broad framework, if only to identify topics for discussion.

1. The current status of Portuguese debts

Portugal's outstanding debt, disbursed, was estimated at $5.7 billion as of last June. The figures given to the September Fund mission are the following:

(In millions of U.S. dollars)

	1976	1977	1978	June 1979	Forecast 1979
Government	258	319	894	912	1,274
Bank of Portugal	1,166	1,681	1,924	1,795	1,606
Private sector	1,468	2,427	2,602	2,957	n.a
Of which: government guarantee	(328)	(488)	(615)	(727)	n.a
Total	2,892	4,427	5,420	5,664	n.a

These figures are the same as those which the Bank of Portugal published in its 1978 report. They do not include the Cabora Bassa liabilities, but they include the liabilities to the Fund (under Bank of Portugal debt).

Compared to figures given to the May 1979 mission, the above are sharply higher for the private sector debt. As there is no evidence of matching flows in the balance of payments, and because huge amortization payments on that account are projected for the second half of 1979, I assume that the private sector figures above include a large amount of short-term debt. I would, therefore, rather use the figures of last May:

(In millions of U.S. dollars)

	1976	1977	1978	Forecast 1979
Private sector	1,265	1,603	1,963	2,189
Total	2,689	3,602	4,781	5,069

Recent debt flows can be estimated from the balance of payments data:

(In millions of U.S. dollars)

	1976	1977	1978	1st half 1979	1979 1/
Drawings					
Government	43	75	585	27	327
Private sector	379	384	527	330	700
Bank of Portugal 2/	701	720	589	70	94
	1,123	1,179	1,701	427	1,121
Repayments					
Government	60	48	29	16	30
Private sector	433	467	352	227	474
Bank of Portugal 2/	--	85	391	181	394
	493	600	772	424	898
Interest 3/	137	208	380	225	478
Debt service	630	808	1,152	649	1,376
Exports:					
Goods and nonfactor services	2,567	2,893	3,552	2,220	3,654
Workers' remittances	975	1,174	1,671	1,024	2,194
	3,542	4,067	5,223	3,244	5,848

The forecast for 1979 is based on our balance of payments forecast of last September, supplemented with the indications that we have been given about the debt service schedule. An implication of that forecast is that, because of large repayments of BOP debts, debt service in 1979 would be larger than drawings on new loans. Debt outstanding, however, would rise to $5,069 million. Incomplete data on the debt service schedule pertaining to the debt as of June 1979 have also been given to the mission. These data only cover the debt service for the Government and the Bank of Portugal through 1980. As regards the Government however we do have the amortization schedule for the $450 million euro-dollar borrowings of 1978, which comprise half of its debt, and for the $300 million loan to be drawn by the end of 1979. For the rest, based on very cursory inspection of the list of debts

Source: Balance of payments data and data provided by The Portuguese authorities

1/ Forecast.
2/ Including IMF.
3/ Including payments on short-term credits.

outstanding, I have assumed amortization over 20 years. Regarding the Bank of Portugal's debt, the 1980 amortization figure of $523 million given to us in September is larger than the $360 million projected last May, itself larger than the $268 envisaged last February. I have accordingly assumed that the debt will be amortized rather quickly, if only to recover the gold pledged against it. Finally, on the assumption that the heavy payments scheduled for the second half of 1979 take care of short-term debt, I have kept the schedule given to us for private debt.

Summing up the amortization schedule would be the following:

(In millions of U.S. dollars)

	1980	1981	1982	1983	1984	1985	1986
Government	25	30	30	180	180	240	90
BOP	523	400	300	300	83	--	--
Private sector	444	389	306	252	195	200	200
	992	819	636	732	458	440	290

On that basis, remaining debt outstanding and interest payments can be estimated (assuming an average 8 per cent interest rate):

	1980	1981	1982	1983	1984	1985	1986
Outstanding (end of period)	4,079	3,260	2,624	1,892	1,434	994	734
Interest	405	326	261	210	151	115	80
Debt service	1,397	1,145	897	942	609	555	370

Contrary to standard practice, I believe that it is legitimate, in Portugal's case, to include workers' remittances in the computation of the debt ratios. On that basis, the 1979 debt service ratio was 23.5 per cent and the 1980 ratio would be about 20.5 per cent. These are fairly high figures, which allow however for substantial repayment of the compensatory financing of 1976-78.

2. Medium-term prospects

That Portugal might borrow heavily, not for adjustment purposes, but for its development, is a strategic option which raises a number of philosophical issues. These can be clarified when account is taken of some technicalities.

(a) An evident requirement is that borrowing policies should be consistent with a stabilization of the debt service ratio as whatever level is considered proper. For this to occur, under given loan terms, disbursements should be constrained not to grow faster than exports. The sustainable disbursements/exports ratio then depends on: (i) the acceptable debt service ratio; (ii) the growth rate of exports (which acts as a constraint on the growth of disbursements); and (iii) the loan terms. The last two elements determine a long-run relationship between disbursements and debt service, i.e., what share of disbursements will in the long run be absorbed by debt service.

In the case of Portugal, the range of that share could be 68 to 86 per cent. This is a fairly open range, so that careful consideration of the export growth and terms assumptions will be necessary to narrow it. It means that if Portugal accepts a 20 per cent debt service ratio, then disbursements consistent with that target can range from 23 to 29 per cent of exports. The table below establishes the relation between debt service and disbursements for various assumption:

(In per cent)

Terms: Export Growth 1/			10	12	14	16
Maturity	grace	interest				
1) Inflation at 6%						
9	3	7	86	78	71	2/
10	4	7	84	76	68	2/
2) Inflation at 8%						
9	3	9	2/	86	79	72
10	4	9	2/	85	77	70

As can be seen from that table, the outcome is fairly sensitive to the export volume growth assumption. The influence of inflation is lesser, because it is offset by matching assumption for the interest rate.

(b) The above relation only prevails in the long run, under steady growth conditions. In the medium run, two additional factors will bear. First, as the country initiates its policy, debt service initially lags behind its long-term value; second, debt service on account of debts outstanding before the policy is initiated must be allowed for. To account for these factors, I have computed an example in which disbursements and exports grow at 14 per cent per year. The loan package includes equal shares of eurocredits (8 years, of which 5 years grace, 10 per cent), supplier's credits (7 years of which 2,8 per cent) and development loans (15 years of which 4,9 per cent). The constraint on the debt service ratio is 20 per cent and this is consistent with a 26 per cent ratio of disbursements/exports.

As Charts 1 and 2 show, this policy would first result in a fairly large net transfer, because of the initial impact of grace periods. As these would expire, debt service would catch up, and would eventually stabilize at about 77 per cent of disbursements, or 20 per cent of exports. The net transfer, after peaking out at about 12 per cent of exports, would decline sharply to 6 per cent. There would, therefore, be a rather serious adjustment problem when the lags unwind.

1/ 4-8 per cent in volume and inflation 6-8 per cent.
2/ Not applicable.

Finally, Portugal might want to borrow more in the early eighties, if only to offset the large repayments by Bank of Portugal. If, however, the 20 per cent debt service ratio constraint is not relaxed, then disbursements will have to be reduced at the end of the program period, and the net transfer will fall even more abruptly, increasing the seriousness of the adjustment problem.

(c) The philosophical implications of the above relate to the broad framework and to the numbers. It is legitimate to emphasize the long-term nature of a debt policy geared to development financing. There is a constraint, which is that debt service will eventually absorb the better part of new financing; that constraint can only be lessened for a short time, because of transitional effects, and then only once, to a limited extent. Thereafter, the country will have to live with a large debt service ratio and a relatively small net transfer. It better be the case that the proceeds are used productively.

The benefits of the policy are a temporary addition to the country's savings and import capacity. In the above example, this addition amounts to 12 per cent of exports for several years, declining thereafter to 6 per cent. This is equivalent to 4 per cent of GDP, declining thereafter to 2 per cent. Does this make a a large difference to Portugal's growth prospects? Judging from Table 2 in the World Bank's paper, this is less than obvious. That Table does show a higher GDP growth in Alternative B; however, that higher growth may not be lasting, if it only reflects the investment of the temporarily high net borrowing. It should be emphasized in that connection that export growth in Alternative B is only marginally higher than in Alternative A. As foreign borrowing would seem to help little with export growth, it can also be expected to add little to the long-term GDP growth prospects. If that is the case, the benefit from borrowing is small; if otherwise, a stronger case needs to be made.

The costs of the policy increase exponentially with the debt service ratio which is targeted. There is first a risk of making a mistake in forecasting export performance. If we base the policy on a 14 per cent growth assumption and the outturn is 12 per cent, the debt service ratio would be 24 per cent in 1987 instead of 19 per cent. Second, already at a 20 per cent debt service ratio, Portugal incurs considerable exposure. Its debt would be in the order of one year's export earnings, and annual borrowings would amount to over a third of annual investment. This means that any shortfall in exports, or the ups and downs of the eurodollar rate, or delays in negotiating project financing, could be felt rather strongly, while at the same time the scope for compensatory financing is much reduced.

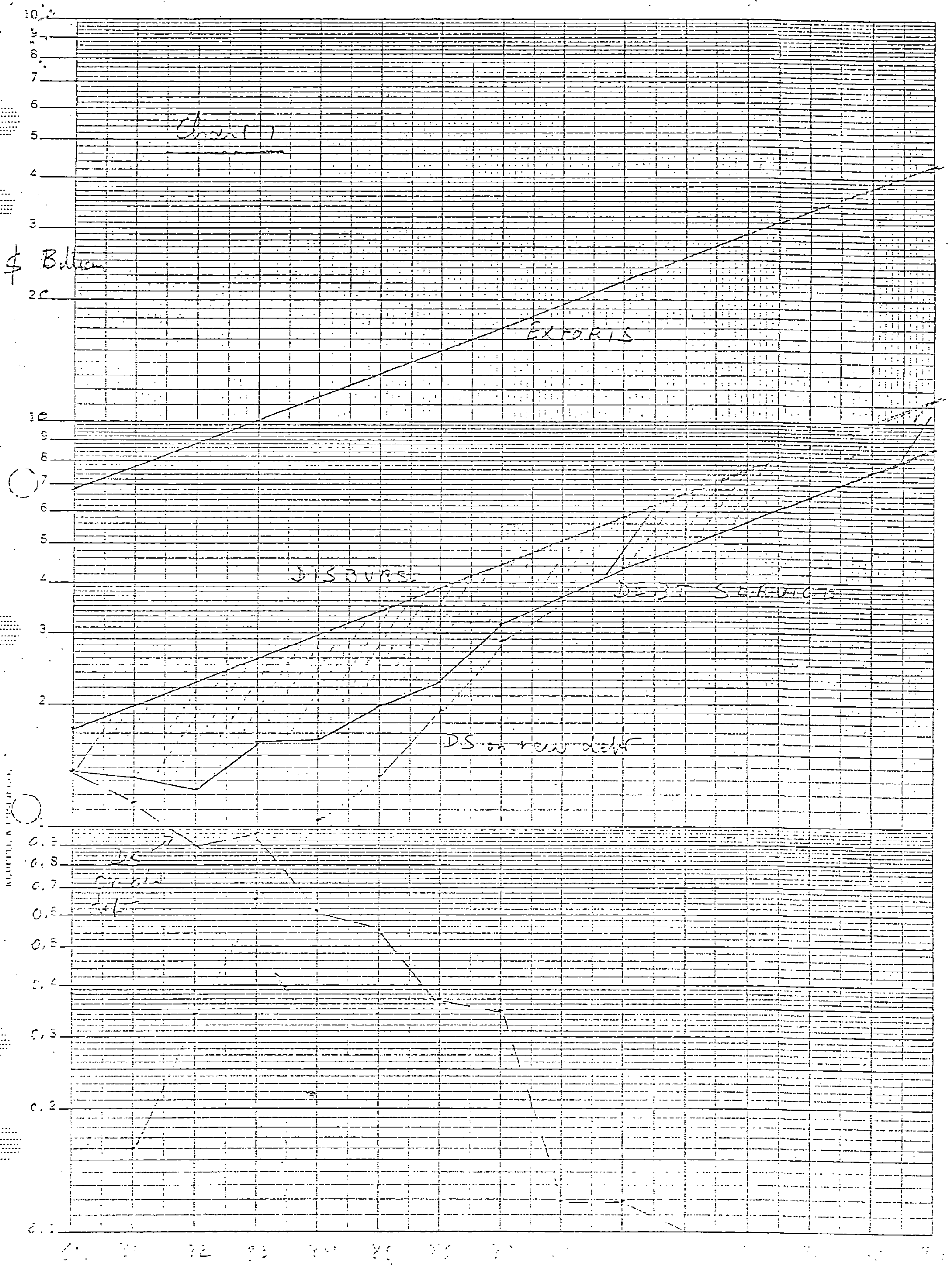
Altogether, it is not obvious that Portugal should systematically go into debt. For one thing, we would need an assurance that the additional resources which this would make available cannot be generated by appropriate domestic management. For another given the nonrepetitive character of these resources, we should consider the possibility of financing them in part through sales of gold. Finally we should press for a cautious use of external financing.

In pressing that last point, we can emphasize that the terms for foreign loans to Portugal are likely to deteriorate if borrowing is increased. This is because additional loans are more likely to be eurocredits than development loans; in addition, the average eurocredit terms could deteriorate in reflection of risk. As a consequence, debt service would increase faster than borrowing capacity. Thus, under the above example, for a debt service ratio of 20 per cent the net transfer amounts to 6 per cent of exports or 2 per cent of GDP. For a debt service ratio of 25 per cent, the net transfer could increase only to 7 per cent of exports or 2.3 per cent of GDP. Does an additional net transfer of 0.3 per cent of GDP warrant the much larger exposure implied by a 25 per cent debt service ratio?

As a final comment, I do not think that the unemployment figures in the World Bank's projection are acceptable. A program which sets unemployment at 10/11 per cent as a target has little chance to be implemented with the kind of financial orthodoxy that would be necessary because of the large external debts. It would, therefore, not be prudent to accept a large debt exposure.

Attachments

cc: Mr. Mitra
Mrs. Ter-Minassian



$ Billion
EXPORTS
DISBURSE
DEBT SERVICE
DS on new debt
10
9
8
7
6
5
4
3
2
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1

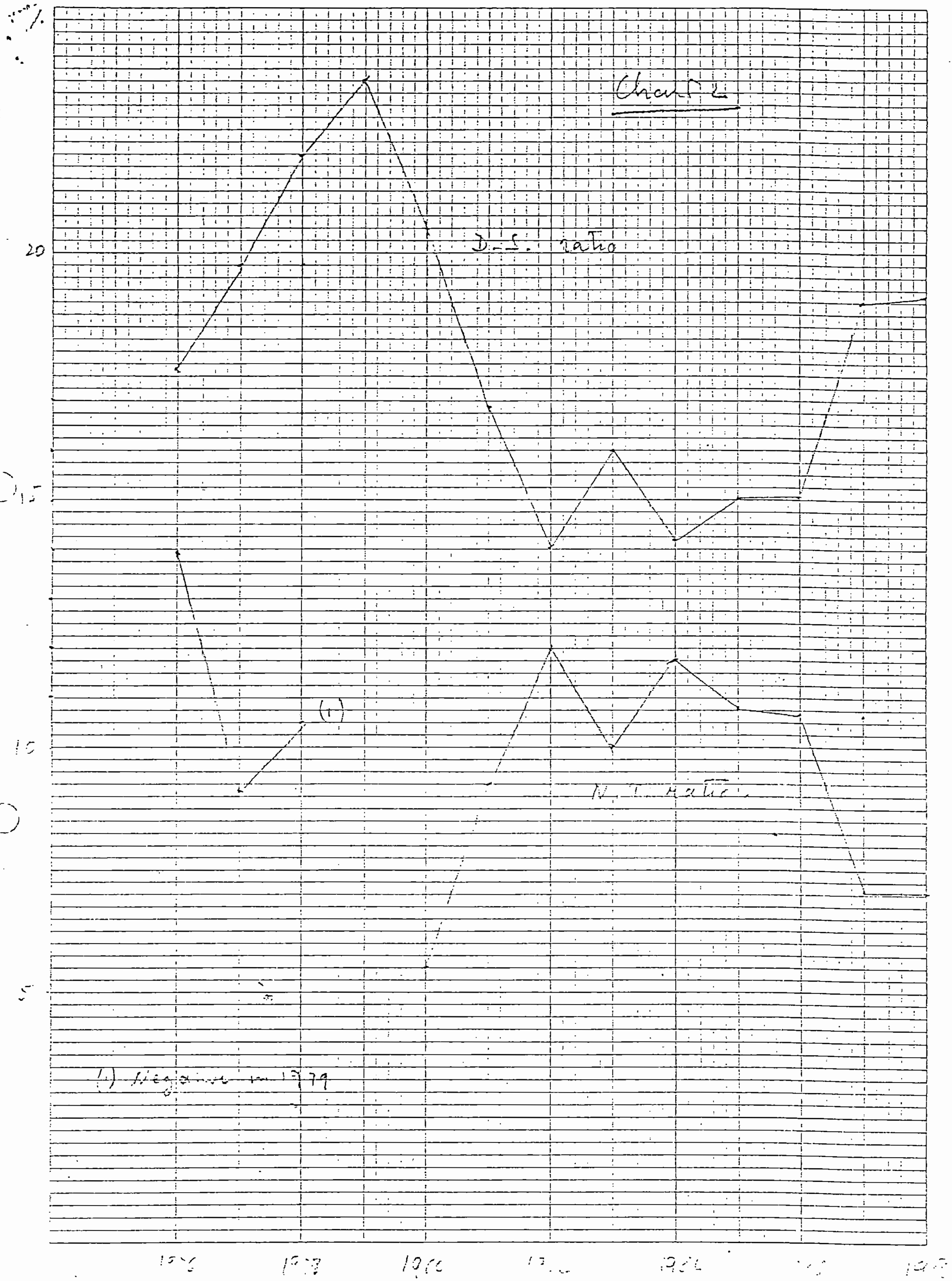


Chart 2
D-S. ratio
N. I. ratio
(1)
20
15
10
5
(1) Negative in 1979
1978
1980
1982

Mr. Whittome

Office Memorandum

TO : Mr. Dubey

DATE: November 16, 1979

FROM : Hans Schmitt

SUBJECT : Portugal - IBRD Draft Report

The draft report entitled "Portugal: Priorities for Public Sector Investment", is of great interest to us as you know. We need an outside view on the Portuguese public investment program in the context of a possible EFF arrangement. Augmented by the SFF this could involve disbursements of up to SDR 485.9 million, or roughly US$600 million over a three-year period. Against this background, we would like to offer the following broad comments on the draft as it presently stands.

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We are a bit disappointed that the second question, regarding the type of supporting policies required, is not explicitly stated or pursued in the present draft. For us, the first requirement of a sustainable program would be that it should stabilize the external debt service ratio at some appropriate level. Given reasonable export forecasts, this requirement would fix annual ceilings on external borrowing gross and net. With this external financing constraint firmly fixed, the viability of the program depends on the domestic savings effort. The draft report simply assumes that this effort will be adequate on both public and private account, without specifying the very serious policy issues that must be addressed to make it so.

The present draft provides two alternative macro-economic scenarios associated with the two alternative investment programs. Moving from the "core" program to the "expanded" program produces a path for the economy that yields (i) a much higher level of per capita consumption by the end of the plan period; (ii) a much lower fiscal deficit in relation to national income; and (iii) a balance of payments not much worse in relation to income than before. Superficially, one gains the impression that the only major policy requirement for achieving this improved prospect is not to save more, but rather to spend more, and that on projects whose intrinsic merits were inadequate to qualify them for inclusion in the "core" program. Clearly other assumptions were changed between the two scenarios. It might be more illuminating for policy purposes to keep those changes to the bare minimum necessary.

It is our impression that a sharper focus on policy issues would show a lot of the detail in your macro-economic projections to be unnecessary. For the few remaining forecasts, however, it would be useful if the underlying assumptions were more clearly specified. We would be particularly interested in how you split exports and imports by volumes and values, how you relate export volumes to market growth, and import volumes to domestic demand. Your debt service projections seem low to us; what have you assumed regarding grace periods? We do not feel very secure about public sector current expenditures growing by only 2 per cent, or about using historical elasticities for tax yields. Finally, how sensitive are your results to deviations from your inflation forecast?

Details apart, the basic problem is, of course, to find a way of linking project-specific investment programs to the macro-economic framework into which they are to fit, in a way that is both simple and sensible. We feel very encouraged by your explicit recognition of this problem during this morning's meeting. We hope that our specification of the two main questions we ourselves bring to the report, may be of some use to you in the next iteration and revision of the report. We are looking forward to it, as you can imagine, with great expectations.

cc: Mr. Whittome
Mr. Sadove
Mr. Kavalsky

Office Memorandum

TO : Mr. Whittome

FROM : Hans Schmitt

DATE: November 6, 1979

SUBJECT : Portugal - MIT Retrospect

Attached please find a retrospect by Rudiger Dornbusch of MIT on their role and ours in the introduction of the crawling peg for the escudo in August 1977, and in its modification and reinforcement in May 1978. The following observations may be of interest:

(i) Dornbusch limits (p. 6) the exchange rate options available in 1977 to two, viz., a single large devaluation (which he says was recommended by us) as against a "small step" devaluation followed by a crawling peg (which he implies was the MIT recommendation). For us the issue in fact concerned only the size of the initial "step" change.

(ii) He advocates (p. 7) a crawling peg, both to maintain competitiveness in a world where relative inflation rates are "uncertain" and also to stabilize inflationary expectations by fixing the forward premium. He concedes that these objectives were "to some extent conflicting." We likewise noted this conflict at the time, and also stressed that inflationary expectations could not in any case be stabilized without monetary restraint.

(iii) He rejects (pp. 11-13) the notion that interest rates in Portugal should have been high enough to provide "a safe cushion against interest induced capital outflows," on the grounds that capital mobility was less in Portugal than in Brazil, where the adjusted interest rate differential continued to favor the United States. He does grant "the crucial role of (worker) remittances" which we also stressed, along with tourist payments, as avenues through which money markets in Portugal were in fact closely linked to the rest of Europe.

(iv) He charges (p. 11) that our insistence on high interest rates reflected indifference to the employment effects of a "reduction" in economic activity; our case rested instead on the need for a "reorientation" of economic activity that would place the growth of employment on a sustainable basis.

I finally draw your attention to the quotation on page 5, in which Dornbusch exhibits considerable personal resentment of the Fund and of its conditionality.

Attachment

cc: Mr. Narvekar

cc. HS

Thank you. When & if you have leisure it would be very worthwhile to write up their view of the Portuguese involvement in a reflective manner that could also be presented to an academic audience. I am told that at the recent Brookings Seminar (perhaps this paper was presented there?) criticism of us in relation to Portugal was conspicuous. [initials] 8/11

Revised, Sept. 1979

PORTUGAL'S CRAWLING PEG*

Rudiger Dornbusch
Massachusetts Institute of Technology

This paper reviews the background to Portugal's adoption of a crawling peg in September 1977. The experience with the new exchange rate regime has been too brief to draw a lot of lessons. The events leading to the adoption of the regime and the early period of implementation are of sufficient interest, however, to warrant an examination.

A Brief History:

Portugal had for a long period been a hard currency country with a consistent balance of payments surplus. At the end of 1973 official reserves amounted to 856 tons of gold and $1.6 billion in foreign exchange.[1] Table 1 shows some of the details of Portugal's performance in the early 1970's. We note the consistent current account surplus, high net foreign assets as a ratio of GNP, high real growth, relatively reasonable inflation rates by comparison with most industrialized countries and certainly by comparison with semi-industrialized countries.

TABLE 1 SOME HISTORY

	1970-73	1974	1975	1976	1977	1978
Current Account ($US million)	248.0	-829	-819	-1246	-961	-572
Net Foreign Assets (% of GNP)	28.6	18.2	10.3	4.6	-4.6	n.a.
Inflation (% p.a.)	8.8	29.2	20.4	19.3	27.7	22.6
Real Growth (% p.a.)	8.7	1.1	-4.3	6.2	5.4	3.2
Real Exchange Rate (1975=100)	99.1	93.2	100.0	99.5	106.4	102.8

Note: The real exchange rate is a weighted average of wholesale prices in the US, UK, Germany and France (each with equal weight) compared to Portugal.

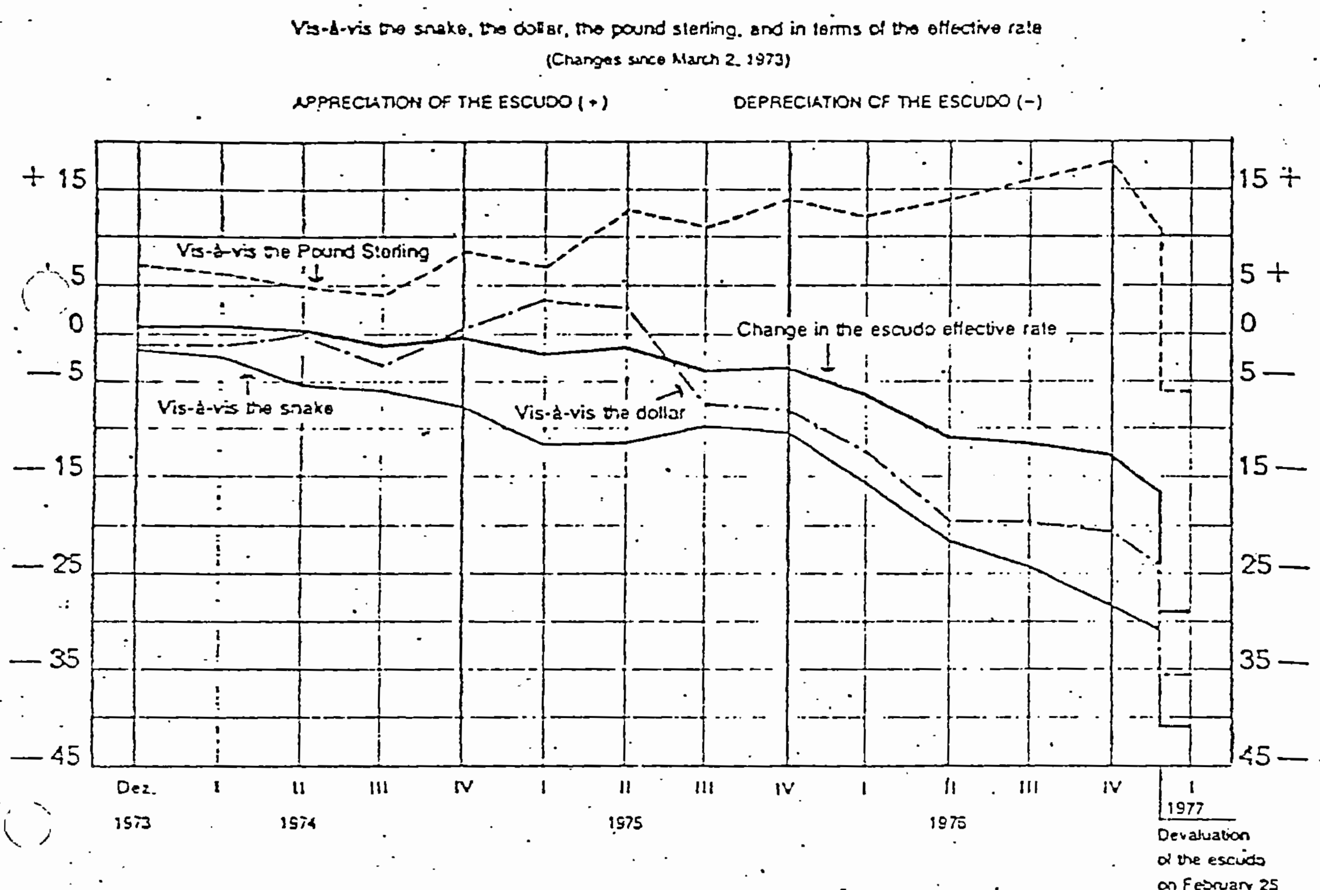
Source: IMF, International Financial Statistics, Banco de Portugal, Relatório, 1979, OECD, Economic Outlook, July 1979.

macroeconomics happened as a direct outgrowth of the revolution and disorganization of the public sector. The Banco de Portugal paid the bills.

By mid-1976 exchange reserves had declined very substantially, the Banco de Portugal had started selling gold and the question of exchange rate adjustments to restore external competitiveness became a policy issue. By September the government, forced by the Central Bank's refusal to grant further credit, took steps to control wages, productivity and imports.

Chart 1 shows the evolution of the escudo from 1973 to early 1977. The effective exchange rate had been allowed to depreciate throughout 1976 with a cumulative depreciation, from December 1975 to December 1976 of nearly ten percent. The policy of gradual depreciation was de facto, unannounced and was certainly aided by the precipitous depreciation of sterling during 1976. The policy of depreciating the effective rate was, however, not considered a full success and by July the rate of depreciation was reduced. The main disadvantages were linked to foreign exchange speculation on the part of the nationalized banks (!), emigrants who delayed remittances and firms who increased inventories of importables.[1]

Against this background of dissatisfaction with the gradual depreciation policy and the continued need to maintain and restore external price competitiveness the escudo was depreciated by 12.5 percent; in terms of the effective rate, in February of 1977. The Bank announced then the intention to maintain henceforth the effective rate constant. By the end of February the nominal effective rate had cumulatively depreciated by nearly



Source: Banco de Portugal

CHART 1 THE DEPRECIATION OF THE ESCUDO:1973-77

The rapidly declining foreign exchange reserves and the illiquidity of the gold reserves forced Portugal in 1977 increasingly to look for outside financing both from banks and from official sources, including the IMF. A first stand-by arrangement was approved in April 1977 for a modest SDR 42 million on the strength of the government program of limits to wage inflation --15% per year--and the depreciation that had taken place in February.

In June 1977 a group of 14 countries joined to fund a $ 750 million loan to Portugal for medium term balance of payments finance. In line with the spirit of the time[1], however, the loan was contingent on successful negotiation of an IMF loan in the upper credit tranch, i.e. conditionality.

One cannot help noting that 1977 marked the 50th anniversary of very similar financial distress; the details are best left to a quote:[1]

> "By 1927 Portugal's financial difficulties had grown so acute as to impel the Government to seek the assistance of the League of Nations in securing a new foreign loan. On the basis of a first-hand investigation in Lisbon, the Financial Committee of Portugal would agree to a program of monetary, budgetary, and fiscal reform and to the establishment in Lisbon of a foreign agent of the League to receive the revenues assigned for the service of the loan and to supervise the spending of its proceeds... It was under these circumstances that Dr. Salazar became Minister of Finance....Under his able leadership Portugal maintained a healthy financial economy and made economic progress without the aid of any further external loans."

The need to support domestic employment meant that there was no serious alternative to balance of payments deficits and their financing. by whom?
The question that had to be addressed, though, was the mix between domestic restraint and deficit financing, the mix between devaluation and trade controls and the leeway for interest rate policy. Discussion in the press turned increasingly to the prospect that the IMF terms of agreement would almost certainly involve major devaluation--perhaps as much as twenty percent. Accordingly it was not surprising that there was a large bulge in the balance of payments deficit arising from overinvoicing, inventory building and any of a number of ways of speculating on foreign exchange and import prices. IMF's fault?

Against this background we have to see the decision to move to a crawling peg and the accompanying policy of continuing wage restraint and increases in interest rates.

The Crawling Peg

The decision to move to a crawling peg was taken in late August 1977. The decision was based on three considerations. First, a decisive move was required to forestall continuing reserve losses from exchange speculation. The alternatives were a large devaluation, as would be part of an IMF package, ? or a policy of gradual depreciation with perhaps a small step devaluation at the front. Second, the preference for a crawling peg was due to the belief that competitiveness has been largely restored through previous depreciation and wage controls and that, in any event, low shortrun elasticities prevented major beneficial impacts of a depreciation. Third, the domestic inflation process was at a critical juncture. Limitations on wage increases had been surprisingly effective, price controls had been gradually removed and the once and for all bulge from the removal of price controls and the February depreciation was being passed through into consumer prices without offsetting increases in wage settlements. This is brought out in Table 2. Under these conditions a large step depreciation would quite inevitably have disrupted altogether the stabilization of inflation.

not based on evidence

if it did not in 1977, why "inevitably" in 1978?

TABLE 2: WAGE AND PRICE INFLATION
(Percent Per Year)

	1977				1978			
	I	II	III	IV	I	II	III	IV
Wages	9.5	11.5	13.3	13.7	8.3	10.5	9.9	
CPI	25.9	41.0	21.4	12.2	22.4	18.2	23.0	25.7
WPI	25.7	35.7	27.7	27.7	25.4	22.4	35.5	40.9

Note: Percentage Increase over same quarter of the preceding year. Seasonally

The details of the crawling peg that was adopted are interesting in two respects. The first is the concept of an announced, moving target depreciation. The idea here was to provide some leeway for policy both because the underlying domestic rate of inflation was uncertain and because the possibility of domestic or foreign price shocks could not be excluded. I come to details of this issue presently. The other important aspect was the opening of a forward market where the central bank reinforced the announced target depreciation rate by selling forward exchange at the implicit premium. Both the announcement of the target depreciation rate and the opening of the central bank forward market were felt to be important elements in the stabilization of inflationary expectations and the elimination of exchange speculation. Use of the crawling peg to stabilize domestic inflation was particularly emphasized in a note by an advisory group:[1]

(1)

(1) seems to be counter to (2)

(2)

> "The target range (of depreciation) should satisfy two (sic) main objectives: First, it is essential that the range be credible, given an appropriate measure of domestic and world inflation. Second, the exchange depreciation is to serve as a stabilizing influence on the domestic inflationary front. Third, the depreciation (should) maintain, if not enhance Portugal's competitive position. These objectives are to some extent conflicting and have therefore to be traded off against each other....

!

Admittedly use of the exchange rate as a means of containing domestic inflation treads the narrow path of credibility and competitiveness. Even though that path may be narrow there is no

The crawling peg policy that was announced in August/September 1977 was one of periodic depreciations of an average of 1.1 percent per month with an initial depreciation of 4 percent. Chart 2 shows the behavior of the effective rate and various bilateral rates for 1977. Table 3 shows the month to month percentage rates of depreciation.

The effective rate was based on a group of sixteen currencies, taking into account not only trade weights but also services and remittances which in the case of Portugal are of course particularly important.[1]

Forward rates were quoted for ten currencies and for maturities of one, three and six months. Table 4 shows the forward premia on the dollar and the realized depreciation rates for the respective maturities. There is no published evidence on the profits on forward dealing and the operation of the forward market [was later suspended in agreement with the IMF.]

This, MIT found hardest to take.

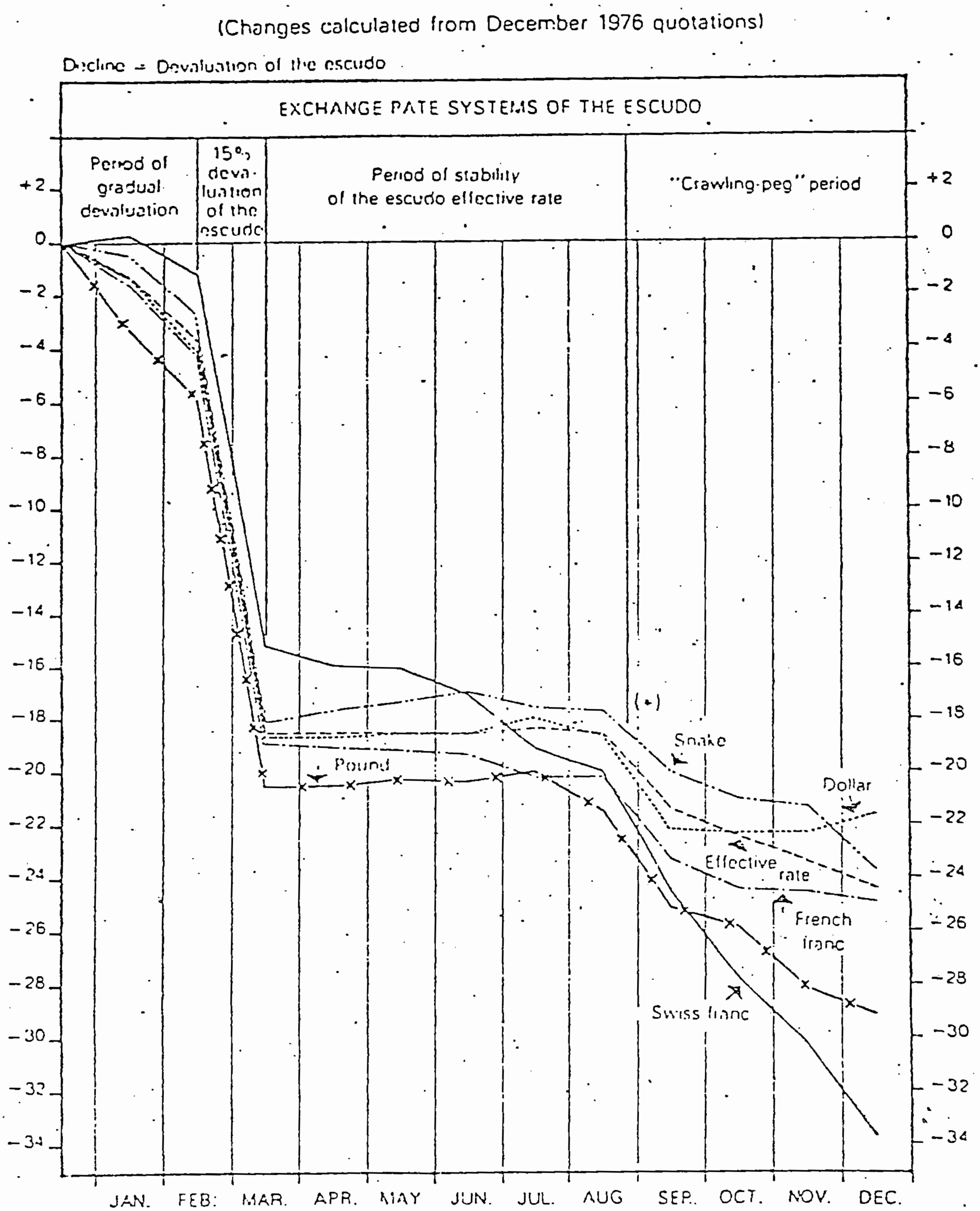
TABLE 4: FORWARD PREMIUM AND REALIZED DEPRECIATION (ESCUDO/$)
(Percent)

	1 MONTH		3 MONTHS		6 MONTHS	
	F	R	F	R	F	R
Sept. 30	1.1	-0.8	3.2	-2.3	6.4	.4
Oct.	1.0	0.8	3.1	-0.9	6.3	3.6
Nov.	1.1	-2.3	3.4	-1.7	6.9	12.1
Dec.	1.1	0.7	3.4	2.9	6.8	14.5

Note: F = forward premium; R = realized escudo/$ depreciation.

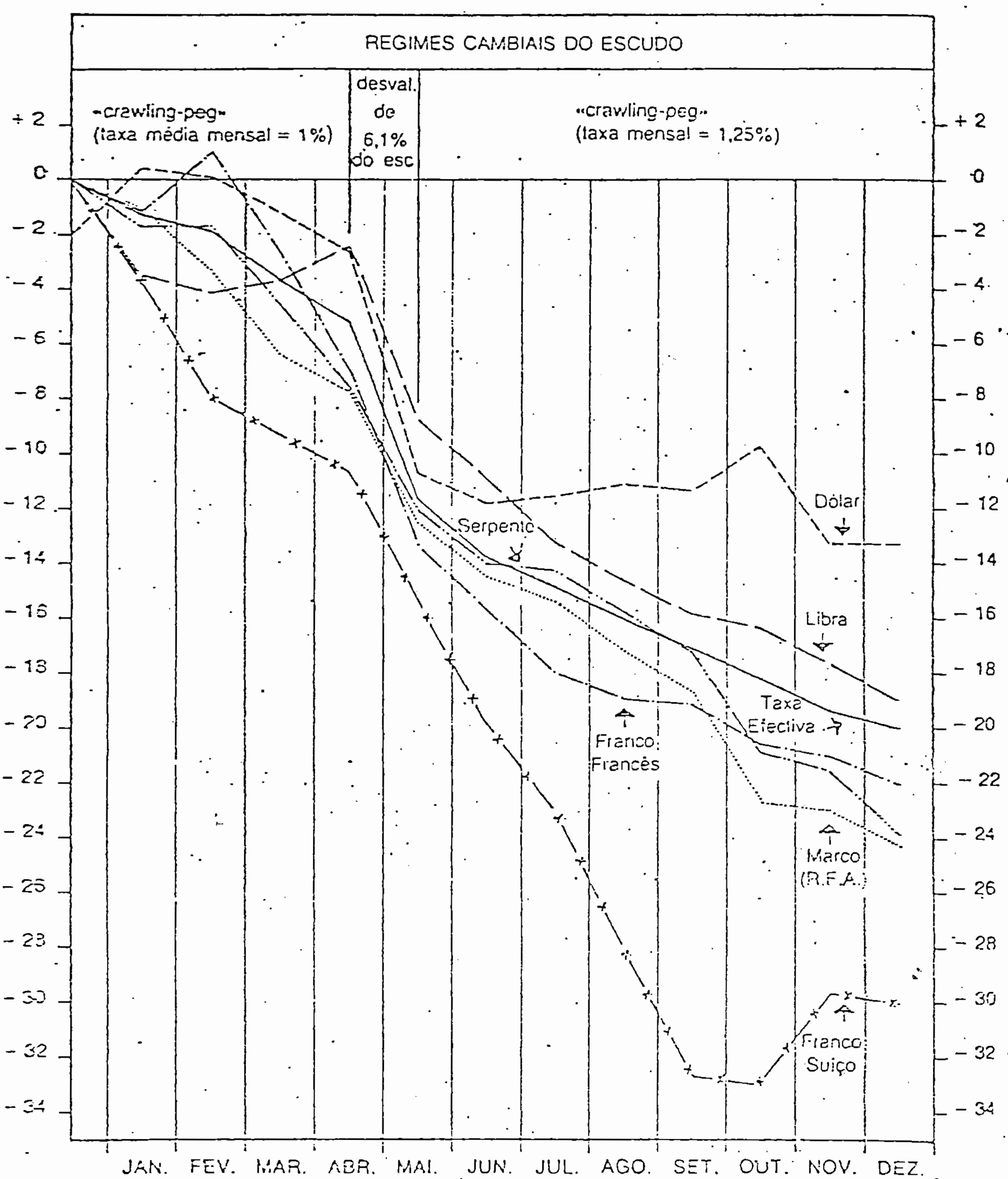
TABLE 3: MONTH TO MONTH PERCENTAGE CHANGE

	Effective Rate Banco de Portugal	Effective Rate I.M.F.	Escudo/$
1977			
1	1.4	n.a.	1.3
2	2.5	2.5	2.8
3	18.2	16.7	17.9
4	0	0.1	-0.1
5	0	0	-0.1
6	0	0	0
7	0	0	-0.7
8	0.3	0.2	0.8
9	4.0	3.8	4.7
10	1.1	1.4	0.1
11	1.1	1.0	0
12	1.1	1.2	-0.9
1978			
1	1.2	1.6	-.4
2	0.7	0.8	0.3
3	2.0	1.7	1.3
4	1.6	1.3	1.6
5	7.3	6.7	9.1
6	2.4	2.5	1.3
7	1.4	1.6	-0.4
8	1.4	1.8	-0.6
9	1.2	1.2	0.3
10	1.4	1.7	-1.8
11	1.4	1.3	4.0
12	0.8	0.5	0.1
1979			



Source: Banco de Portugal

CHART 2 THE ESCUDO DEPRECIATION IN 1977



Source: Banco de Portugal, Rēlatorio

CHART 2A THE ESCUDO DEPRECIATION IN 1978

The steady depreciation policy was followed by and large until May 1978. At that time, [as part of the stand-by agreement in the second credit tranche and access to the larger loan mentioned above,] a once and for all depreciation of 6.1 percent was undertaken and the average monthly rate of depreciation, through the end of 1978, was raised "in principle" to 1.25 percent.[1] The cumulative depreciation from August 1977 to January 1979 amounted to about 27 percent or an average monthly rate of 1.8 percent.

"force majeur"?!

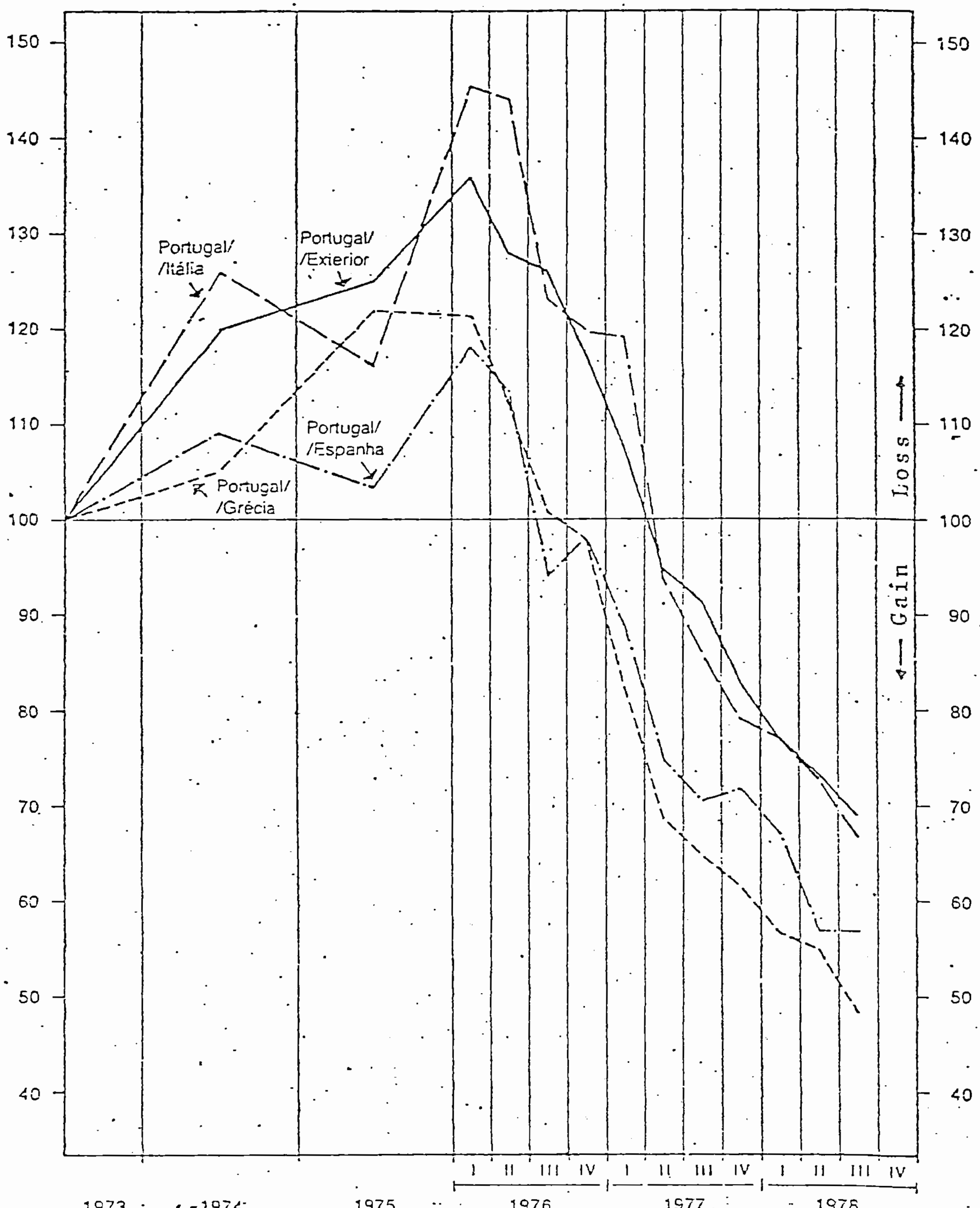
Portugal's competitive position is shown in Table 1 and also in Chart 3. The former looks at a comparison of wholesale prices in Portugal and in Portugal's markets. The latter offers a comparison on the basis of unit labor costs. Both measures suggest a gain in competitiveness since 1975.

Inflation and Interest Rates:

In moving to a crawling policy two questions stood out as particularly important. One concerned interest rate policy and the degree of latitude for deviations from the world rate of interest. The other concerned the assessment of inflation divergence and hence the setting of the trend rate of depreciation.

At the time the crawl was considered there was very little expertise on the experience of other countries with a crawling peg regime. The traditional advice, certainly as it came from the IMF, was that interest rates had to be high enough relative to world levels to provide a safe cushion against interest induced capital flows. Furthermore, since [a reduction] in economic activity could not but improve the external balance there was no conflict, in this view, between the requirements of international

a reorientation was required


150
140
130
120
110
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90
80
70
60
50
40
Portugal/
/Itália
Portugal/
/Exterior
Portugal/
/Espanha
Portugal/
/Grécia
Loss
Gain
I
II
III
IV
1973
1974
1975
1976
1977
1978

would have little impact on commodity speculation and illegal capital flows and would primarily affect domestic investment, primarily housing construction, that stood out by low import content and high labor use. A policy of high interest rates seemed therefore unattractive and was seen as a potential shortcoming of the crawling peg regime.

yes; in the event, it had a lot of impact after all

It is perhaps of anecdotal interest to note that the interest rate issue was resolved by a night-shift calculation of realized interest differentials, adjusted for exchange depreciation, between Brazil and the U.S. The calculations showed persistent yield differential in a market that was substantially more developed and integrated and thus provided plausible evidence against the view of perfect capital mobility.[1]

MIT approach, not IMF

Portugal's market more integrated, thru tourist industry and worker's remittance

TABLE 4: INTEREST RATES

	1977				1978		
	I	II	III	IV	I	II	III
Discount Rate	8.0	8.0	13.0	13.0	13.0	18.0	18.0
Deposit Rate	12.0	12.0	16.0	16.0	16.0	20.0	20.0

Source: International Financial Statistics anf Banco de Portugal, Relatorio

Reinforcing this evidence was the recognition that under an alternative regime -- prospective discrete devaluation sometime in the near future and repeated infrequently--the same issue of capital mobility would arise and, indeed, had been the very reason for the accelerating reserve losses.

i.e. there was capital mobility!!!

As Table 4 reveals there was, after all, a policy of raising interest in the move to the crawl in Fall 1977 and, of course, in the agreement with the IMF in Spring 1978. The general rise in interest rates conceals the substantial discrimination and credit rationing, favoring exports and industries deposit rates lending were crucial; rates only to maintain bank viability

with low import content, in particular construction, and put at a disadvantage import finance. Most importantly, the crucial role of remittances was recognized throughout by special deposit arrangements, including foreign currency deposits for nonresidents. !! !

The question of interest differentials and a credible depreciation target was difficult not only because of appalling statistics but also because an inflationary bulge from the February depreciation, decontrol of consumer prices and increased import restrictions made it difficult to discern the underlying rate of inflation. Uncertainty about productivity developments made it difficult to estimate the trend in costs. Under these circumstances there was a temptation to take the most recent inflation rumors-- thirty percent and rising was a fashionable number-- and base the depreciation path on that assessment. Very fortunately the Bank took the view that a lower estimate was more realistic an evaluation of the underlying rate of cost inflation. Accordingly a 10-15 percent rate of trend depreciation was judged adaequate to maintain competitiveness without foregoing the benefits of inflation stabilisation.

The problem of identifying an appropriate trend depreciation highlights an important aspect of the Portuguese crawl, namely that it was adopted under conditions of high uncertainty and not in the circumstances of well-defined, steady state inflation differentials. Moreover, the crawl was quite decidedly part of an incomes policy . In line with limits on wage increases the crawl was to stabilize inflation by lending a credible government commitment--an announced exchange rate target path and forward markets at those rates-- to the

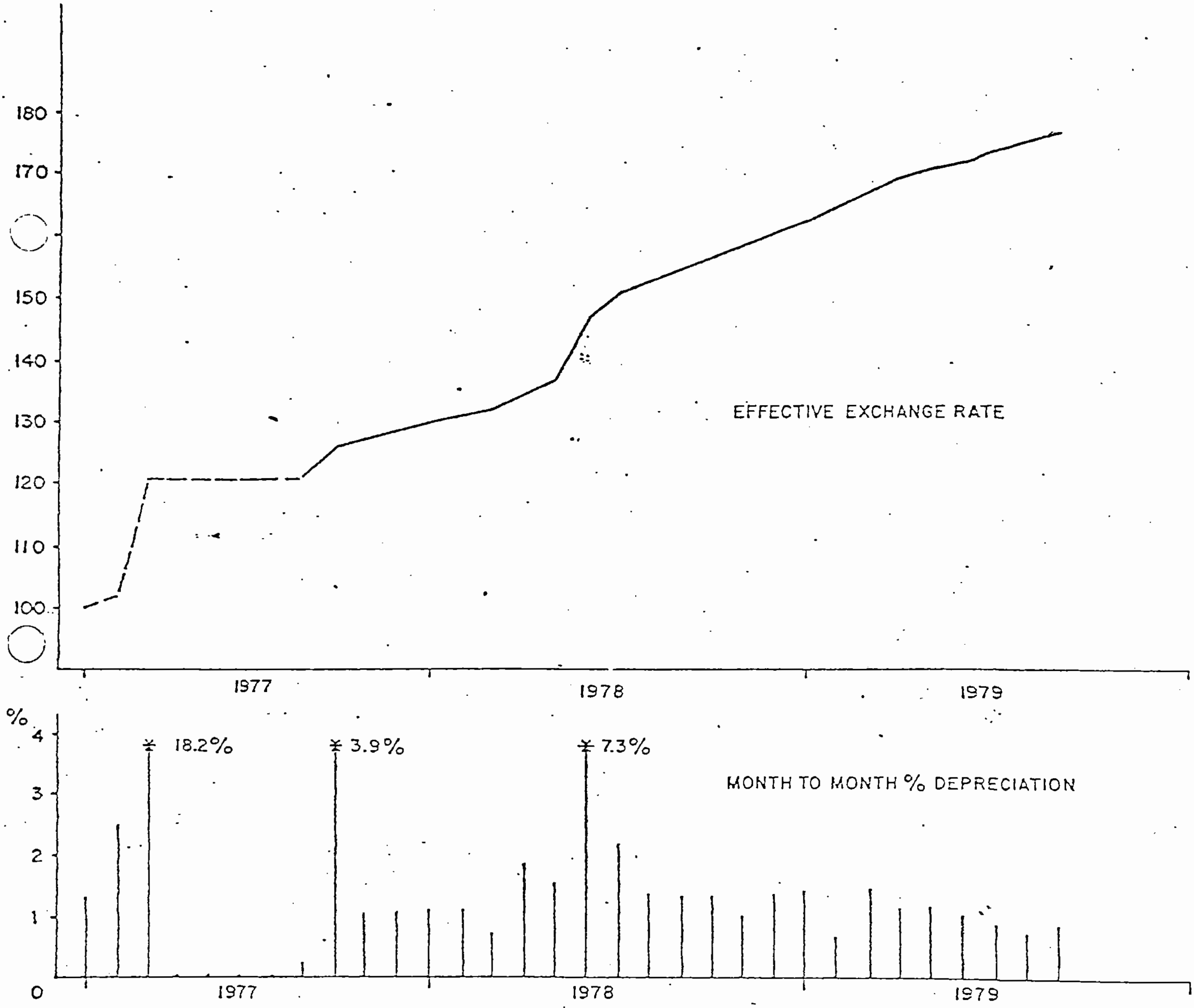

CHART 2 THE EFFECTIVE EXCHANGE RATE

Mr. Whittome

Office Memorandum

TO : Mr. Sadove

DATE: October 25, 1979

FROM : Hans Schmitt

SUBJECT : Portugal - Borrowing Program

Attached please find a memorandum sketching out our preferred approach to external debt management in Portugal. You may be particularly interested in the way that limits on the external current account deficit may be derived from it. Also, there are some preliminary comments in the memorandum on relevant aspects of the Sadove-Chaudhry paper recently presented to the Gulbenkian conference in Lisbon. Your reactions will be welcome.

Attachment

cc: Mr. Whittome
Mr. Kavalsky
Mr. Chaudhry
Mr. Dhonte

Office Memorandum

TO : Mr. Schmitt

DATE: October 22, 1979

FROM : Pierre Dhonte P Dh

SUBJECT : Portugal - External Debt: Long-Run Perspectives

The World Bank projections which you circulated under your October 12 memorandum are not specific enough to provide a basis for an external debt projection. It may, however, be useful at this stage to sketch a broad framework, if only to identify topics for discussion.

1. The current status of Portuguese debts

Portugal's outstanding debt, disbursed, was estimated at $5.7 billion as of last June. The figures given to the September Fund mission are the following:

(In millions of U.S. dollars)

	1976	1977	1978	June 1979	Forecast 1979
Government	258	319	894	912	1,274
Bank of Portugal	1,166	1,681	1,924	1,795	1,606
Private sector	1,468	2,427	2,602	2,957	n.a
Of which: government guarantee	(328)	(488)	(615)	(727)	n.a
Total	2,892	4,427	5,420	5,664	n.a

These figures are the same as those which the Bank of Portugal published in its 1978 report. They do not include the Cabora Bassa liabilities, but they include the liabilities to the Fund (under Bank of Portugal debt).

Compared to figures given to the May 1979 mission, the above are sharply higher for the private sector debt. As there is no evidence of matching flows in the balance of payments, and because huge amortization payments on that account are projected for the second half of 1979, I assume that the private sector figures above include a large amount of short-term debt. I would, therefore, rather use the figures of last May:

(In millions of U.S. dollars)

	1976	1977	1978	Forecast 1979
Private sector	1,265	1,603	1,963	2,189
Total	2,689	3,602	4,781	5,069

Recent debt flows can be estimated from the balance of payments data:

(In millions of U.S. dollars)

	1976	1977	1978	1st half 1979	1979 1/
Drawings					
Government	43	75	585	27	327
Private sector	379	384	527	330	700
Bank of Portugal 2/	701	720	589	70	94
	1,123	1,179	1,701	427	1,121
Repayments					
Government	60	48	29	16	30
Private sector	433	467	352	227	474
Bank of Portugal 2/	--	85	391	181	394
	493	600	772	424	898
Interest 3/	137	208	380	225	478
Debt service	630	808	1,152	649	1,376
Exports:					
Goods and nonfactor services	2,567	2,893	3,552	2,220	3,654
Workers' remittances	975	1,174	1,671	1,024	2,194
	3,542	4,067	5,223	3,244	5,848

The forecast for 1979 is based on our balance of payments forecast of last September, supplemented with the indications that we have been given about the debt service schedule. An implication of that forecast is that, because of large repayments of BOP debts, debt service in 1979 would be larger than drawings on new loans. Debt outstanding, however, would rise to $5,069 million. Incomplete data on the debt service schedule pertaining to the debt as of June 1979 have also been given to the mission. These data only cover the debt service for the Government and the Bank of Portugal through 1980. As regards the Government however we do have the amortization schedule for the $450 million euro-dollar borrowings of 1978, which comprise half of its debt, and for the $300 million loan to be drawn by the end of 1979. For the rest, based on very cursory inspection of the list of debts

Source: Balance of payments data and data provided by The Portuguese authorities

1/ Forecast.
2/ Including IMF.
3/ Including payments on short-term credits.

outstanding, I have assumed amortization over 20 years. Regarding the Bank of Portugal's debt, the 1980 amortization figure of $523 million given to us in September is larger than the $360 million projected last May, itself larger than the $268 envisaged last February. I have accordingly assumed that the debt will be amortized rather quickly, if only to recover the gold pledged against it. Finally, on the assumption that the heavy payments scheduled for the second half of 1979 take care of short-term debt, I have kept the schedule given to us for private debt.

Summing up the amortization schedule would be the following:

(In millions of U.S. dollars)

	1980	1981	1982	1983	1984	1985	1986
Government	25	30	30	180	180	240	90
BOP	523	400	300	300	83	---	---
Private sector	444	389	306	252	195	200	200
	992	819	636	732	458	440	290

On that basis, remaining debt outstanding and interest payments can be estimated (assuming an average 8 per cent interest rate):

Outstanding (end of period)	4,079	3,260	2,624	1,892	1,434	994	734
Interest	405	326	261	210	151	115	80
Debt service	1,397	1,145	897	942	609	555	370

Contrary to standard practice, I believe that it is legitimate, in Portugal's case, to include workers' remittances in the computation of the debt ratios. On that basis, the 1979 debt service ratio was 23.5 per cent and the 1980 ratio would be about 20.5 per cent. These are fairly high figures, which allow however for substantial repayment of the compensatory financing of 1976-78.

2. Medium-term prospects

That Portugal might borrow heavily, not for adjustment purposes, but for its development, is a strategic option which raises a number of philosophical issues. These can be clarified when account is taken of some technicalities.

(a) An evident requirement is that borrowing policies should be consistent with a stabilization of the debt service ratio as whatever level is considered proper. For this to occur, under given loan terms, disbursements should be constrained not to grow faster than exports. The sustainable disbursements/exports ratio then depends on: (i) the acceptable debt service ratio; (ii) the growth rate of exports (which acts as a constraint on the growth of disbursements); and (iii) the loan terms. The last two elements determine a long-run relationship between disbursements and debt service, i.e., what share of disbursements will in the long run be absorbed by debt service.

In the case of Portugal, the range of that share could be 68 to 86 per cent. This is a fairly open range, so that careful consideration of the export growth and terms assumptions will be necessary to narrow it. It means that if Portugal accepts a 20 per cent debt service ratio, then disbursements consistent with that target can range from 23 to 29 per cent of exports. The table below establishes the relation between debt service and disbursements for various assumption:

(In per cent)

Terms:			Export Growth 1/	10	12	14	16
Maturity	grace	interest					
1) Inflation at 6%							
9	3	7		86	78	71	2/
10	4	7		84	76	68	2/
2) Inflation at 8%							
9	3	9		2/	86	79	72
10	4	9		2/	85	77	70

As can be seen from that table, the outcome is fairly sensitive to the export volume growth assumption. The influence of inflation is lesser, because it is offset by matching assumption for the interest rate.

(b) The above relation only prevails in the long run, under steady growth conditions. In the medium run, two additional factors will bear. First, as the country initiates its policy, debt service initially lags behind its long-term value; second, debt service on account of debts outstanding before the policy is initiated must be allowed for. To account for these factors, I have computed an example in which disbursements and exports grow at 14 per cent per year. The loan package includes equal shares of eurocredits (8 years, of which 5 years grace, 10 per cent), supplier's credits (7 years of which 2,8 per cent) and development loans (15 years of which 4,9 per cent). The constraint on the debt service ratio is 20 per cent and this is consistent with a 26 per cent ratio of disbursements/exports.

As Charts 1 and 2 show, this policy would first result in a fairly large net transfer, because of the initial impact of grace periods. As these would expire, debt service would catch up, and would eventually stabilize at about 77 per cent of disbursements, or 20 per cent of exports. The net transfer, after peaking out at about 12 per cent of exports, would decline sharply to 6 per cent. There would, therefore, be a rather serious adjustment problem when the lags unwind.

1/ 4-8 per cent in volume and inflation 6-8 per cent.
2/ Not applicable.

Finally, Portugal might want to borrow more in the early eighties, if only to offset the large repayments by Bank of Portugal. If, however, the 20 per cent debt service ratio constraint is not relaxed, then disbursements will have to be reduced at the end of the program period, and the net transfer will fall even more abruptly, increasing the seriousness of the adjustment problem.

(c) The philosophical implications of the above relate to the broad framework and to the numbers. It is legitimate to emphasize the long-term nature of a debt policy geared to development financing. There is a constraint, which is that debt service will eventually absorb the better part of new financing; that constraint can only be lessened for a short time, because of transitional effects, and then only once, to a limited extent. Thereafter, the country will have to live with a large debt service ratio and a relatively small net transfer. It better be the case that the proceeds are used productively.

The benefits of the policy are a temporary addition to the country's savings and import capacity. In the above example, this addition amounts to 12 per cent of exports for several years, declining thereafter to 6 per cent. This is equivalent to 4 per cent of GDP, declining thereafter to 2 per cent. Does this make a a large difference to Portugal's growth prospects? Judging from Table 2 in the World Bank's paper, this is less than obvious. That Table does show a higher GDP growth in Alternative B; however, that higher growth may not be lasting, if it only reflects the investment of the temporarily high net borrowing. It should be emphasized in that connection that export growth in Alternative B is only marginally higher than in Alternative A. As foreign borrowing would seem to help little with export growth, it can also be expected to add little to the long-term GDP growth prospects. If that is the case, the benefit from borrowing is small; if otherwise, a stronger case needs to be made.

The costs of the policy increase exponentially with the debt service ratio which is targeted. There is first a risk of making a mistake in forecasting export performance. If we base the policy on a 14 per cent growth assumption and the outturn is 12 per cent, the debt service ratio would be 24 per cent in 1987 instead of 19 per cent. Second, already at a 20 per cent debt service ratio, Portugal incurs considerable exposure. Its debt would be in the order of one year's export earnings, and annual borrowings would amount to over a third of annual investment. This means that any shortfall in exports, or the ups and downs of the euro-dollar rate, or delays in negotiating project financing, could be felt rather strongly, while at the same time the scope for compensatory financing is much reduced.

Altogether, it is not obvious that Portugal should systematically go into debt. For one thing, we would need an assurance that the additional resources which this would make available cannot be generated by appropriate domestic management. For another given the nonrepetitive character of these resources, we should consider the possibility of financing them in part through sales of gold. Finally we should press for a cautious use of external financing.

In pressing that last point, we can emphasize that the terms for foreign loans to Portugal are likely to deteriorate if borrowing is increased. This is because additional loans are more likely to be eurocredits than development loans; in addition, the average eurocredit terms could deteriorate in reflection of risk. As a consequence, debt service would increase faster than borrowing capacity. Thus, under the above example, for a debt service ratio of 20 per cent the net transfer amounts to 6 per cent of exports or 2 per cent of GDP. For a debt service ratio of 25 per cent, the net transfer could increase only to 7 per cent of exports or 2.3 per cent of GDP. Does an additional net transfer of 0.3 per cent of GDP warrant the much larger exposure implied by a 25 per cent debt service ratio?

As a final comment, I do not think that the unemployment figures in the World Bank's projection are acceptable. A program which sets unemployment at 10/11 per cent as a target has little chance to be implemented with the kind of financial orthodoxy that would be necessary because of the large external debts. It would, therefore, not be prudent to accept a large debt exposure.

Attachments

cc: Mr. Mitra
Mrs. Ter-Minassian

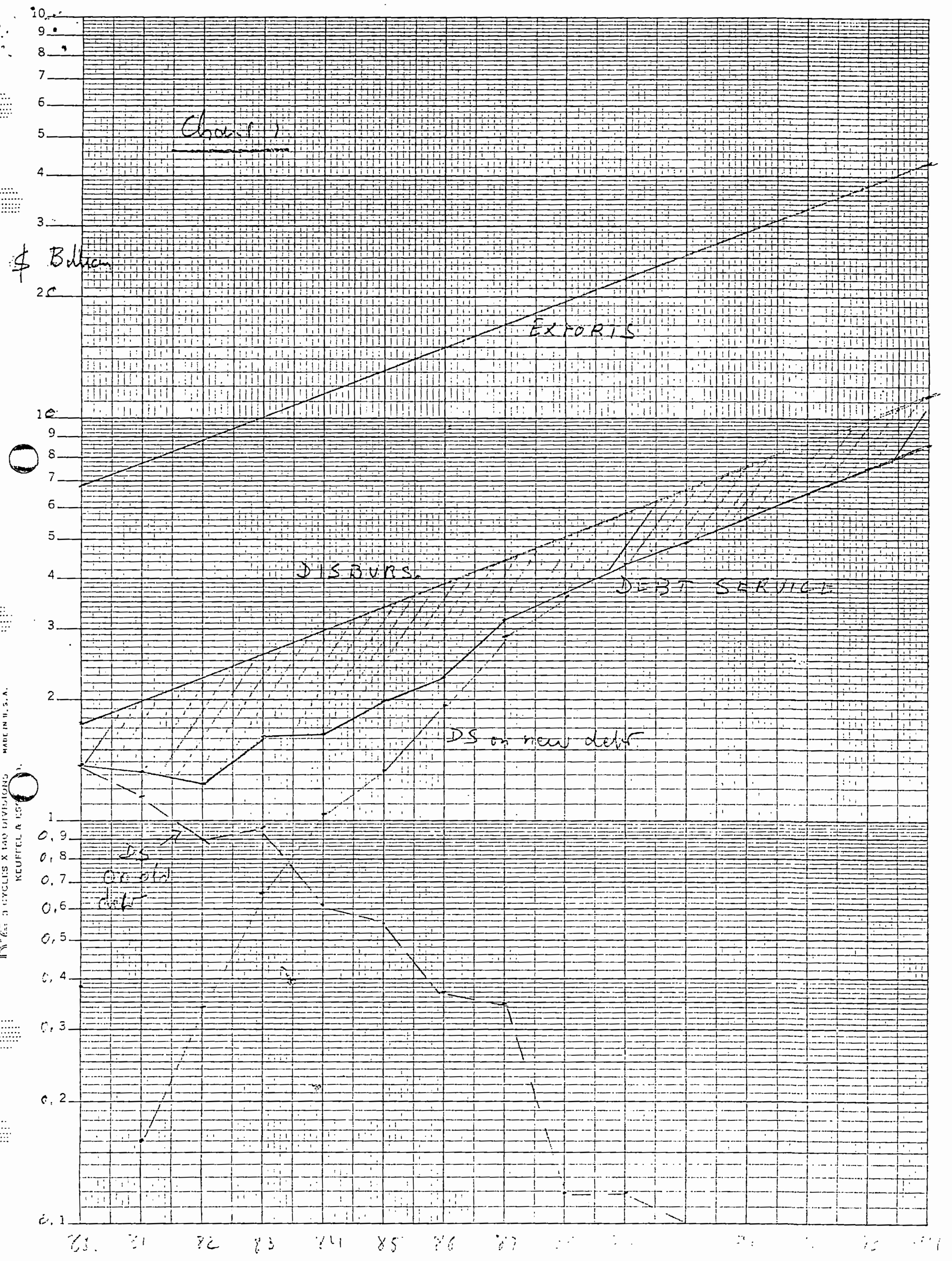
Chart 1
$ Billion
EXPORTS
DISBURS.
DEBT SERVICE
DS on new debt
DS on old debt
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KEUFFEL & ESSER CO.

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J

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION

INTERNATIONAL MONETARY FUND

Press Release No. 46

October 3, 1979

Statement by the Hon. ANTONIO de SOUSA FRANCO, Minister of Finance and Governor of the Bank for PORTUGAL, at the Joint Annual Discussion

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It is my great pleasure to participate in these Annual Sessions of the Board of Governors of the World Bank Group and the IMF. I wish to join my fellow Governors in extending our warmest thanks to the people and Government of Yugoslavia for the kind hospitality shown to us. We are delighted that these meetings bring us into further contact with the people and culture of Yugoslavia.

I must also thank Chairman Muldoon for his enlightening speech reviewing the tangible progress already made by the IMF and the World Bank Group and reminding us of the magnitude of the tasks to be accomplished.

The year since we last met has been marked by important accomplishments in the field of international economic cooperation: the successful conclusion of the Tokyo Round, the close consultation among leading industrial countries, and the UNCTAD V, where some progress was made toward a convergence of views on several issues of interest to both developing and developed countries. The Fund and the World Bank have made important additions to the stock of means available to them, and therefore strengthened their ability to assist members in solving their payments and development problems.

Yet recent and prospective economic developments are a cause for serious concern. Unemployment continues unabated in many countries, and the high rates of inflation seem in some cases to accelerate. We are already witnessing some slowing down of the rate of economic growth in the industrial countries and forecasts for the near future are still more disquieting. The rate of growth of non-oil developing countries has shown a relatively better performance. This however has been possible only at the cost of higher rates of inflation and increasing external debt.

One positive development in 1979 is the better distribution of external surpluses among the large industrial countries. But the current account imbalance between these countries and the developing countries is expected to widen further, owing to insufficient growth in world trade, rising protectionism, and declining terms of trade.

In Portugal, like in many other countries, this adverse international climate added to the difficulties of domestic origin. Following the stabilization program adopted since last year, GDP growth is expected to slow down from 3.2 per cent in 1978 to 2.5 per cent in 1979. Because of weak domestic demand prospects and tight credit conditions, fixed investment was almost stagnant. The sluggish rate of activity in 1979 made impossible any progress in the employment situation and the prospects for inflation appear worse than in 1978. Real wages may decline for the third consecutive year.

On the bright side, the contribution of the foreign balance to economic growth remains at a high level. In 1978 Portugal entered into a stand-by arrangement with the Fund and the measures taken on the lines of that arrangement to achieve a better payments position have led to the desired results. The current deficit was reduced by more than 50 per cent in 1978, and the overall balance of payments showed a surplus for the first time in several years. The improvement of the external position continued in 1979 and the deficit on current account will fall below the $500 million level, representing only 2 per cent of GDP. At the same time, due to the surplus on the overall balance and the increase in the price of gold, our reserves are now 1.5 per cent higher than our total external debt and cover about 18 months of imports. This was possible without Portugal's having introduced any payments restrictions. Merchandise exports in volume went up by 13 per cent, while imports stagnated. Following that remarkable performance, exports in 1979 are expected to proceed at a brisk pace given the good competitive position of Portuguese goods brought about by the crawling escudo devaluation. However, a negative element conditioning the growth of Portuguese trade is the existence of quotas on some of my country's most important exports.

The growing wave of protectionism is one of the main causes of concern in present days. This is mainly the case in sectors particularly sensitive to the developing countries, such as textiles, footwear, shipbuilding. It is, thus, very necessary that the industrial countries endeavor to maintain a liberal attitude toward world trade. There is no justification for the new barriers that have been imposed in recent years by several industrial countries on imports of manufactures from developing countries. The obligations of liberalization of payments for current transactions, as provided by the Articles of Agreement of the Fund, will lose much of their meaning if countries impose restrictions on trade transactions. Industrial countries should allow that those changes entail the structural adjustments in their economies which are made necessary by the emergence of new producers in good competitive positions.

I should now like to refer to the activities of the Fund and the Bank and express our views on them. Since the last Annual Meeting, the Fund took some important steps to improve the conditionality attaching to the use of its resources, the compensatory financing was liberalized, several measures were taken to promote the role of the SDR in the international monetary system, and the Fund's liquidity was increased.

We welcome the recent adoption by the Fund of the revised directives on conditionality. Conditionality is a necessary aspect of the Fund's operations, but it has excessively restricted the recourse by members to the Fund's resources in the upper credit tranches. The new guidelines, as we see them, represent some progress in the demarcation of the area of application of conditionality and allow for greater flexibility of policies in the process of adjustment. It is to be hoped that in the future the design and content of the stabilization programs in stand-by arrangements will correspond to the spirit of the new guidelines and thus encourage the timely recourse to the Fund facilities.

Adjustment programs aimed at stabilization have often generated low growth rates, unemployment, and significant social costs. Now this does not seem to correspond to the aims of the Fund, which are the correction of maladjustments without resorting to measures destructive of both international and national prosperity. Specifically, the Fund should be sensitive to the needs of its members which have to make strong efforts of adjustment, adapt its financial assistance to each particular set of situations, and make a distinction between internal and external factors influencing the imbalances.

The recent liberalization of the compensatory financing facility offers new possibilities of access to it by member countries with balance of payments difficulties arising from temporary export shortfalls. The Fund should further explore the possibility of improving the conditions of the facility, namely, along the lines proposed in the Arusha program. We would also welcome an early consideration and successful decision on the possibilities for the Fund to provide additional balance of payments support in order to cope with the increase in the price of foodstuffs in the low-income countries.

We want to join other speakers who have expressed satisfaction at the entry into force of the supplementary financing facility and appreciation of those member countries willing to contribute to it. In this connection we should like to support the proposals submitted to the Fund for the establishment of an interest subsidy account in favor of the less developed member countries who may use this facility. The financing of the account could draw its inspiration from the action taken in the case of the oil facility.

With the new resources provided by the supplementary facility and the 50 per cent increase in quotas within the Seventh General Review, the liquidity available to the Fund will be more adequate to its task.

Before closing these few considerations of the Fund's activities, I should like to refer to SDR developments and the proposed substitution account. We are in agreement with those many member countries who claim that the amounts of SDR allocations should be more in line with the objectives defined for this asset. The share of SDRs in total international reserves has been too low for too long, if we take into account those objectives, and the amounts of the allocations for the current basic period do not represent a great progress in that direction.

The measures taken this year by the Executive Directors to improve the financial qualities of the SDR and to widen its usability, namely, in the settlement of financial obligations, in loans, and as collateral, represent an important step to enhance the role of the asset. The role of the SDR would also be enhanced by the establishment of a substitution account.

We support the creation of this account. In our view, the substitutions should be entirely voluntary. Consequently, we hope that the conclusions of the further studies to be carried out will be that the SDR assets of the substitution account should have a yield closer to the market rate and offer an adequate liquidity.

International monetary cooperation should be reinforced by new steps that are both courageous and careful.

The new authority of the Fund as supervisor and coordinator of economic policies of its member countries and the efforts within the European Economic Community to strengthen monetary cooperation among its members offer the best possibilities of an orderly operation of the international monetary system and of greater balance in the economic relations of the world.

I will now turn to the problems that fall in the domain of the World Bank Group.

First, I would like to stress the important role played by the three institutions in their attack on the problems of development, about which the published World Development Reports give a very clear picture. I am quite pleased to take this opportunity to congratulate the management of the Bank for the remarkable quality of these reports. The Group's contribution to the solution of the problems of development covers now all the areas involved. In the activity of these organizations an increased attention is being devoted to projects of a social nature such as those in the fields of rural development, basic sanitation, education, and urban development. This significant change in the lending policy of the Bank and the Association, the most recent development of which is the decision to have separate projects for health, is essentially due to the persevering efforts of the President of the institutions, which we fully support as a way to meet the specific needs of each country and different cultural and social patterns.

To be able to enlarge its assistance to developing countries, the World Bank Group needs to have available a volume of funds greatly in excess of those coming from the reimbursement of loans granted and from its own borrowing, which in turn is limited by the total amount of the capital of the two institutions that can have access to borrowed funds--the Bank and the Corporation. That is why it is important for the IBRD to have a substantial capital increase. I am happy to inform you that, on behalf of the Republic of Portugal, I have just conveyed my vote in favor of the two resolutions submitted by the Executive Directors of the Bank to the Governors concerning the capital increase.

The activity of IDA in favor of the less developed countries is hopefully also to be expanded in the coming years, thanks to the replenishment of its funds now in its final stage of discussion among the prospective participants. It is a privilege for me to announce that my Government has just decided to submit to the Parliament, in due course, the necessary legislation authorizing Portugal to become a member of the Association and to contribute--although with a modest amount--to the replenishment under consideration.

In this way, the Portuguese authorities wish to respond to the call the World Bank Group has been addressing to the middle-income member countries to participate, according to their possibilities, in the international effort of assistance to the least developed nations. It supplements the assistance Portugal has been extending directly to some low-income countries to which we are closely linked.

The improvement of the role to be played by the World Bank institutions requires not only the provision of increasing financial means by their member countries. It also involves a constant amelioration of the ways through which the resources they use are put at the disposal of the borrowers. In this context it is worthwhile mentioning the decision taken during the past fiscal year to adopt a currency pooling system designed to put the borrowers in the same position as to foreign exchange rate variations associated with the funds received from the Group.

A development in the Bank's activity in recent years that should be stressed is the expansion of cofinancing. This is allowing the organization to extend its action to a larger number of projects with the same application of funds. Cofinancing has the additional advantage of facilitating the access of borrowers to the international capital markets. The policy to increase cofinancing is, therefore, to be welcomed.

The continued improvements in the functioning of these institutions are certainly to be praised. They may have to face, however, in the near future, new problems, arising from the need to adapt their activities to a changing world in which economic crisis is part of a deep cultural and social change, and the building of a new economic order represents the only chance for more wealth, development, and justice.

As the Governor for a country undergoing profound economic and social changes, the pace of which largely depends on the international environment, I put much hope in the success of the World Bank Group and the IMF in meeting their challenges.

1. Country
2. Use of Fund Resources

THE WORLD BANK
INTERNATIONAL MONETARY FUND

Boards of Governors • 1979 Annual Meetings • Belgrade, Yugoslavia

Prior to August 27, 1979

Mail Address:

JOINT SECRETARIAT —
ANNUAL MEETINGS
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WASHINGTON, D.C. 20431
U.S.A.

Cable Address:

INTERMEET
WASHINGTONDC (USA)

Telex Addresses:

(RCA) 248331 IMF UR
(ITT) 440040 FUND UI
(WUI) 64111 INTERFUND
(TRT) 197677 FUND UT

After August 27, 1979

Mail Address:

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IMF — WORLD BANK
SAVA CENTAR
P.O. BOX 1
11070 BELGRADE 58
YUGOSLAVIA

Cable Address:

INTERMEET
BELGRADE
YUGOSLAVIA

Telex Address:

12015
BELGRADE

October 2, 1979

MEMORANDUM FOR THE FILES

Subject: Portugal

The Minister of Finance of Portugal, Mr. de Sousa Franco, accompanied by Mr. Silva Lopes, Mr. Constancio, Mr. Vilar, and Mr. Do Valle called on Mr. Whittome today at 5:00 p.m. Mr. Whittome expressed his regret that it had not been possible to reach agreement on a stand-by in the recent discussions but he appreciated the difficulties of the political circumstances and emphasized the staff's readiness to resume discussions at any time when there were prospects of a successful conclusion. He then went on to refer to the importance of keeping strict control over finances of the public sector, particularly in the face of a worsening external position and the prospects for prices.

The Minister said he would like to explain the background to the recent talks. He himself had hoped to negotiate an agreement, but discussions with the other parties concerned had shown that there was no prospect of reaching agreement, particularly because of disagreements about public sector prices and the budget generally. The present Government would do its best to keep things going on a path that would be consistent with the resumption of negotiations by the new Government, which should be formed in December or January. He hoped to have a draft budget by the second half of October and would certainly make every effort to keep the deficit down to acceptable levels. However, the Ministry of Finance is faced with an awkward problem in that there were many areas over which they had no control (e.g., unemployment benefits, the consequences of the recent decision not to raise fertilizer prices, and a number of autonomous services).

Mr. Whittome asked whether the unwillingness of the Communist Party to reach an agreement with the Fund were rooted in a dislike of the economic policies with which we were associated or dislike of the Fund as an institution. The latter was thought to be the more important factor, but Mr. Silva Lopes and Mr. Constancio both pointed out that there had been circumstances in the past--and might be in the future--in which the Communists were prepared to acquiesce in negotiations with the Fund.

Brian Rose BR

cc: SED

440040 FUND UI

cc: SED

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NO.21

ATTENTION TREASURER

RE: EXECUTIVE BOARD DECISION OF JUNE 22,1979, ON
COMPENSATORY FINANCING FACILITY

WE WOULD BE INTERESTED IN USING JAPANESE YEN FOR THE REPURCHASE OF SRD 6.5 MILLION TO BE EFFECTED NOT LATTER THAN OCTOBER 1, 1979.

PLEASE INFORM IF THIS CAN MEET WITH THE FUND'S AGREEMENT.

[redacted]

BANCO DE PORTUGAL-LISBON+++

COL 21 22 1979 6.5 1 1979 [redacted]

TEST NUMBER:
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ITT World Communications Inc.
ITT World Communications Inc.

Brief for the Thirty-Fourth Annual Meeting

Exchange rate: Since August 1977 Portugal has used a crawling peg system of exchange rate adjustments to compensate for the difference between domestic and international price developments. After a step adjustment of 6.1 per cent in May 1978, the authorities announced that the escudo would be allowed to depreciate at a monthly rate of about 1.25 per cent. The effective exchange rate (trade-weighted) depreciated by 20 per cent during 1978 and at the end of the year was at a level 49 per cent below that of May 1, 1970. An official announcement was made that the rate of depreciation would be reduced by 1 per cent per month from April 1979. From July 1979 the monthly rate of depreciation appears to have been cut to 0.75 per cent though no formal announcement has been made.

Quota: SDR 172 million.

Use of Fund resources: Fund holdings of escudos amount to 99.7 per cent of quota net of those resulting from outstanding purchases under the compensatory financing and oil facilities. Portugal is likely to purchase the first credit tranche outright if an agreement with the Fund is reached on a stand-by arrangement in mid-September 1979, which would bring the Fund's holdings of escudos up to 150 per cent of quota.

Last consultation: November 1978. Discussions have been held frequently with the Portuguese authorities since then, most recently in September 1979.

Political developments: At present Portugal is governed by a caretaker administration of the center left which is charged with preparing fresh parliamentary elections for early December. A further general election is due in autumn 1980. Then, in 1981, a Presidential election is to take place. In recent years Portugal has suffered from a series of unstable governments and it is feared that considerable political uncertainty is likely to continue for the next year to 18 months.

Personalities: Professor Antõnio Sousa Franco, the present Minister of Finance and Planning, belongs to the dissident wing of the Social Democratic Party and is certain to go out of office after the December elections. He has asked for a resumption of negotiations with the Fund. Dr. José da Silva Lopes, the present Governor of the Bank of Portugal and Governor for the Fund, is highly experienced in the management of the Portuguese economy. He is sympathetic to the Fund and recognizes well the value of a stand-by arrangement with the Fund in light of the political uncertainties of the near future. Dr. Vitor Constancio, Vice-Governor of the Bank of Portugal and Alternate Governor for the Fund has played a prominant part in the past negotiations with us. He is the top economic specialist in Mario Soares' Socialist Party.

Balance of payments: In 1978 the deficit on the current account fell to US$775 million (4 1/2 per cent of GDP) from US$1.5 billion (9 per cent of GDP) in 1977 and compensatory financing was limited to US$450 million in contrast with US$1.4 billion a year earlier, largely as a result of policy measures including an acceleration of the depreciation of the escudo, sharp increases in interest rates and credit restraint under the aegis of a Fund program. These measures succeeded in attracting capital and increasing workers' remittances while discouraging imports for speculative stockbuilding. The depreciation of the escudo, in conjunction with domestic wage restraint, made large gains in export market shares possible. The improvement in the current account, however, seems to be ending largely on account of the increases in oil prices and the outlook for the world economy as well as a recovery in imports owing to an upturn of the stock cycle. The financing requirement for the deficit will be met this year by borrowing from the Eurodollar market. The deficit for 1980, however, threatens again to exceed US$1.2 billion--a level that may bring financing difficulties and is clearly unsustainable over the medium term. A central objective of the stand-by arrangement with Portugal that, it is hoped, will be agreed in September 1979 is a reduction of this deficit to a more manageable figure of say, US$900 million. At the end of June 1979 gross international reserves (including gold valued at the official price) totaled US$1.6 billion.

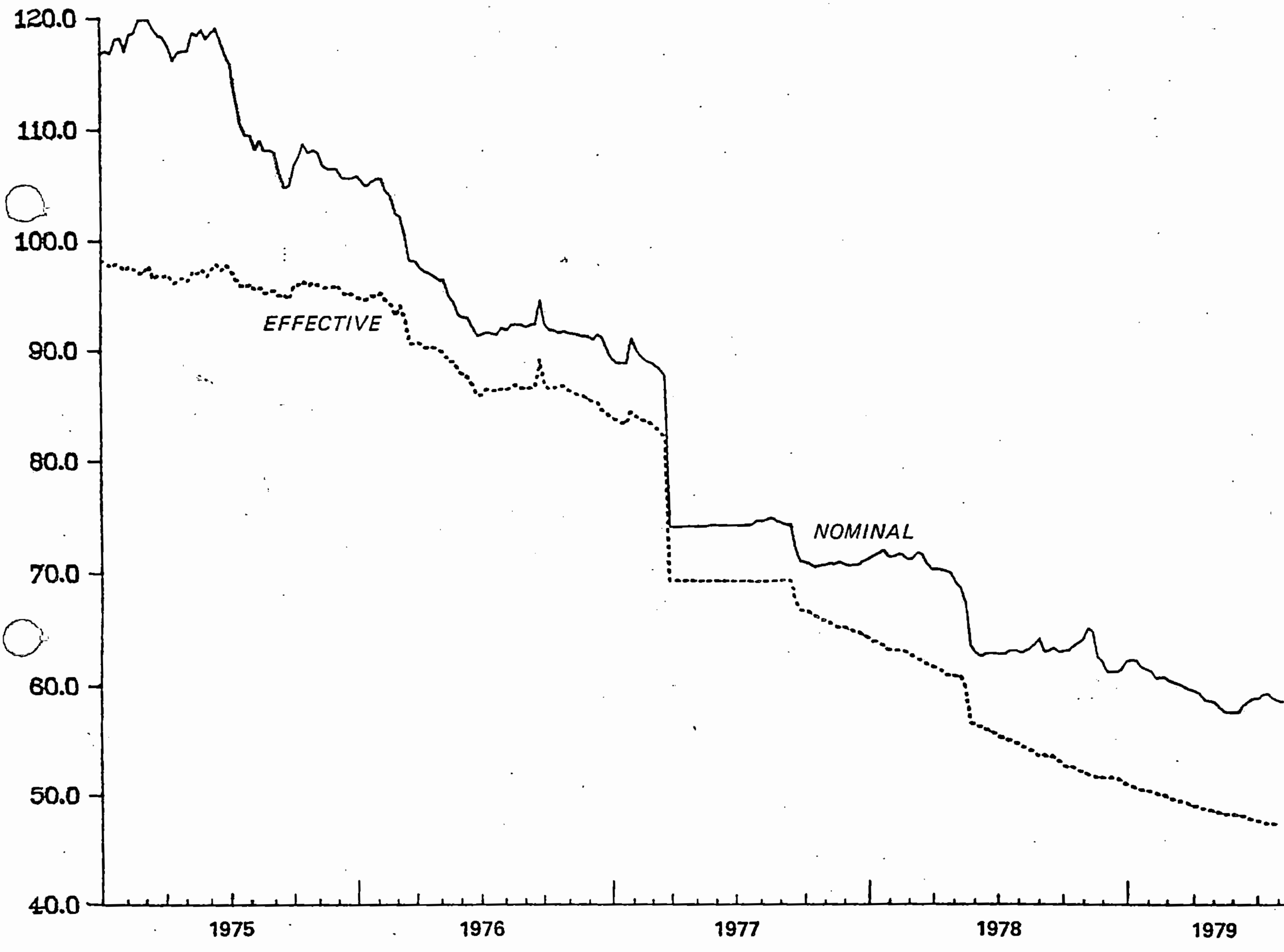
Exchange and trade restrictions: The restrictions on trade and payments which were introduced in the years following the overthrow of the old regime are being relaxed. A 60 per cent surcharge affects about 2 per cent of imports. A 10 per cent surcharge, applicable to nearly one third of imports, is expected to be phased out by the end of the year. In addition, restrictions on outward remittances of profits and dividends are being relaxed.

Domestic developments: In 1978 real gross domestic product increased by some 3.2 per cent, which represented a slowdown from the 6 per cent rise of the previous year, and the rate of inflation decelerated to 22 per cent from 27 1/2 per cent in 1977. The improvement in inflation seen in 1978 is almost certain to end this year largely on account of an expansionary thrust from the budget and higher oil prices. A sizable contribution to the projected 3.5 per cent growth of GDP in 1979 is expected to be made by public consumption and transfers. Fiscal policy has proved difficult to manage in recent years: in 1978 the deficit of the public sector exceeded budget estimates by a large margin and a similar development is expected this year. The new stand-by program will focus particularly on the 1980 government budget with the aim of reducing the rate of inflation.

September 1979

PORTUGAL

INDICES OF U.S. DOLLAR RATES AND
TRADE WEIGHTED EFFECTIVE EXCHANGE RATES
(BASED ON MAY 1, 1970, PARITIES)



Rudiger Dornbusch

Massachusetts Institute of Technology

This paper reviews the background to Portugal's adoption of a crawling peg in September 1977. The experience with the new exchange rate regime has been too brief to draw a lot of lessons. The events leading to the adoption of the regime and the early period of implementation are of sufficient interest, however, to warrant an examination.

A Brief History:

Portugal had for a long period been a hard currency country with a consistent balance of payments surplus. At the end of 1973 official reserves amounted to 856 tons of gold and $1.6 billion in foreign exchange.[1] Table 1 shows some of the details of Portugal's performance in the early 1970's. We note the consistent current account surplus, high net foreign assets as a ratio of GNP, high real growth, relatively reasonable inflation rates by comparison with most industrialized countries and certainly by comparison with semi-industrialized countries.

TABLE 1 SOME HISTORY

	1970-73	1974	1975	1976	1977	1978
Current Account ($US million)	248.0	-829	-819	-1246	-961	-572
Net Foreign Assets(% of GNP)	28.6	18.2	10.3	4.6	-4.6	n.a.
Inflation (% p.a.)	8.8	29.2	20.4	19.3	27.7	22.6
Real Growth (% p.a.)	8.7	1.1	-4.3	6.2	5.4	3.2
Real Exchange Rate (1975=100)	99.1	93.2	100.0	99.5	106.4	102.8

Note: The real exchange rate is a weighted average of wholesale prices in the US, UK, Germany and France (each with equal weight) compared to Portugal.

Source: IMF, International Financial Statistics, Banco de Portugal, Relatório, 1979, OECD, Economic Outlook, July 1979.

* A Paper prepared for the conference on "The Crawling Peg: Past Performance and Future Prospects." Rio de Janeiro, October 1979. Financial support was provided by a grant from the National Science Foundation.

[1] See J. Silva Lopes "Problems of the Current Portuguese Economic Situation." Speech at a lunch of the Steering Committee of the EFTA Industrial Fund, April 1978.

Revised, Sept. 1979

PORTUGAL'S CRAWLING PEG*

Rudiger Dornbusch
Massachusetts Institute of Technology

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Balance of payments and exchange rate problems were not at the center of public policy discussion in 1974-75. There was no experience with problems of external finance, for one, because there had traditionally been a surplus. In addition of course, there were ample exchange reserves. More importantly, the social re-organization was much more exciting than esoteric questions of trade balance adjustment, competitiveness or exchange rate management. In fact, there was very little economic management in 1974-76. Mostly

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[1] While real wages rose initially, following the revolution they have by now returned to their 1973 level and perhaps have even declined further.

macroeconomics happened as a direct outgrowth of the revolution and disorganization of the public sector. The Banco de Portugal paid the bills.

By mid-1976 exchange reserves had declined very substantially, the Banco de Portugal had started selling gold and the question of exchange rate adjustments to restore external competitiveness became a policy issue. By September the government, forced by the Central Bank's refusal to grant further credit, took steps to control wages, productivity and imports.

Chart 1 shows the evolution of the escudo from 1973 to early 1977. The effective exchange rate had been allowed to depreciate throughout 1976 with a cumulative depreciation, from December 1975 to December 1976 of nearly ten percent. The policy of gradual depreciation was de facto, unannounced and was certainly aided by the precipitous depreciation of sterling during 1976. The policy of depreciating the effective rate was, however, not considered a full success and by July the rate of depreciation was reduced. The main disadvantages were linked to foreign exchange speculation on the part of the nationalized banks (!), emigrants who delayed remittances and firms who increased inventories of importables.[1]

Against this background of dissatisfaction with the gradual depreciation policy and the continued need to maintain and restore external price competitiveness the escudo was depreciated by 12.5 percent, in terms of the effective rate, in February of 1977. The Bank announced then the intention to maintain henceforth the effective rate constant. By the end of February the nominal effective rate had cumulatively depreciated by nearly 30 percent since 1973 and by nearly 20 percent in the last two months.

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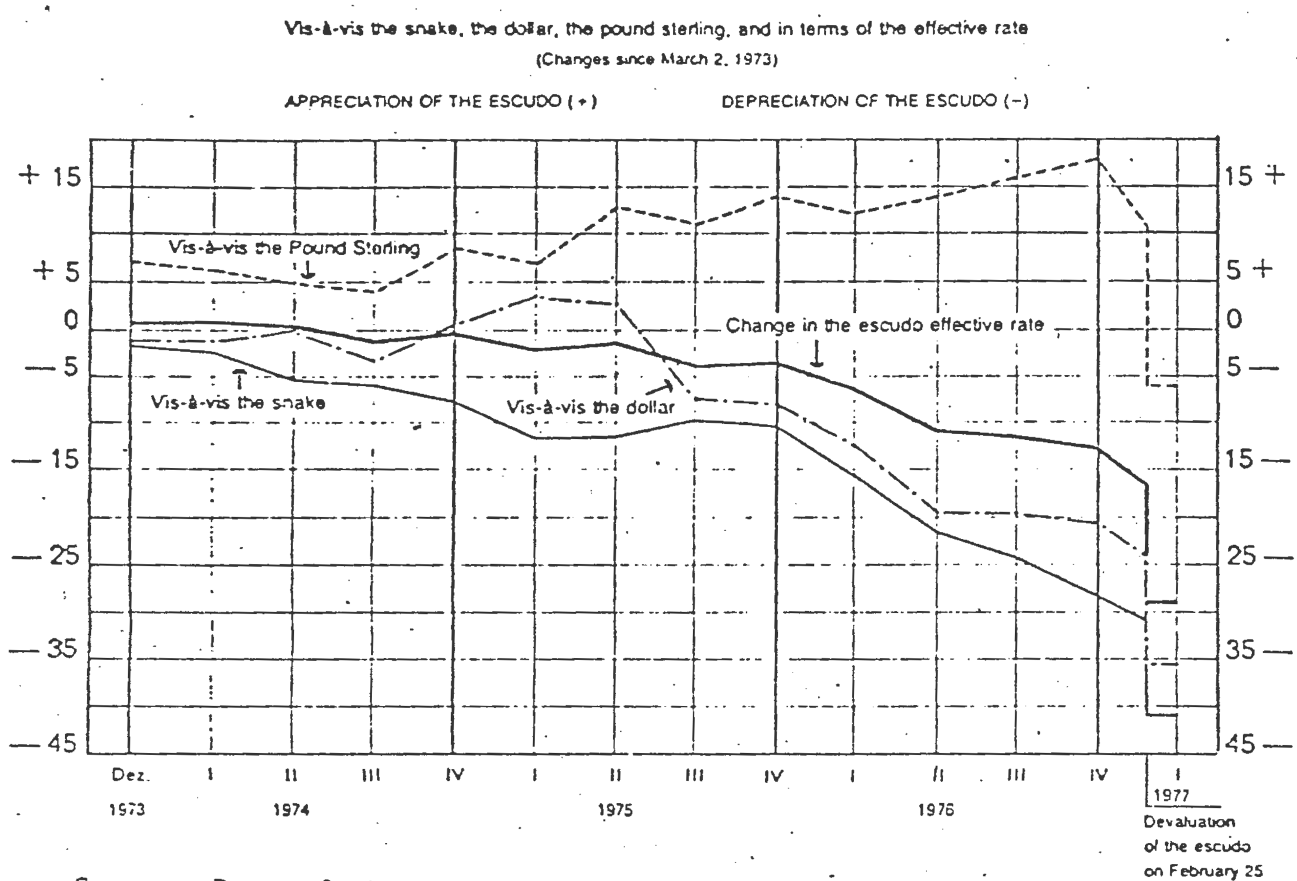
[1] See Banco de Portugal, Report of the Board of Directors for the Year 1976, p. 184.



Source: Banco de Portugal

CHART 1 THE DEPRECIATION OF THE ESCUDO:1973-77

The rapidly declining foreign exchange reserves and the illiquidity of the gold reserves forced Portugal in 1977 increasingly to look for outside financing both from banks and from official sources, including the IMF. A first stand-by arrangement was approved in April 1977 for a modest SDR 42 million on the strength of the government program of limits to wage inflation --15% per year--and the depreciation that had taken place in February.

In June 1977 a group of 14 countries joined to fund a $ 750 million loan to Portugal for medium term balance of payments finance. In line with the spirit of the time[1], however, the loan was contingent on successful

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1 On the spirit of the time see S. Fay and H. Young The Day the £ Nearly Died, Reprinted from the Sunday Times, London, 1979.

negotiation of an IMF loan in the upper credit tranch, i.e. conditionality.

One cannot help noting that 1977 marked the 50th anniversary of very similar financial distress; the details are best left to a quote:[1]

> "By 1927 Portugal's financial difficulties had grown so acute as to impel the Government to seek the assistance of the League of Nations in securing a new foreign loan. On the basis of a first-hand investigation in Lisbon, the Financial Committee of Portugal would agree to a program of monetary, budgetary, and fiscal reform and to the establishment in Lisbon of a foreign agent of the League to receive the revenues assigned for the service of the loan and to supervise the spending of its proceeds... It was under these circumstances that Dr. Salazar became Minister of Finance....Under his able leadership Portugal maintained a healthy financial economy and made economic progress without the aid of any further external loans."

The need to support domestic employment meant that there was no serious alternative to balance of payments deficits and their financing. The question that had to be addressed, though, was the mix between domestic restraint and deficit financing, the mix between devaluation and trade controls and the leeway for interest rate policy. Discussion in the press turned increasingly to the prospect that the IMF terms of agreement would almost certainly involve major devaluation--perhaps as much as twenty percent. Accordingly it was not surprising that there was a large bulge in the balance of payments deficit arising from overinvoicing, inventory building and any of a number of ways of speculating on foreign exchange and import prices.

Against this background we have to see the decision to move to a crawling peg and the accompanying policy of continuing wage restraint and increases in interest rates.

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1 William H. Wynne State Insolvency and Foreign Bondholders, Vol. III, Yale University Press, 1951, pp. 384-385.

The Crawling Peg

The decision to move to a crawling peg was taken in late August 1977. The decision was based on three considerations. First, a decisive move was required to forestall continuing reserve losses from exchange speculation. The alternatives were a large devaluation, as would be part of an IMF package, or a policy of gradual depreciation with perhaps a small step devaluation at the fromt. Second, the preference for a crawling peg was due to the belief that competitiveness has been largely restored through previous depreciation and wage controls and that, in any event, low shortrun elasticities prevented major beneficial impacts of a depreciation. Third, the domestic inflation process was at a critical juncture. Limitations on wage increases had been surprisingly effective, price controls had been gradually removed and the once and for all bulge from the removal of price controls and the February depreciation was being passed through into consumer prices without offsetting increases in wage settlements. This is brought out in Table 2. Under these conditions a large step depreciation would quite inevitably have disrupted altogether the stabilization of inflation.

TABLE 2: WAGE AND PRICE INFLATION
(Percent Per Year)

	1977				1978			
	I	II	III	IV	I	II	III	IV
Wages	9.5	11.5	13.3	13.7	8.3	10.5	9.9	
CPI	25.9	41.0	21.4	12.2	22.4	18.2	23.0	25.7
WPI	25.7	35.7	27.7	27.7	25.4	22.4	35.5	40.9

Note: Percentage Increase over same quarter of the preceding year. Seasonally unadjusted.

Source: IMF International Financial Statistics and Banco de Portugal, Relatorio

The details of the crawling peg that was adopted are interesting in two respects. The first is the concept of an announced, moving target depreciation. The idea here was to provide some leeway for policy both because the underlying domestic rate of inflation was uncertain and because the possibility of domestic or foreign price shocks could not be excluded. I come to details of this issue presently. The other important aspect was the opening of a forward market where the central bank reinforced the announced target depreciation rate by selling forward exchange at the implicit premium. Both the announcement of the target depreciation rate and the opening of the central bank forward market were felt to be important elements in the stabilization of inflationary expectations and the elimination of exchange speculation. Use of the crawling peg to stabilize domestic inflation was particularly emphasized in a note by an advisory group:[1]

> "The target range (of depreciation) should satisfy two (sic) main objectives: First, it is essential that the range be credible, given an appropriate measure of domestic and world inflation. Second, the exchange depreciation is to serve as a stabilizing influence on the domestic inflationary front. Third, the depreciation (should) maintain, if not enhance Portugal's competitive position. These objectives are to some extent conflicting and have therefore to be traded off against each other....
>
> Admittedly use of the exchange rate as a means of containing domestic inflation treads the narrow path of credibility and competitiveness. Even though that path may be narrow there is no doubt that it should be used consciously and with determination..."

[1] M.I.T. Group "Current Prospects and Policy Options" Banco de Portugal, internal memorandum, August 1977.

The crawling peg policy that was announced in August/September 1977 was one of periodic depreciations of an average of 1.1 percent per month with an initial depreciation of 4 percent. Chart 2 shows the behavior of the effective rate and various bilateral rates for 1977. Table 3 shows the month to month percentage rates of depreciation.

The effective rate was based on a group of sixteen currencies, taking into account not only trade weights but also services and remittances which in the case of Portugal are of course particularly important.[1]

Forward rates were quoted for ten currencies and for maturities of one, three and six months. Table 4 shows the forward premia on the dollar and the realized depreciation rates for the respective maturities. There is no published evidence on the profits on forward dealing and the operation of the forward market was later suspended in agreement with the IMF.

TABLE 4: FORWARD PREMIUM AND REALIZED DEPRECIATION (ESCUDO/$)
(Percent)

	1 MONTH		3 MONTHS		6 MONTHS	
	F	R	F	R	F	R
Sept. 30	1.1	-0.8	3.2	-2.3	6.4	.4
Oct.	1.0	0.8	3.1	-0.9	6.3	3.6
Nov.	1.1	-2.3	3.4	-1.7	6.9	12.1
Dec.	1.1	0.7	3.4	2.9	6.8	14.5

Note: F = forward premium; R = realized escudo/$ depreciation.

Source: Banco de Portugal Report of the Board of Directors, Lisbon, 1978. and International Financial Statistics.

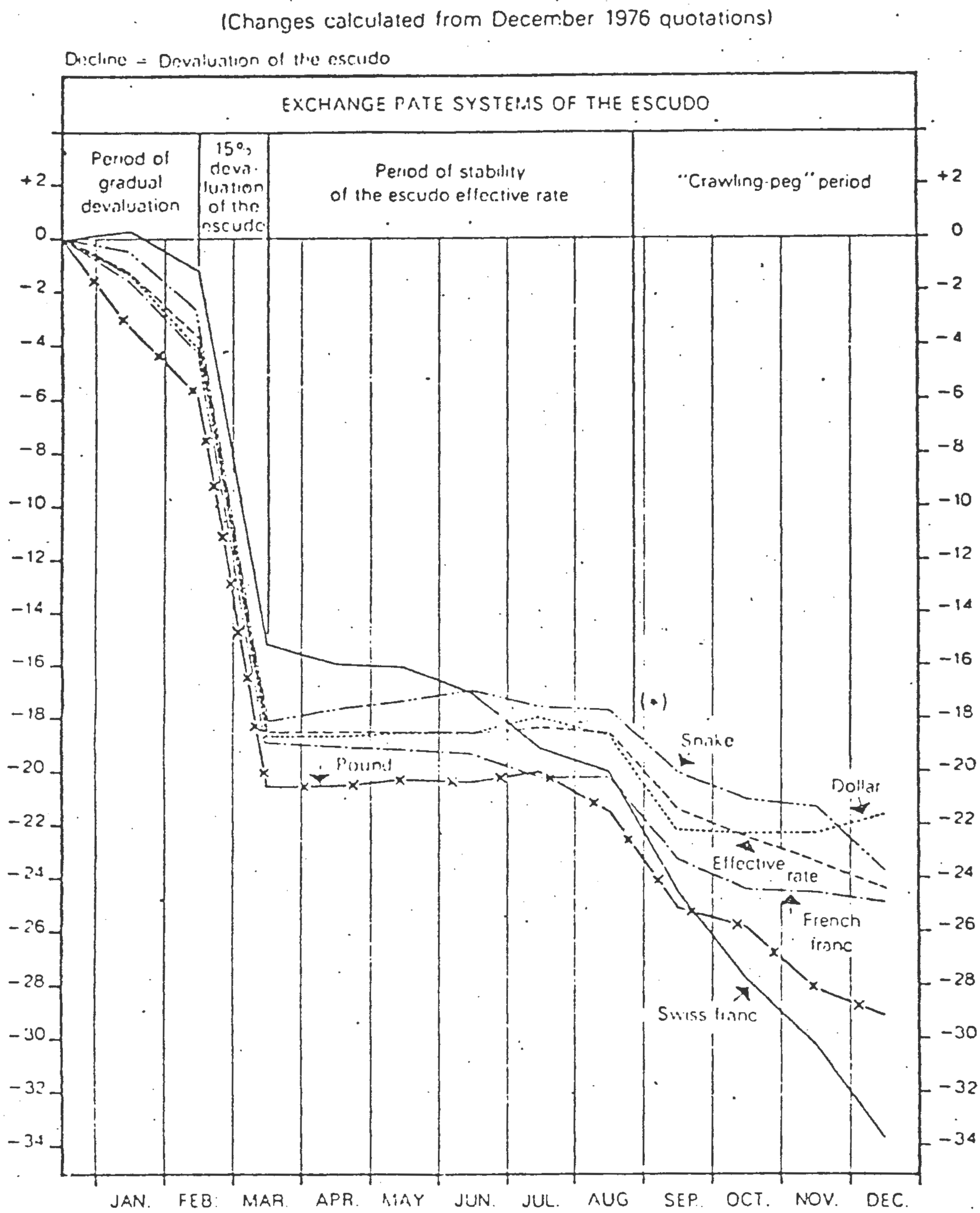
[1] In Table 3 the IMF effective rate uses trade weights for 27 currencies, It is apparent that the divergence is minor,

[2] For extensive work on the efficency of black markrts and forward markets in escudos see J,Braga de Macedo "Exchange Rate Behavior with Currency Inconvertibili: The Experience of Portugal."Doctoral dissertation,in progress,Yale University.

TABLE 3: MONTH TO MONTH PERCENTAGE CHANGE

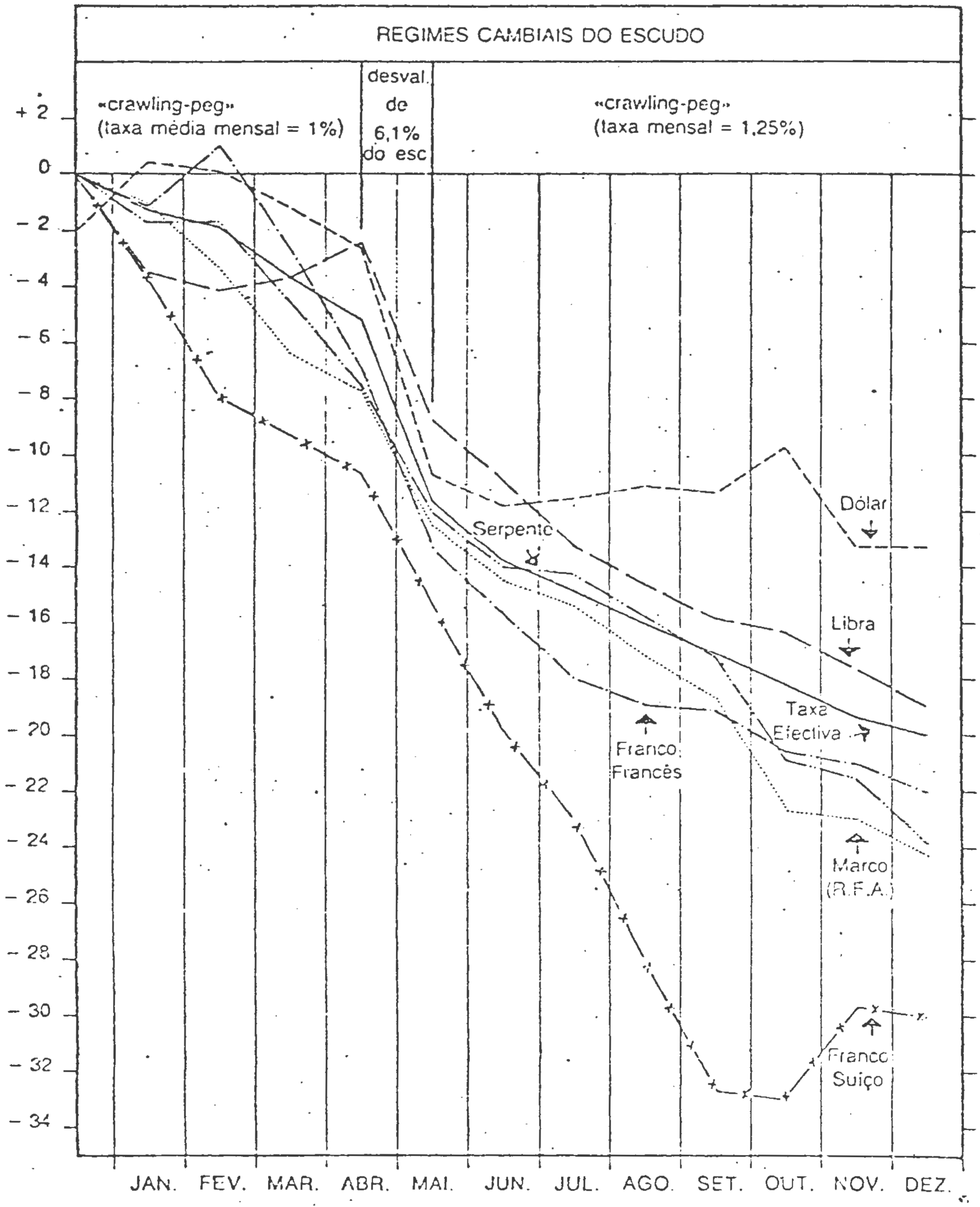
	Effective Rate Banco de Portugal	Effective Rate I.M.F.	Escudo/$
1977			
1	1.4	n.a.	1.3
2	2.5	2.5	2.8
3	18.2	16.7	17.9
4	0	0.1	-0.1
5	0	0	-0.1
6	0	0	0
7	0	0	-0.7
8	0.3	0.2	0.8
9	4.0	3.8	4.7
10	1.1	1.4	0.1
11	1.1	1.0	0
12	1.1	1.2	-0.9
1978			
1	1.2	1.6	-.4
2	0.7	0.8	0.3
3	2.0	1.7	1.3
4	1.6	1.3	1.6
5	7.3	6.7	9.1
6	2.4	2.5	1.3
7	1.4	1.6	-0.4
8	1.4	1.8	-0.6
9	1.2	1.2	0.3
10	1.4	1.7	-1.8
11	1.4	1.3	4.0
12	0.8	0.5	0.1
1979			
1	1.5	1.6	0.6
2	1.2	n.a.	1.5

Source: Banco de Portugal Indicadores de Conjuntura, March 15, 1979 and I.M.F. European Department.



Source: Banco de Portugal

CHART 2 THE ESCUDO DEPRECIATION IN 1977



Source: Banco de Portugal, Rēlatorio

CHART 2A THE ESCUDO DEPRECIATION IN 1978

The steady depreciation policy was followed by and large until May 1978. At that time, as part of the stand-by agreement in the second credit tranche and access to the larger loan mentioned above, a once and for all depreciation of 6.1 percent was undertaken and the average monthly rate of depreciation, through the end of 1978, was raised "in principle" to 1.25 percent.[1] The cumulative depreciation from August 1977 to January 1979 amounted to about 27 percent or an average monthly rate of 1.8 percent.

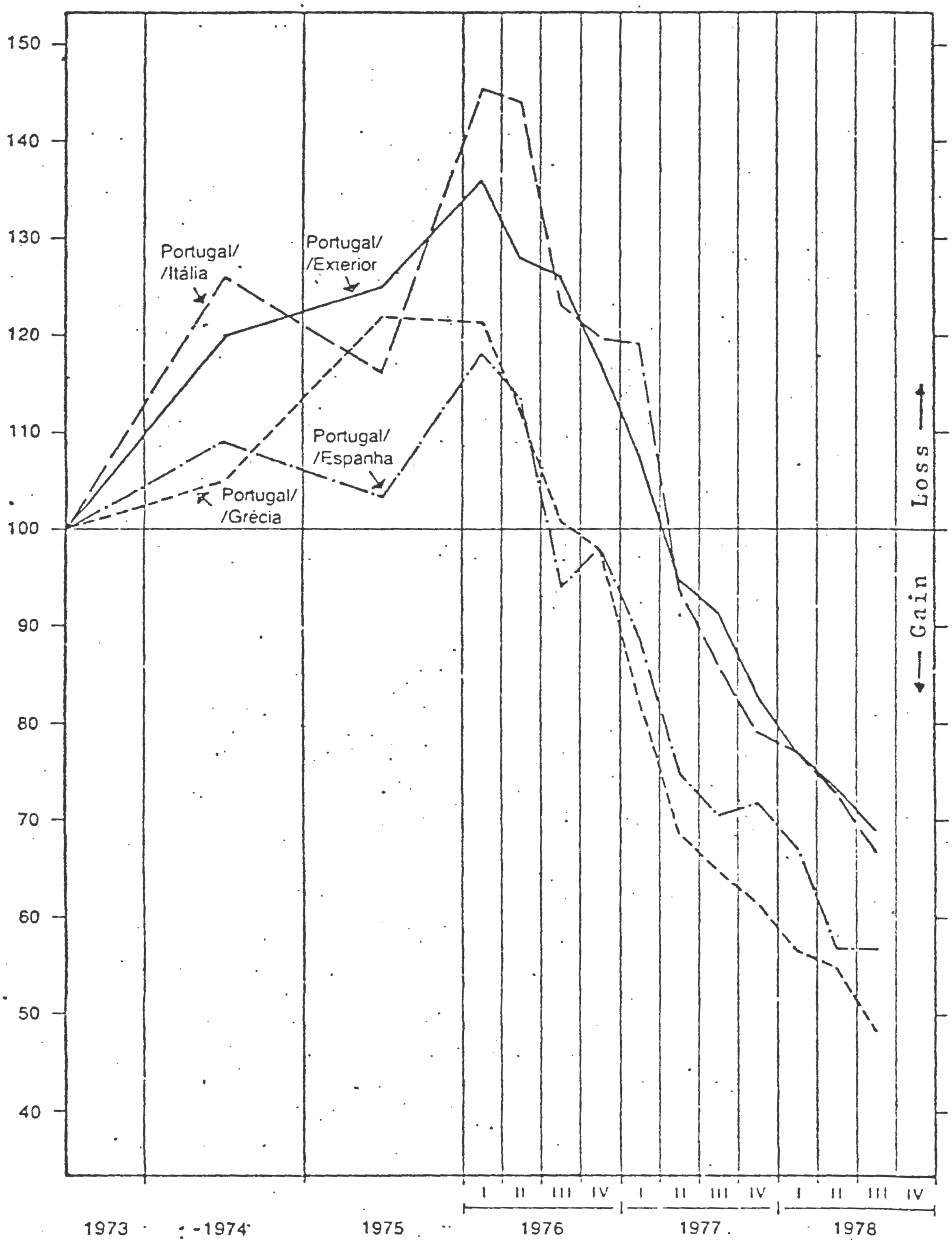
Portugal's competitive position is shown in Table 1 and also in Chart 3. The former looks at a comparison of wholesale prices in Portugal and in Portugal's markets. The latter offers a comparison on the basis of unit labor costs. Both measures suggest a gain in competitiveness since 1975.

Inflation and Interest Rates:

In moving to a crawling policy two questions stood out as particularly important. One concerned interest rate policy and the degree of latitude for deviations from the world rate of interest. The other concerned the assessment of inflation divergence and hence the setting of the trend rate of depreciation.

At the time the crawl was considered there was very little expertise on the experience of other countries with a crawling peg regime. The traditional advice, certainly as it came from the IMF, was that interest rates had to be high enough relative to world levels to provide a safe cushion against interest induced capital flows. Furthermore, since a reduction in economic activity could not but improve the external balance there was no conflict, in this view, between the requirements of international interest rate alignments and other macroeconomic objectives. The alternative view, strongly endorsed by the Bank, was that a high interest rate policy

1 See Banco de Portugal, Relatorio, 1979



Source: Banco de Portugal, Relatorio,1979

CHART 3 EXTERNAL COMPETITIVENESS

would have little impact on commodity speculation and illegal capital flows and would primarily affect domestic investment, primarily housing construction, that stood out by low import content and high labor use. A policy of high interest rates seemed therefore unattractive and was seen as a potential shortcoming of the crawling peg regime.

It is perhaps of anecdotal interest to note that the interest rate issue was resolved by a night-shift calculation of realized interest differentials, adjusted for exchange depreciation, between Brazil and the U.S. The calculations showed persistent yield differential in a market that was substantially more developed and integrated and thus provided plausible evidence against the view of perfect capital mobility.[1]

TABLE 4: INTEREST RATES

	1977				1978		
	I	II	III	IV	I	II	III
Discount Rate	8.0	8.0	13.0	13.0	13.0	18.0	18.0
Deposit Rate	12.0	12!0	16.0	16.0	16.0	20.0	20.0

Source: International Financial Statistics anf Banco de Portugal, Relatorio

Reinforcing this evidence was the recognition that under an alternative regime -- prospective discrete devaluation sometime in the near future and repeated infrequently--the same issue of capital mobility would arise and, indeed, had been the very reason for the accelerating reserve losses.

As Table 4 reveals there was, after all, a policy of raising interest in the move to the crawl in Fall 1977 and, of course, in the agreement with the IMF in Spring 1978. The general rise in interest rates conceals the substantial discrimination and credit rationing, favoring exports and industries

[1] See MIT Group, op. cit.

[2] The letter of Intent to the IMF was reproduced in Economia, May 1978.

with low import content, in particular construction, and put at a disadvantage import finance. Most importantly, the crucial role of remittances was recognized throughout by special deposit arrangements, including foreign currency deposits for nonresidents.

The question of interest differentials and a credible depreciation target was difficult not only because of appalling statistics but also because an inflationary bulge from the February depreciation, decontrol of consumer prices and increased import restrictions made it difficult to discern the underlying rate of inflation. Uncertainty about productivity developments made it difficult to estimate the trend in costs. Under these circumstances there was a temptation to take the most recent inflation rumors-- thirty percent and rising was a fashionable number-- and base the depreciation path on that assessment. Very fortunately the Bank took the view that a lower estimate was more realistic an evaluation of the underlying rate of cost inflation. Accordingly a 10-15 percent rate of trend depreciation was judged adaequate to maintain competitiveness without foregoing the benefits of inflation stabilisation.

The problem of identifying an appropriate trend depreciation highlights an important aspect of the Portuguese crawl, namely that it was adopted under conditions of high uncertainty and not in the circumstances of well-defined, steady state inflation differentials. Moreover, the crawl was quite decidedly part of an incomes policy . In line with limits on wage increases the crawl was to stabilize inflation by lending a credible government commitment--an announced exchange rate target path and forward markets at those rates-- to the incomes policy package. In this respect the Portuguese crawl was perhaps unusual, and with the benefit of hindsight, initially helped stabilize inflation.

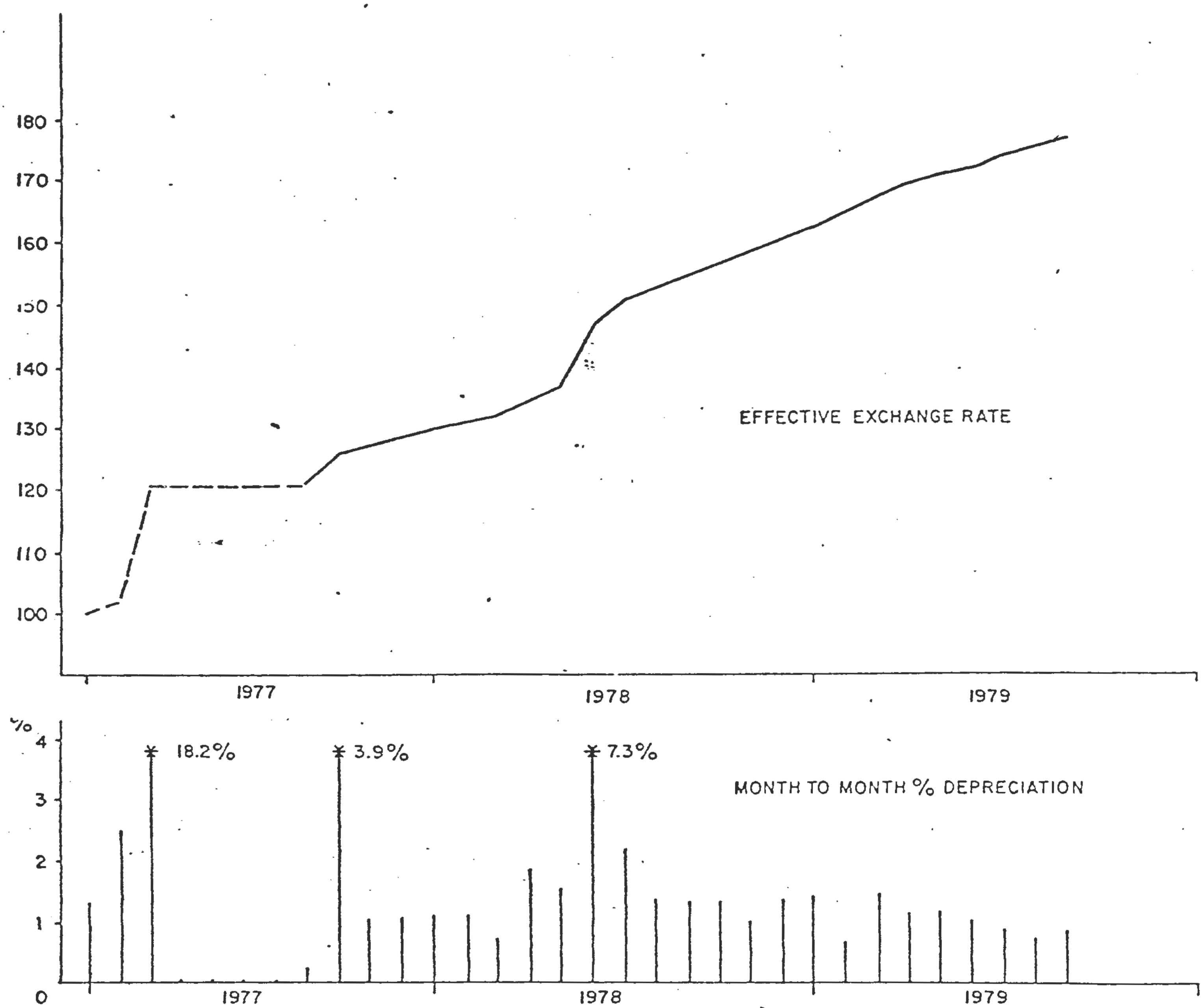


CHART 2 THE EFFECTIVE EXCHANGE RATE

Office Memorandum

TO : Mr. Shahid Chaudhry, IBRD

DATE: September 6, 1979

FROM : Hans Schmitt HS

SUBJECT : Portugal--Investment and Growth

Attached please find a paper on "Money, Interest, and Growth" in Portugal which is generally congenial to us. The author, Maxwell Fry, is to present it to the same conference you are preparing a paper for.

I should like to draw your attention to his tabulation on page 2 from which the following summary can be derived:

	Growth in Real GNP (Per cent)	Investment to GNP (Per cent)	Incremental Capital-Output Ratio
1965-1973	7.20	21.44	2.98
1974-1979	2.05	22.50	10.98

Fry notes that "even in the best three year period since the Revolution, 1976-1978, when growth averaged 4.49 per cent and investment 23.40 per cent of GNP, the ICOR of 5.21 was 75 per cent higher than its 1965-1973 average." He concludes in a way that puts the ball squarely in the World Bank's court, I think, by stating that "the main concern for policymakers here is clearly that of raising the productivity of the large volume of investment."

Now, it seems to me that the whole reason for the abominably high ICOR in Portugal may not be found in the substandard quality of investment projects. Other factors that have operated to keep the growth of output down include for example the loss of export markets. However, it does not take the special expertise of the World Bank to point these out to us or to the Portuguese. It is precisely in the field of project appraisal that the World Bank's unique contribution lies.

It is in this field, too, that we in the Fund look forward very eagerly for your contribution in Portugal. What is the approximate size of the public investment program that can be justified on rigorous project criteria? Any answer requires some macroeconomic input of course, but more importantly, it will also help us set the macroeconomic conditions for its realization.

Best wishes to you on your own venture.

Attachment

cc: Mr. Whittome ✓
Mr. Sadove
Mr. Dubey
Mr. Kavalsky

Preliminary Draft August 1979

MONEY, INTEREST AND GROWTH

Maxwell J. Fry
University of Hawaii

1. Introduction

Since May 1978, the Banco de Portugal has achieved its primary short run objective of monetary policy, namely a dramatic improvement in Portugal's balance of payments. Prior to the adoption of active monetary policy, which began hesitantly in September 1977, there was considerable pessimism both inside and outside the Bank regarding the efficacy and potency of monetary policy for achieving any objective at all. Although the 1978 Annual Report makes it clear that the Bank's staff now regards monetary policy - specifically control over the volume of domestic credit and the level of nominal interest rates - as a powerful weapon in conjunction with appropriate exchange rate policy for short run balance of payments objectives, pessimism persists with respect to monetary policy's role for longer run objectives of decreasing inflation and accelerating economic growth (1).

Present orthodoxy in the Banco de Portugal holds (a) that inflation is an exogenous variable for monetary analysis and, hence, cannot be influenced at an acceptable cost by monetary policy; (b) that restrictive monetary policy reduces growth but expansionary policy does not raise it; and (c) that domestic saving is low because per capita income in Portugal is low (2). The Annual Report pinpoints ".... the insufficiency of domestic savings to finance the investment necessary to increase the rate of development" as a characteristic of the Portuguese economy which produces a conflict for monetary policy between "..... the objectives of financing economic development in the medium term and those of ensuring a reasonable degree of financial stability in the short term" (3).

This paper considers critically the pessimism over longer term monetary policy. Saving, investment and growth are everywhere interdependent. Saving and investment are both determined, in part, by the rate of economic growth. Rapid growth raises the saving rate which, in turn, releases resources necessary to sustain growth through higher investment. If investment is depressed, growth falls and so too the saving rate. A buoyant investment climate, on the other hand, ensures that higher saving rates will be absorbed by higher investment rather than reduce income. It is, therefore, evident that any analysis of saving, investment and growth must recognise this close interdependency. In other words, two way causality is assumed unless otherwise indicated.

Table 1 provides a basic picture of rates of growth in real gross national product (GNP), gross investment (I), national government saving (Sng), national private saving (Snp) and foreign saving (Sf). By definition, I = Sng + Snp + Sf. Here, foreign saving is measured as imports of goods and services minus exports of goods and services minus net factor income from abroad, as given in the national income accounts. This definition means that workers' remittances are treated as foreign saving and interest payment on Portugal's foreign debt as a current account expenditure. National government saving is defined as current receipts minus current expenditure of the administrative public sector, hence excluding government owned enterprises. National private saving is the residual - Snp = I - Sng - Sf. All figures in Table 1 are undoubtedly subject to wide margins of error.

A glance at Table 1 is sufficient to see that the situation before and after the 1974 Revolution differed in a number of important respects. These stand out when averages for the periods 1965-1973 and 1974-1979 are compared (all figures are percentages):

	Growth in Real GNP	I/GNP	Sng/GNP	Snp/GNP	Sf/GNP
1965-73	7.20	21.44	3.43	13.13	4.88
1974-79	2.05	22.50	-2.61	11.94	13.17

The rate of economic growth in the post-Revolution period has been under one third that experienced in the 1965-1973 period. However, the rate of investment has actually increased. The incremental capital/output ratio (ICOR) has therefore risen from 2.98 in the earlier years to 10.97 in the 1974-1979 period. Even in the best three year period since the Revolution, 1976-1978, when growth averaged 4.49 per cent and investment 23.40 per cent of GNP, the ICOR of 5.21 was 75 per cent higher than its 1965-1973 average. The main concern for policy makers here is clearly that of raising the productivity of the relatively large volume of investment.

The national saving rate has fallen by over 7 percentage points between the pre- and post-Revolution periods. Six percentage points of this decline are accounted for by the growing current account deficit of the government, which reached 3.71 per cent of GNP in 1978 and could rise to 5 per cent of GNP in 1979.

TABLE 1

Saving, Investment and Growth

(Percentages)

Date	Growth in Real GNP	I/GNP	Sng/GNP	Snp/GNP	Sf/GNP	Deficit financing/ GNP
1965	7.56	19.22	2.62	12.25	4.36	
1966	3.73	24.00	2.93	17.00	4.08	
1967	7.72	16.49	2.43	11.87	2.20	
1968	8.82	18.79	2.88	11.25	4.66	
1969	2.27	18.95	4.29	10.74	3.93	
1970	9.01	23.46	4.75	12.42	6.28	
1971	6.35	21.89	4.35	10.45	7.09	
1972	8.04	24.08	3.44	15.86	4.79	
1973	11.63	26.07	3.20	16.34	6.52	
1974	1.28	24.67	0.38	9.91	14.38	
1975	-5.10	16.35	-2.46	6.21	12.60	7.51
1976	6.06	20.99	-2.79	9.34	14.45	10.14
1977	5.04	25.67	-2.05	11.30	16.41	7.94
1978	2.42	23.55	-3.71	13.58	13.68	10.81
1979	3.00	23.78	-5.00	21.28	7.50	10.00

Source: Banco de Portugal, Report of the Board of Directors, various issues (Lisbon: Banco de Portugal, annual); Instituto Nacional de Estatistica, Contas Nacionais, various issues (Lisbon: Instituto Nacional de Estatistica, annual); Banco de Portugal, Research Department.

The overall government deficit shows an even more alarming increase. It is the inflationary consequences of this overall deficit which is the main concern of this paper. Recourse to deficit financing exceeded 10 per cent of GNP in 1976 and 1978, and may well do so again in 1979. The difference between pre- and post-Revolution periods is shown in Table 1. It is suggested below that the inflation created by this deficit itself enlarged the gap between government expenditure and revenue, reduced national private saving and, most seriously, lowered the growth rate by lowering the average efficiency of investment.

The subsequent section analyses both the short and medium term relationship between inflation and growth in a country, such as Portugal, where nominal institutional interest rates are fixed by administrative decision. Under such institutional arrangements, it turns out that there is likely to be a negative relationship between inflation and growth. The reason for this lies in the effect of inflation on credit availability.

Inflation seems to generate little concern in Portugal - certainly, far less concern than it did three years ago in 1976. This change in attitude springs presumably from the fact that inflation is no longer ravaging the balance of payments as it did until mid-1978. The main short run inflation induced problem has been eliminated. From a longer run perspective, however, inflation is still creating problems by seriously reducing the rate of economic growth.

In 1976, inflation was blamed on organised labour. However, since labour accepted reduced real earnings in 1977 and 1978 of 7 and 4 per cent, respectively (4), the unions can hardly be used as a scapegoat in 1979. There is little reason to doubt that nominal wage increases might have been brought down to 8 per cent in 1977 and 2 per cent in 1978 if inflation in those years had been reduced to 16 and 6 per cent, respectively. That this was impossible lies in the fact that government resorted increasingly to the inflation tax to meet the growing gap between expenditures and conventional revenue. The reliance on the inflation tax was facilitated by the government monopoly over Portugal's financial system. An analysis of inflation tax and monopoly finance is presented in Section 3.

Efficient financial intermediation between savers and investors is a prerequisite for raising both the quantity and quality of investment in a mixed economy such as the Portuguese. Inflation and monopoly finance has reduced significantly the efficiency of financial intermediation in Portugal, even in comparison with the situation before the Revolution, which was itself far from optimal.

Accelerated growth requires greater financial efficiency. This is incompatible with increasing use by the government of the inflation tax. This has to be substituted by alternative revenue sources or reduced government expenditure. Then efficiency of financial intermediation in Portugal may be improved through the introduction of some competition from the private sector. The problem with this strategy is that it takes time and may prove painful in the short run. A government with a life expectancy of only six months is unlikely to embark upon these critical fiscal reforms. But unless the fiscal reforms are undertaken, financial reform and development is impossible. A decisive outcome from the next elections would thus appear to be a prerequisite for faster economic growth in Portugal.

2. Inflation and Growth

The naive Phillips curve can easily be modified slightly to represent a tradeoff between inflation and growth. The expectations augmented Phillips curve suggests that the long run Phillips curve is vertical. As worldwide inflation accelerated during the first half of the 1970s, a number of countries experienced a negative relationship between inflation and growth. Between 1965 and 1973 inflation (as measured by the GNP implicit deflator) averaged 5.15 per cent a year in Portugal. Between 1974 and 1979 it averaged 20.89 per cent. As already seen, growth declined from an average annual rate of 7.20 per cent during the pre-Revoultion period to 2.05 per cent in the post-Revolution period.

One explanation for the phenomenon of the negative inflation-growth relationship is that higher inflation rates are also more variable. Increased volatility of inflation lowers economic efficiency and so growth by increasing uncertainty. In the pre-Revolution period, inflation's standard deviation in Portugal was 2.67 whereas in the post-Revolution period it was 4.73. (However, the coefficient of variation actually fell from 0.52 to 0.23 between these two periods.)

A second explanation is that government involvement in the price setting process tends to expand when inflation rises. "Increasing volatility and increasing government intervention with the price system are the major factors that seem likely to raise unemployment /and, concomitantly, lower growth/" (5). In 1978, almost half of consumers' expenditure was subject to price control in Portugal (6).

Portugal's negative relationship between inflation and growth may well be attributable, in part, to increasing volatility of inflation and government intervention in the price setting process. The 1974 Revolution itself is certainly responsible in part too. Nevertheless, the analysis in this section concentrates on the effects of interest rate regulation, an area of continuous government intervention throughout both the pre- and post-Revolution period.

Inflation and expected inflation affect growth in Portugal through two distinct channels. First, the ratio of the actual to the expected price level (P/P*) has a positive influence on growth.

This variable comes from recent extensions of the expectations augmented Phillips curve (7). If actual price exceeds expected price, entrepreneurs interpret the difference to reflect a real increase in demand for their products. Their response is to raise the rate of capacity utilisation of existing capital to increase output immediately and to invest more to increase capacity.

Expected inflation also affects short run growth through the real deposit rate of interest ($d-\dot{P}^*$). Under Portugal's disequilibrium interest rate system, real money demand determines, in part, the real supply of domestic credit. In part, real money demand also determines the level of net foreign assets within the banking system. Together, domestic credit and net foreign assets are the assets backing the monetary liabilities of the banking system. Ceteris paribus, falling real money demand reduces real domestic credit and net foreign assets. Real money demand in Portugal is reduced by a decline in the real deposit rate of interest (8).

As inflation accelerates and the real deposit rate of interest falls, an increasing proportion of the declining supply of real domestic credit is expropriated by government to finance its rising deficit (9). The government deficit tends to increase because of the lag in the collection of tax receipts (10), erosion of the tax base, price freezes on government services, etc. Hence, funds for both working and fixed capital investment are doubly squeezed (11). The growth rate declines.

In fact, the upheaval of the Revolution in Portugal increased greatly demand for credit. Hence, the analysis above is incomplete. Not only did domestic credit as a percentage of GNP rise from an average of 64 per cent in the period 1966-1973 to 93 per cent in 1974-1979 (see Table 2), but the investment rate increased also. However, the government did expropriate an increasing proportion of domestic credit on the one hand, and negative real loan rates created a demand for credit to finance unproductive stockpiling on the other. The investment figure includes these stocks. And they explain, in part, the low productivity of measured investment in the post-Revolution period.

Credit demands of government, stockpilers, speculators, and nationalised businesses running at losses have competed with and crowded out credit demand for working and fixed capital of small and medium sized private enterprises. Since these constitute Portugal's relatively efficient sector, the growth rate declined.

Rising domestic credit and falling money demand as percentages of GNP were met by a massive loss of foreign assets. From 76 billion escudos at the end of 1973, net foreign assets fell continuously to -54 billion escudos at the end of May, 1978. Had this been impossible, the fall in money demand as a percentage of GNP from 92 per cent in 1973 to 82 per cent in 1977 would have been matched by a similar fall in domestic credit. The decline in net foreign assets enabled the expansion in domestic credit as a percentage of GNP. Without this, growth would have been reduced far more than it actually was.

TABLE 2

Domestic Credit

Date	DC	NDCg	DCp	% NDCg/DC	% DC/GNP	% DCp/GNP
	(Millions of Escudos)					
1966	66,310	930	65,380	1.40	56.30	55.51
1967	73,040	940	72,100	1.29	55.38	54.67
1968	81,380	825	80,555	1.01	55.76	55.20
1969	95,680	-330	96,010	-0.34	59.68	59.88
1970	113,930	-1,605	115,535	-1.41	63.92	64.82
1971	136,070	-3,625	139,695	-2.66	68.38	70.20
1972	169,360	-1,315	170,675	-0.78	73.06	73.62
1973	219,350	435	218,915	0.20	77.35	77.19
1974	276,095	3,930	272,165	1.42	80.80	79.65
1975	368,910	21,200	347,710	5.75	98.15	92.51
1976	416,128	60,956	355,172	14.65	89.75	76.61
1977	576,656	102,950	473,706	17.85	93.71	76.98
1978	783,195	145,248	637,948	18.55	102.06	83.13
1979	959,242	198,197	761,045	20.66	95.92	76.10

Source: International Financial Statistics, computer tape; Banco de Portugal, Research Department.

Note: 1966-1975 Mid-year estimates from an average of beginning and end of year figures.

1976-1978 Centred quarterly averages.

1979 30 June 1979.

Inflation in the post-Revolution period was followed by rising nominal institutional rates of interest. On the deposit side, this was essential to restore adjusted interest rate parity with Portugal's trading partners (12). On the loan side, however, higher nominal, albeit still negative, real interest rates produced a cash flow problem. The effect of inflation here is to reduce the effective maturity of a loan. For example, consider a 20 year mortgage loan at 4 per cent with no inflation repaid in equal annual instalments. After five years, 82 per cent of the loan has still to be repaid. With 20 per cent inflation and a nominal interest rate of 24.8 per cent, only 39 per cent of the loan deflated to constant prices remains to be repaid after five years. The same phenomenon occurs, of course, when the entire principal is repaid in nominal terms on maturity of the loan, but nominal interest rates compensate exactly for the declining real value of the principal through higher nominal interest payments. In effect, here the loan is actually being repaid in instalments. Without indexation of the outstanding loan balance, inflation reduces the effective maturity of any loan. Hence, fixed investments become more difficult to finance in practice, simply due to the inevitable cash flow problem which shortened loan maturity creates. With fixed investment thus deterred, growth falls.

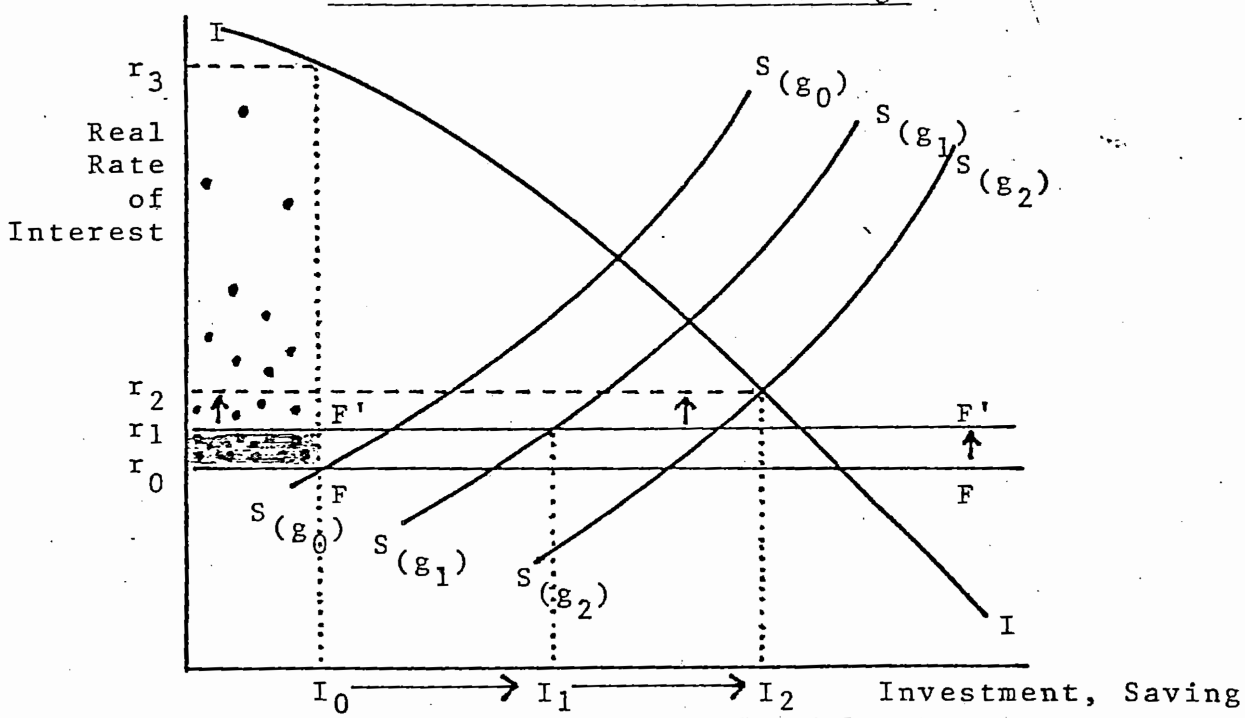
The main effect of inflation on growth in Portugal appears to have occurred as a result of negative real institutional interest rates, specifically loan rates of interest. Negative real loan rates were imposed on Portugal's nationalised financial institutions for a variety of reasons - to mitigate the cash flow problem already mentioned in the previous paragraph, to encourage "priority" activities, to compensate for the political uncertainty in the aftermath of the Revolution, etc. There also appeared, for a time, to be insufficient loan demand. In fact, the newly nationalised banks were ultra-cautious, ultra-conservative. For a while, bankers felt that they no longer had the authority - and certainly had no incentive - to assume normal business risks. Hence, many potential borrowers were rationed out. In fact, it is difficult to imagine the possibility of a market determined negative real rate of interest produced by "low" demand for credit except in the most extraordinary circumstances.

For virtually all of the post-Revolution period, it seems safe to conclude that deposit and loan rate ceilings have been binding. To the extent that there has been any competition between the banks in Portugal, it has taken the form of advertising, branch expansion, etc. The marginal utility to depositors of bank expenditure on nonprice competition is well below that of expenditure on interest payment because demand for money declines when real deposit rates fall and more nonprice competition is substituted for interest payment. In other words, nonprice competition is not a perfect substitute for price competition. Hence, deposit rate ceilings widen the spread between effective deposit and loan rates of interest. This, in turn, depresses saving and reduces the level of both saving and investment.

Bank deposits represent the main financial repository for savings in Portugal. Likewise, they represent the predominant source of loanable funds. The effects of ceilings on deposit rates of interest on the volume of saving and investment as well as on the average efficiency of investment are shown in Figure 1. Saving, $S_{(g_0)}$, at a growth rate g_0 is a function of the real rate of interest (14). F is the interest rate ceiling, which holds the real rate, r, below its equilibrium level. Actual investment is limited to I_0, the amount of saving forthcoming at the real interest rate r_0. If the ceiling applied only to savers' interest rates, e.g. only to deposit and not loan rates of interest, the investor/borrower would face an interest rate of r_3, the rate which clears the market by equating demand for funds (investment) with the limited supply (saving).

FIGURE 1

Saving and Investment under Interest Rates Ceilings



In fact, there have been binding loan rate ceilings as well. Until May 1978, the effect of the ceilings was, in the main, to ration out completely some potential borrowers (investors). Since May 1978, when credit volume ceilings were introduced, even "creditworthy" borrowers have been rationed. When loan rate ceilings are binding and effective, nonprice rationing must occur. This takes place on the basis of collateral offered, political influence, planning priorities, "name," loan size, and possibly certain covert benefits to the responsible loan officers.

The point is that these criteria can be counted on to discriminate inefficiently between investment opportunities. Furthermore, there is bound to be a strong preference for traditional, low yielding investment, e.g. in trade, because these appear safest, simplest and cheapest to finance. Loan rate ceilings discourage risk taking on the part of financial institutions; risk premia cannot be charged when ceilings are effective. This itself rations out a large proportion of potentially high yielding investments. There is, therefore, a strong tendency for the investments which are financed to yield returns barely above the ceiling rate r_0. These are shown in Figure 1 by the dots. When the real loan rate is negative, it should not be too surprising to discover investments yielding negative real returns. Provided the return is somewhat less negative than the loan rate, the entrepreneur still makes a profit. Obviously, however, negative yielding investments produce negative growth in real GNP.

Raising the interest rate ceiling from FF to F'F' in Figure 1 increases saving and investment. It also deters entrepreneurs from borrowing to finance projects illustrated by the dots in the shaded area, which might have been undertaken before. The growth rate rises and so shifts the saving function to $S_{(g_1)}$. In this situation the real rate of interest as the return to savers is the key to a higher level of investment, and as a rationing device to greater investment efficiency. The impacts on growth are multiplicative.

In a recent pooled time series analysis for seven Asian countries with binding interest rate ceilings, the combined effect of below equilibrium rates on both the quantity and quality of investment was estimated to produce half a percentage point in economic growth foregone for every one percentage point by which the real deposit rate of interest was held below its market equilibrium level (15). The same order of magnitude was found in a separate study for the Turkish economy (16).

Unlike Portugal, these countries did not possess large foreign exchange reserves. In Portugal, the rate of investment actually increased, despite lower real deposit rates of interest and so lower national saving rates, because foreign exchange reserves could be drawn down rapidly and large scale foreign borrowing was possible. On the other hand, higher investment rates in the post-Revolution period have been accompanied by much lower rates of economic growth. The effect of negative real interest rates on average investment efficiency, therefore, may well have been greater in Portugal than in these eight countries subjected to econometric analysis.

One might well have predicted that inflation and the concomitant negative real interest rates would have been more destructive in Portugal than in many other countries. Some of the factors promoting economic inefficiency in the face of inflation have already been discussed - price (including, of course, interest rate) controls, cash flow difficulties, the increasingly segmented credit market in which government, nationalised and other big business have pre-empted the supply of negative cost credit, strong risk aversion, etc. The next section turns to a further source of inefficiency - monopoly finance.

3. Inflation Tax and Monopoly Finance

The inefficiencies created by inflation and negative real interest rates are well recognised. That inflation at a rate of 25 per cent persists and is unlikely to decline in the foreseeable future in Portugal is a result of the government's deficit. If this is an inherent feature of Portuguese democracy, one might then propose that the more destructive effects of inflation be avoided. One obvious prescription would be to abolish interest rate controls or, at least, to establish positive real deposit rates to encourage more saving.

Abolishing interest rate ceilings would, however, open the door to competition within the financial sector. Private sector investment societies would thrive and markets in direct claims (e.g. commercial bills) would flourish. Such competition would, of course, destroy the monopoly profit of the financial system accruing to the government. This profit is extracted in the forms both of profits paid over as current revenue to the government and of cheap credit. At present, the Portuguese government is in no position to forego either revenue source.

Long run profit maximisation from a monopolised financial system can be illustrated as follows. Assume that currency and demand deposits are perfect substitutes and that both are costless to produce. The total is defined as C. Assume that time deposits of six months' maturity, T, are offered and that the cost of time deposits is solely the interest payment. Nominal wealth, PW, can be held in three assets - C, T and tangible assets (inflation hedges) A. The nominal yields on these three assets are r_C, r_T and r_A, respectively. Here, r_C is zero at all times. The yield on tangible assets, r_A, is the inflation rate. The government sets r_T and r_A.

For this illustration, a complete system of linear demand equations satisfying the Slutsky symmetry conditions, the additivity and substitutability constraints, provided for the latter that C, T and A possess just two attributes - return and liquidity - is used (17):

$$\frac{C}{PW} = b_1 r_C - b_1 r_T + b_3; \tag{1}$$

$$\frac{T}{PW} = - b_1 r_C + b_2 r_T - (b_2 - b_1) r_A + b_4; \tag{2}$$

$$\frac{A}{PW} = - (b_2 - b_1) r_T + (b_2 - b_1) r_A + b_5. \tag{3}$$

Provided C, T and A are not Giffen goods, $b_2 > b_1 > 0$.

Real revenue from money issue, R, is

$$R = \frac{1}{P}\frac{dM}{dt} - \frac{Q}{P}, \tag{4}$$

where P is the price level, M = C + T and $Q = Tr_T$. In long run equilibrium, r_C, r_T and r_A are constant. Assuming W constant, demand for C and T will grow in proportion to the price level, i.e. by r_A. Therefore, equation (4) can be rewritten

$$R = \frac{C}{P} r_A + \frac{T}{P} r_A - \frac{T}{P} r_T. \tag{5}$$

Recalling that $r_C = 0$, equations (1) and (2) can be substituted into (5):

$$R = [-b_1 r_T + b_3] W r_A + [b_2 r_T - (b_2 - b_1) r_A + b_4] W (r_A - r_T). \tag{6}$$

Real revenue is maximised when $\frac{\partial R}{\partial r_T} = \frac{\partial R}{\partial r_A} = 0$. The solution in terms of r_T and r_A is

$$r_T = \frac{b_3}{2b_1}; \tag{7}$$

$$r_A = \frac{b_3 + b_4}{2(b_2 - b_1)} + r_T. \tag{8}$$

The following illustrative values are taken from an earlier study of deposit substitutability in Portugal: $b_1 = 2.308$; $b_2 = 6.427$; $b_3 = 0.240$; $b_4 = 0.191$ (18). In this case, the revenue maximising time deposit rate of interest is 0.0520, i.e. 5.20 per cent, and the appropriate inflation rate is 0.1043, i.e. 10.43 per cent. Clearly, a negative real time deposit rate can well be a profit maximising solution, despite its adverse effect on national private saving.

Negative loan rate ceilings are also an essential element of monopoly finance. With positive loan rate ceilings, competition could and would develop as large private firms resorted to direct finance through a bill market and investment societies offered financial claims with considerably more attractive yields than the present maximum of 22¼ per cent on five year bonds. Such taxable returns cannot compete with the untaxed 22 per cent offered on government bonds - not a new phenomenon in Portugal (19). Hence, loan ceilings preserve the monopoly, some of whose profits are distributed to big private as well as nationalised industries which might otherwise break the monopoly through direct finance. So far, this strategy has succeeded, the secondary market being kept in a state of "near paralysis" (20).

There are three major drawbacks to this system of monopoly finance from the view point of social cost. First, Portugal's financial intermediaries are extremely high cost. Personnel costs as a percentage of earning assets or total deposits have increased alarmingly in the post-Revolution period. These high and rising intermediation costs - several times greater than similar costs in, for example, the United States - have simply reduced the monopoly profit for the government and used up scarce resources in a socially inefficient way.

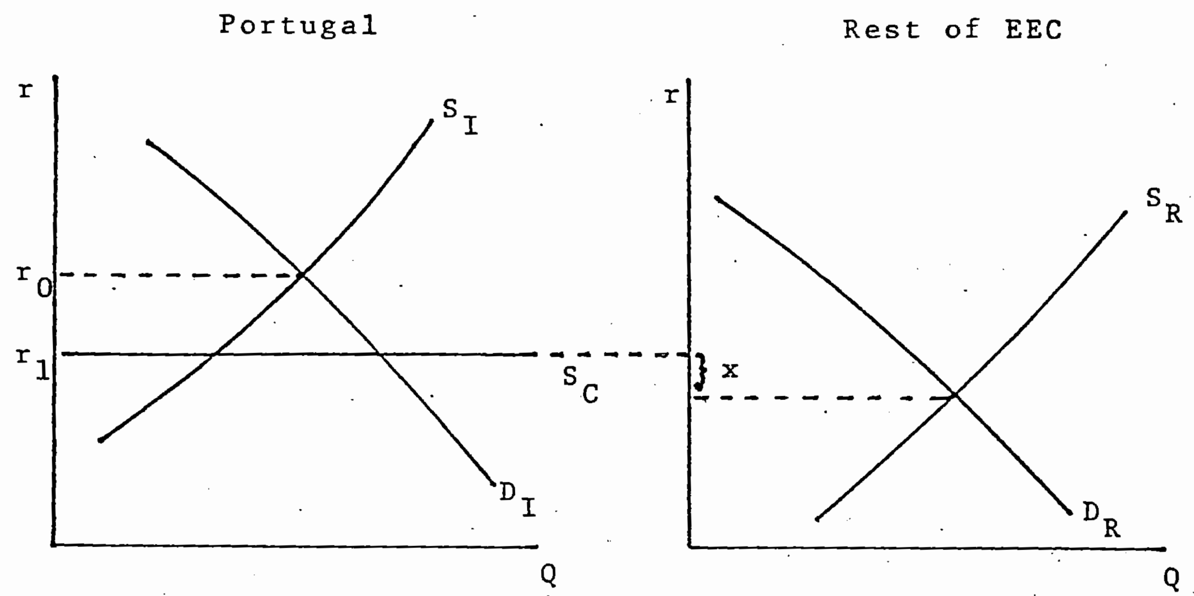
The second major social cost of monopoly finance is that is has of necessity suppressed financial development. There is now a large and growing literature on the costs of financial repression and financial restriction, which space prevents reviewing here (21).

The third major social cost in an open economy, such as the Portuguese, springs from the inefficient overuse of external financial markets (22). Note that Portugal has been a net capital importer throughout the period 1965-1979. If transactions costs (including costs of information and risk) are greater for intercountry financial transfers than for intracountry transfers, freely determined equilibrium rates of interest adjusted for expected exchange rate changes will be higher in capital importing countries than in the rest of the world.

This analysis is illustrated in Figure 2. It is assumed that the capital importing country is small relative to the rest of the European Economic Community (EEC) which is treated here as having one perfectly integrated capital market. The capital importing country therefore faces a perfectly elastic supply of foreign funds at an interest rate marked up by some amount x, which incorporates transaction cost and risk differentials, above the world average. In Figure 2, S_I and D_I represent the national supply of and demand for capital, respectively, in the capital importing country. S_C is the elastic supply of foreign funds. D_R and S_R are demand for and

FIGURE 2

International Capital Flows



supply of capital in the rest of the world. In the absence of capital inflows, the equilibrium interest rate in the capital importing country is r_0. Capital inflow lowers the interest rate to r_1.

Four assumptions are now made for the analysis to follow: (a) Portugal is small relative to the rest of the EEC, which is treated as a completely integrated economy. (b) Financial claims on which no binding interest rate ceilings exist (uncontrolled claims) are not perfect substitutes for claims on which ceilings exist. This implies that total national supply of loanable funds is smaller, *ceteris paribus*, than it would be in the absence of any binding ceilings. (c) There is a cost premium of x per cent on funds crossing international frontiers, which may well incorporate a risk premium as well as transactions and information costs. Hence, free market interest rates will be higher in a capital importing country such as Portugal than in capital exporting countries. (d) Uncontrolled claims are traded only on international markets located outside the deficit or capital importing country considered here. Hence, residents in Portugal who wish to buy such uncontrolled claims must pay the international transfer premium. This is also the case for those wishing to obtain funds by selling such claims.

Under these conditions, the supply of national funds to local investors in Portugal (the capital importing country) will be smaller than it would be in the absence of interest rate ceilings. The returns on national controlled financial claims are lower than they would be under free market conditions. Hence, substitution occurs and savers transfer more of their funds to the international market. Their net return equals the international market interest rate on uncontrolled claims minus the costs of the international transfer, i.e. r - x per cent where r represents the market interest rate on these claims. The free market borrowing rate in the capital importing country will equal r + x, since borrowers must pay the market interest rate plus the international transfer premium to obtain funds from the international market for uncontrolled claims.

From 1974 until May 1978, national loan rates in Portugal were held below international rates adjusted for expected exchange rate changes. Those able to borrow locally - government, nationalised industry and big private firms - had no incentive to resort to the international market. Savers, of course, did. Other potential borrowers/investors were excluded effectively from both national and international capital markets, the former as a result of the nonprice rationing criteria, the latter becuase of the prohibitive information costs facing small borrowers on such markets. The result was, of course, a rapid depletion of foreign exchange reserves. After May 1978, even favoured borrowers were rationed - their marginal loan rates in the national market became infinite. Therefore, they began to borrow on the uncontrolled international capital market. Foreign exchange reserves then began to rise. In both periods, however, interest rate ceilings in Portugal reduced the supply of national saving for local investment.

Binding interest rate ceilings cause a larger amount of international lending and borrowing. Hence, they result in a larger total cost of international transfers, which is borne solely by the capital importing country, than would be the case in the absence of these ceilings. Abolition of interest rate ceilings would increase the supply of local capital in Portugal and reduce the volume of capital flight. Wasteful transfer costs would be reduced, a welfare gain for Portugal.

4. Prescription

If low growth is basically the result of fiscal difficulties, the remedy must lie first and foremost in reform of Portugal's public finances. That this is needed has never been in doubt (23). Tax rates have been raised substantially over the past few years. Their yields have been disappointing - "central government tax revenue in 1978 increased by only 21 per cent of the initial forecasts" (24). The OECD report continues with an explanation of this huge shortfall: "Various factors are responsible for this trend, among them the delay in the adoption of the budget, the slowdown in imports and the lowering of the surcharge on the latter. Furthermore, administrative difficulties prevented the budgeted extension of the transactions tax to certain services. Finally, tax evasion increased appreciably according to the Portuguese experts, partly as a result of the credit restrictions which have strained firms' cash positions" (25).

A discussion of tax reforms would be quite beyond the scope of this paper. It is, however, important to note that the inflation tax has reduced significantly real revenue from other taxes as well as from the provision of services, such as transport, which have tended to become increasingly subsidised. The tax base does appear to have been eroded by inflation and lags in tax collection have lowered the real value of the taxes collected. This suggests that price stability may not leave the government as short of revenue as its present difficulties under inflation might imply.

A non-inflationary climate would undoubtedly reduce real expenditure too. First, subsidies for activities subject to price ceilings would rapidly disappear. Second, the effective maturity of the government debt would be lengthened by price stability, thus easing the government's own cash flow problem.

It is one thing to agree that the government's deficit may fall considerably if inflation declines. It is quite another matter to set the Portuguese economy on the transition path from inflation to price stability. In the first place, some administrative reform, at least within the Ministry of Finance but preferably throughout the public sector, is essential. Without a minimum of reform, implementation of the existing tax regulations will remain partial at best. Unexpectedly low tax elasticities invariably indicate administrative weakness.

The second prerequisite is political stability. A government with a life expectancy of six months has no chance of reaping the benefits of administrative reform, even if it could carry out such reforms. Furthermore, there is a strong temptation for a temporary government to increase expenditure commitments without undue concern over revenue provision. "Spend now, pay later" is an all too seductive principle for gaining short term political popularity. It has gained ground in Portugal.

A financial development programme for Portugal has been outlined elsewhere (26). Further discussion here is unwarranted. Rather, this paper ends with two proposals regarding interest rate policy during the transition from high inflation to price stability. In fact, they are equally applicable for a continuation of the present policy of inflationary finance.

The first recommendation is for the Banco de Portugal to rely more on interest rate and less on nonprice rationing of credit. The existing credit ceilings are binding. Hence, loan rates could be raised until demand was reduced to the fixed quantity supplied. In addition, it is important to replace cash base control for credit ceilings as soon as possible (27).

The second proposal is to index bank loans to the pre-announced value of the foreign currency basket against which the escudo's crawl is fixed. The interest rate on such indexed loans might be just above the weighted average of prime loan rates in the basket countries. This _ex ante_ (in contrast to _ex post_) indexation would not only lengthen effective loan maturities but also allow nominal rates to fall in step with a planned reduction of inflation.

When government abandons monopoly finance as a revenue source, negotiable certificates of deposit for maturities of, say, 2 - 5 years might also be indexed to the foreign currency basket with yields around one percentage point below the loan rate. In this way, integration with the EEC could take place without fear of increasing the costly circular flow of funds from Portuguese savers through the EEC capital markets to Portuguese investors. More importantly, this might be a first step in the direction of the abolition of interest rate ceilings, whose primary direct beneficiary would be the small and medium sized business enterprise. Indirectly, of course, everyone would gain from the ensuing higher rate of economic growth.

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Notes

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[1] Banco de Portugal 1979, p.

[2] Banco de Portugal 1979, p.

[3] Banco de Portugal 1979, p.

[4] Organisation for Economic Co-operation and Development 1979, p.

[5] Friedman 1976.

[6] Organisation for Economic Co-operation and Development 1979, p.

[7] Korteweg 1978; Laidler 1978.

[8] Fry 1976.

[9] Agheyli and Khan 1977 and 1978; Dutton 1971; Fry 1973; Ness 1972; Nichols 1974.

[10] Banco de Portugal 1978, p.196.

[11] Kapur 1976.

[12] Cardoso 1980.

[13] Fry 1978<u>c</u> and 1978<u>d</u>; Fry and Farhi 1979.

[14] Fry 1977<u>a</u>.

[15] Fry 1979<u>e</u>.

[16] Fry 1979<u>d</u>.

[17] Fry 1978<u>b</u>.

[18] Fry 1978<u>b</u>.

19 Lundberg 1964.

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21 Fry 1976, 1977a, 1978c and 1979d; Fry and Farhi 1979; McKinnon 1973; Shaw 1973.

22 Fry 1979b.

23 Cavaco Silva 1980.

24 Organisation for Economic Co-operation and Development 1979, p.

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27 Fry 1979a and 1979c.

August 31, 1979

MEMORANDUM FOR FILES

Subject: Portugal

I spoke to Mr. da Silva Lopes about his invitation to attend the conference in Lisbon from September 26 to 28. I said that I thought we should not attend. He said that he saw the reasons for disquiet but he had envisaged a Fund observer as playing a silent role and perhaps not being a senior person. I said that I thought the difficulties remained but we would re-think and send a message with Mr. Schmitt.

Is there any advantage, provided our discussions are concluded by September 26, in asking Mrs. Ter-Minassian or Mr. Mitra to stay on for a couple of days?

I also asked about the timing of elections and was told that nothing was certain but that January was now being mentioned as a possibility.

L.A. Whittome

cc: Mr. Schmitt
Mr. de Fontenay

Mr. Whittome

August 28, 1979

MEMORANDUM FOR THE FILES

Subject: Portuguese Economic Policy

Some remarks made by Finance Minister Sousa Franco in his intervention in the debate on the program of the Fifth Constitutional Government and reported in the Portuguese press may be of interest.

1. The Minister stated that for the remaining months of 1979 the maintenance of the competitiveness of the Portuguese economy and prevention of an acceleration in the cost of living in the face of an increase in the price of food products, particularly those imported, required the maintenance of the present system of gradual devaluation of the escudo. An increase in the monthly rate of depreciation was, however, not necessary.

2. The Minister stated that negotiations with the IMF would commence only when he judged the time to be opportune and that such negotiations would not affect the investment priorities of the Portuguese economy or those of internal politics.

3. The Minister warned that a deterioration in the deficit of the government's budget was to be expected. He expected that receipts would fall behind budgetary estimates owing to the delay in the approval of the budget and the promulgation of the complementary legislation. It appears that receipts until April 1979 have been Esc 10 billion below estimates. The estimates for expenditures would be considerably exceeded. The Minister stated that if the Government was to implement the recent law on the wages of civil servants (a 30 per cent increase was awarded), maintain the quality of public services, support the deficit of the Fondo de Abasticimento following the increase in petrol prices, pay interest on public debt and keep the subsidies of public enterprises at the same nominal levels as that of 1978, the budget deficit would increase by Esc 20 billion according to provisional forecasts. The first revised forecast of the deficit amounted to Esc 121 billion. Even a deficit of this magnitude would only be realized at the cost of additional great sacrifices. The Minister would not sanction public expenditures that had been provided for even by the law, if such expenditures would render the forecast for overall expenditures and the deficit to be beyond what had been authorized by Parliament.

4. The Minister added that it was the Government's intention to put the public enterprises on a sounder financial footing and better management and that these could not be attained by extending increasing subsidies to them, however popular such a measure may be. Various projects of the public enterprises would be delayed or cancelled as the available financing is being exhausted.

5. No mention was made of the pricing measures that we expect the Government to take, but this is not surprising given the context of the intervention.

6. The Government favored a reduction in the discount rate accompanied by an adjustment of the interest rates on both the assets and liabilities side of the financial institutions.

SM

Saumya Mitra

cc: Mr. Whittome
Mr. Schmitt
Mr. Dhonte
Mrs. Ter-Minassian

cc: SED

Portugal

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RUA GONÇALO SAMPAIO, 329 - 3.º Dto. PORTO TELEF. 69 49 50 - 69 49 59 TELEX 22853, COSEC - P PORTO

INTERNATIONAL MONETARY FUND
19th and H. Street, N.W.
WASHINGTON, DC20431
U.S.A.

SUA REFERÊNCIA

SUA COMUNICAÇÃO DE

NOSSA REFERÊNCIA RE-434/79

DATA 27 AGO. 1979

ASSUNTO :

Dear Sirs,

This is merely to inform you that, by decision of the Government, Dr. Antônio Bagão Félix, member of the Board, has been replaced by Dr. José Sales Henriques.

With kindest regards, we remain,

Yours faithfully
Companhia de Seguro de Créditos, E.P.
THE MANAGEMENT BOARD

Alberto Regueira

August 24, 1979

MEMORANDUM FOR FILES

Subject: Portugal--1980 Elections

Mr. Mendes, Political Counselor at the Portuguese Embassy, tells me that Article 177 of the Portuguese Constitution provides that the annual legislative session of the Assembly of the Republic shall be held between October 15 and June 15. Another article provides that the Assembly of the Republic shall meet on the tenth day after the final result of the election. The Constitution also requires an election to be held in the fifth year after the election of 1976. From these provisions Mr. Mendes draws the conclusion that the 1980 election will be held at the beginning of October and that the new Assembly of the Republic shall meet on October 15, 1980.

SD

Saumya Mitra

cc: Mr. Whittome
Mr. Schmitt
Mr. Dhonte
Mrs. Ter-Minassian

ell. Whittome

2

Office Memorandum

TO : Mr. Mitra

DATE: August 22, 1979

FROM : T. Ter-Minassian T.T.M.

SUBJECT : Portugal--Indicators of Fiscal Stimulus

I thought it useful to spell out in more detail some reservations I have about your indicators of fiscal impact in Portugal with a view to stimulating a discussion among the members of the team on this rather important issue.

As I understand it, your concept of cyclically neutral balance differs significantly from that developed by the German Council of Experts and utilized in our WEO exercises. You calculate the cyclically neutral balance by assuming a constant ratio of taxes to potential GDP and of expenditure to actual GDP, while the Germans postulate a constant ratio of taxes to actual GDP and of expenditure to potential GDP. Your indicator thus seems more akin to the full employment budget surplus 1/ than to the German concept. The attached table shows estimates of the cyclically adjusted balance (PSBR) for the years 1974-80, calculated according to the German method. It can be seen that there are significant differences, compared with your estimates.

A more serious objection that I have regards your interpretation of the difference between the actual and the cyclically neutral balance as an indicator of excessive fiscal stimulus. The cyclically adjusted balance can at best provide an indication of the "appropriate" fiscal posture if GNP was at its potential level. It cannot provide an indication of what the budget should be like when income falls below potential. The gap between actual and cyclically adjusted balance provides no more than a qualitative indication of the direction of fiscal impact. At best it can be regarded as an ordinal measure, in the sense that an increase in the gap indicates an additional degree of stimulus. I say at best because I believe that an unambiguous indicator of fiscal impact could only be arrived at by wighting the various budgetary items in such a way as to reflect their relative effects on demand. Line 4 in the attached table shows the changes in the cyclical effects of the budget. It indicates that the public sector budget became more expansionary every year from 1974 to 1979. It also suggests that the budget balance proposed in your program for 1980 would provide a substantial withdrawal of stimulus to the economy.

Attachment

cc: Mr. Whittome
Mr. Schmitt
Mr. de Fontenay
Mr. Dhonte

1/ Except for the fact, in the full employment surplus calculations, expenditure are taken at their actual level rather than as a constant ratio to GDP.

Portugal: Fiscal Stimulus 1/

(In billions of escudos)

	1974	1975	1976	1977	1978	1979 2/	1980 Unchanged policies	1980 Program
1. Actual overall balance of the public sector	-7.1	-18.5	-32.9	-45.5	-79.3	-106.0	-145.0	-86.0
2. Cyclically adjusted balance	-7.1	-16.4	-16.7	-19.9	-26.8	-35.9	-42.0	-46.7
3. Cyclical effects of the budget (1-2)	--	2.1	16.2	25.6	52.5	70.1	103.0	39.3
In per cent of GNP	--	0.6	3.5	4.1	6.7	7.1	8.0	3.2
4. Fiscal stimulus 3/ in per cent of GNP	...	0.6	2.9	0.6	2.6	0.4	0.9	-4.8

Sources: Bank of Portugal, Annual Report; and staff calculations.

1/ The calculations are based on the standard methodology of cyclically neutral budget. See: Dernburg, T.F.: Fiscal Analysis in the Federal Republic of Germany: The Cyclically Neutral Budget, IMF, Staff Papers, November 1975. The real rate of growth of potential GDP is assumed at 4 per cent. 1974 is taken as base year.

2/ Staff projection.

3/ Year-to-year changes in the cyclical effects of the budget.

8/21/79

cc. Whittome

August 9, 1979

MEMORANDUM FOR FILES

Subject: Portugal--Budget Deficit

The weekly Expresso has it that Finance Minister Sousa Franco is to be the "super-coordinator" in matters economic. According to a news report of August 4, the Minister has made clear to the Portuguese the grave financial situation he has inherited and that the budget deficit, implicit in the version passed by the Assembly, could reach Esc 140 billion, compared with Esc 78 billion in the budget proposed in May. (In view of certain likely amendments to the budget, particularly deletion of the extraordinary tax on labor incomes, the Fund negotiating team had accepted a ceiling of about Esc 81 billion.) The report goes on to say that Minister Sousa Franco cannot delay for long certain measures that the Mota Pinto government had postponed, such as the increase in prices that had been brought to its attention by the Fund.

SM

Saumya Mitra

cc: Mr. Whittome
Mr. Schmitt
Mr. de Fontenay

r18/b

INTERNATIONAL MONETARY FUND

TO : Mr. Whittome

FROM: Hans Schmitt

This memo was originally composed with half a thought toward leaking it through Lobisa to Silva Lopes. It might have provided him with a little ammunition. Do you see any pay-off in that?

HS
8/3

Spoke to H.S. We agreed that matters seemed to be moving rapidly enough of their own accord.

LAW
6/8

F18K

Office Memorandum

TO : Mr. L.A. Whittome

DATE: August 3, 1979

FROM : Hans Schmitt HS

SUBJECT : Portugal--Recovery Program

The two charts attached here trace the impact of the 1978/79 stabilization program on the main monetary aggregates in Portugal and on associated developments in the real economy. Together I think they argue for maintaining a steady course in economic policy if a sustainable recovery of economic growth is to be assured.

Chart 1 shows increases in money and domestic credit as percentages of the money stock one year earlier. When the two increases are equal, all domestic credit expansion will have been absorbed in domestic money balances, leaving no margin of liquidity to flow abroad as long as nonmonetary items also net out. With no net outflow of liquidity equilibrium in the overall balance of payments will have been attained. The intersection of the two lines on the chart shows that such equilibrium was achieved over the year ending in the first quarter of 1979. The question is, at what cost in terms of economic activity?

Chart 2 shows that industrial production, after a strong recovery from the 1975 slump, continued to grow even in the stabilization period, as a rapid expansion in production for exports compensated for restraints on output for the domestic market. Thus the restructuring of the economy necessary for external adjustment did not seriously constrain the momentum of economic activity in Portugal. Indeed, though business expectations slumped in the middle of last year, they have shown renewed buoyancy from the fourth quarter onward.

To complete this shift toward a sustainable structure of growth, it is important for policy to hold to a steady course. First, domestic credit expansion should continue to be limited to the increase in the domestic demand for money balances; to keep the demand for money in line with domestic credit requirements, a high rate of interest must continue to be maintained. Next, to allow an increasing portion of the permissible supply of domestic credit to go to the expanding export sector, the government deficit must progressively be reduced.

To encourage the required structural adjustment, exchange rate policy must continue to equalize domestic and external inflation rates. A slower rate of depreciation than this would place Portuguese exports--and import substitutes--at an unnecessary competitive disadvantage. Lastly, if external borrowing is to make a positive contribution to economic recovery, it should be limited to financing the import requirements of productive investment. Financing additional imports beyond that would again place domestic production at an unnecessary competitive disadvantage.

In sum, a recovery program will have to be based on continued domestic austerity. Such austerity may be difficult to sustain in a fluid political setting without the underpinning of a new stand-by arrangement.

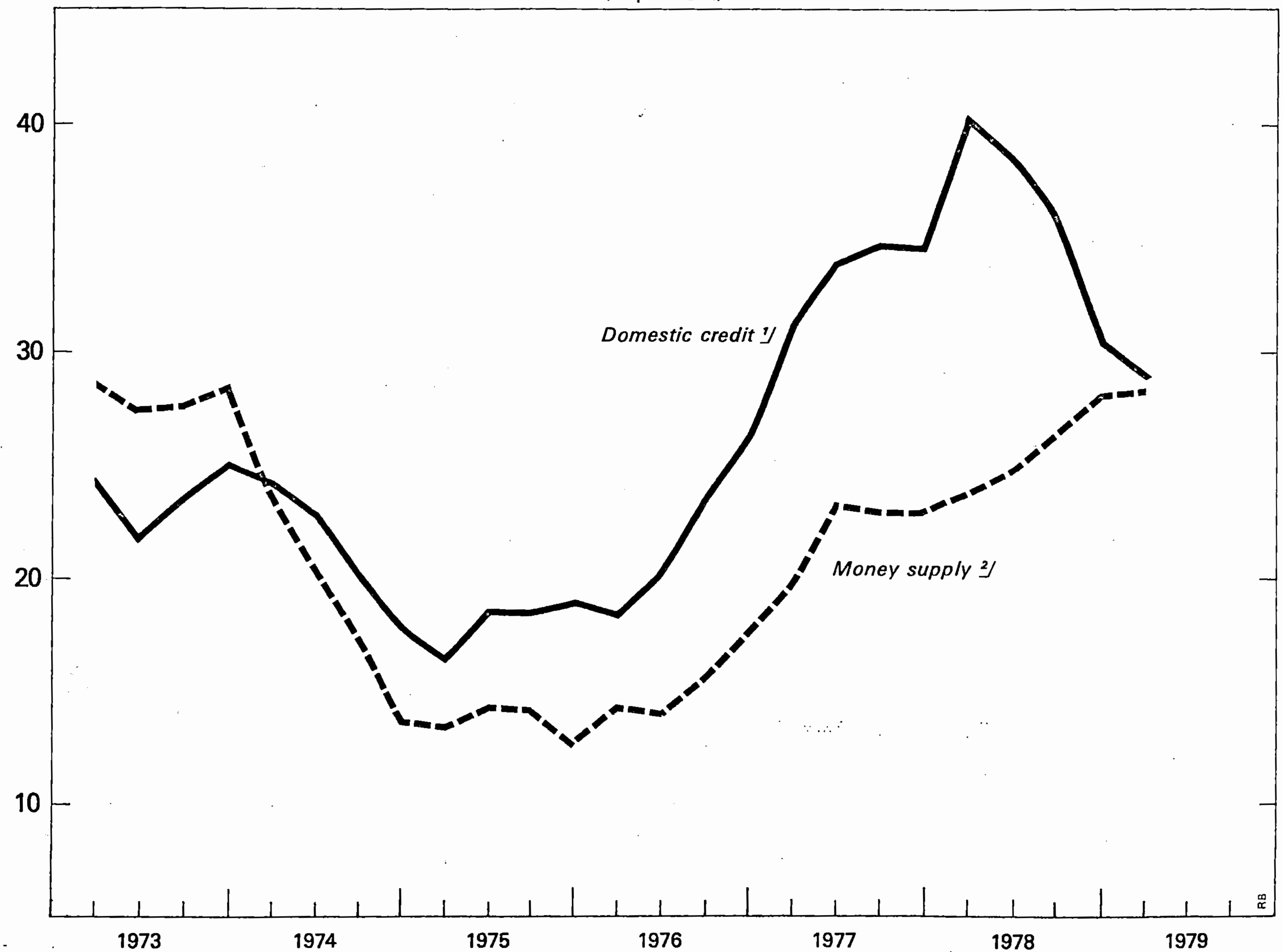
Attachments

CHART 1

PORTUGAL

DOMESTIC CREDIT AND MONETARY EXPANSION

(In per cent)

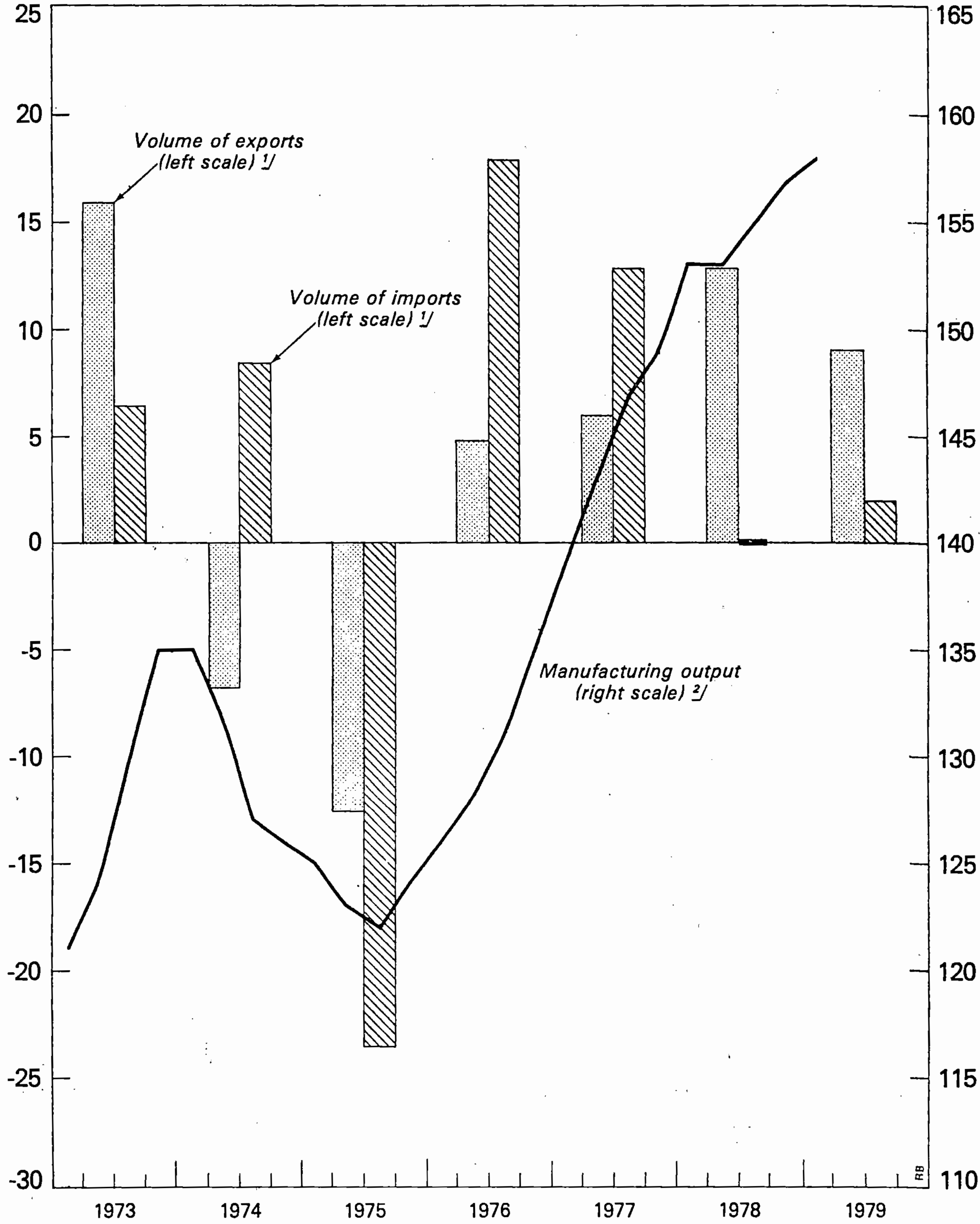


Source: Data provided by the Portuguese authorities.
1/ Domestic credit expansion during previous 12 months as percentage of money stock at beginning of period.
2/ Increase in M2 over previous 12 months.

CHART 2

PORTUGAL

SELECTED OUTPUT INDICATORS



1/ Percentage change from previous year.
2/ 1971 = 100.

PORTUGAL

August 1, 1979

MEMORANDUM FOR FILES

Subject: Managing Director's Lunches with Executive Directors

At the lunches held last week I spoke in the following terms:

Turkey

1. Reference to the rapid rise in central bank money in late June and early July but with some reassuring noises based on Woodward's messages.

2. Summary of results of most recent debt rescheduling meeting.

3. Summary of political timetable.

4. Reference to "precondition" element in November review.

Portugal

1. Summary of Mr. de Fontenay's visit and its outcome.

2. Reminder of political timetable.

3. Reasonable prospect that external financing adequate through the 1980 election.

Israel

1. Inflation accelerating--may reach 100 per cent.

2. Current account's rapid deterioration -$3.8 billion in 1979 and perhaps -$5.0 billion in 1980 representing 43 per cent and 55 per cent of GDP respectively.

3. External financing presently assured through the United States.

4. Summary of political situation

Romania

1. Deterioration of current account since end 1978 due to terms of trade and very high rates of growth.

2. Estimates of current account deficit with convertible area being $1 billion in 1979 and $1 1/4 billion in 1980.

3. Reminder that Romania is now a net oil importer and several important new projects are based on oil.

Yugoslavia

1. Deteriorating current account -$1 1/2 billion in 1979 and -$1 3/4 billion in prospect for 1980.

2. Fear of unemployment.

The only other country on which a direct question was put was Spain, to which I gave a generally reassuring reply.

L. A. Whittome

Office Memorandum

TO : Mr. Whittome

FROM : Hans Schmitt

DATE: July 31, 1979

SUBJECT : More on Portugal

Mr. Labisa, the Alternate Executive Director for Portugal at the World Bank, called me for a personal chat about the new cabinet in Lisbon. He calculates the vote of confidence will come on August 17, with the elections to follow around the middle of November. A successor cabinet is unlikely to be confirmed until about Christmas. Meanwhile the present team would have to begin formulating a 1980 budget, he thinks, and raise prices at least on gasoline.

He confirms that the new minister of finance, Mr. Sousa Franco, was one of the Social Democrats who recently broke away from the Sa Carmeiro loyalists in the hope of making an accomodation with Soares' Socialists. He is a prominent professor of public finance at the Catholic University of Lisbon, and was once a secretary of state in the Finance Ministry.

The Minister of Economics and Planning, Mr. Correia Gago was foreign minister under Soares sometime back, and has since then been chairman of the Board of Petrogal, the Portuguese petroleum company. He was at one time head of the planning office when it was still in the Prime Minister's office. Mr. Labisa did not know how close he is to Sousa Franco, but thought they both belonged to the liberal Catholic movement that the new Prime Minister is also very prominent in.

The Minister of Industry, Mr. Marques Videira, when secretary of state for industry negotiated a power loan last January with the World Bank, and has since been on the Board of the State Power Company (E.D.P.). The new Minister of Transport has until now been head of the Portuguese airline (T.A.P.).

Mr. Labisa could say very little about the new Ministers of Agriculture, Commerce, and Labor.

Taking the cabinet as a whole Mr. Labisa thought care must have been taken to position the cabinet neatly between Mr. Soares Socialists and Mr. Sa Carneiro's Social Democrats by excluding any close associates of either.

cc: Mr. de Fontenay
Mrs. Ter-Minassian
Mr. Mitra

Office Memorandum

TO : Mr. Whittome

FROM : Hans Schmitt HS

DATE: July 31, 1979

SUBJECT : Portugal--New Government

A.F.P. reports from Lisbon that the "grey eminence" behind Mme. Pintasilgo, the new Prime Minister, is Mme. Manuela Silva, who does not now hold any formal office but was State Secretary for Planning in Mr. Soares first Government. She resigned in 1977, in protest over the course of the negotiations with the Fund, and is now reported as defending a greater autonomy for Portugal from international financial organizations such as the Fund.

cc: Mr. de Fontenay

July 19, 1979

MEMORANDUM FOR FILES

Subject: Portugal

If my haphazard, and very limited, knowledge of Portuguese has not led me too astray, it appears that it will be necessary for President Eanes to appoint a caretaker prime minister for the 90-day run up to the general election. This prime minister and his program has to be approved, or at least tolerated, by the National Assembly, which will apparently vote to this end prior to its dissolution. It appears that Senhor Mota Pinto will have to make way as his government had chosen to resign last June, and the name of the present Minister of Finance, Manuel Jacinto Nunes, is one of the three being mentioned most frequently for the caretaker position. In the event of his appointment, the Portuguese government may well decide to be more forthcoming on the public tariff measures that are the preconditions for a stand by arrangement with us.

cc: Mr. L.A. Whittome
Mr. Hans Schmitt
Mr. Patrick de Fontenay

SM

Saumya Mitra

Office Memorandum

TO : Mr. L.A. Whittome

FROM : Hans Schmitt

DATE: July 19, 1979

SUBJECT : Portugal

You have no doubt seen the attached clipping from the Financial Times of July 18. The $300 million consortium loan, which had originally been predicated on a Fund stand-by, has gone through without it, on the basis of the recent performance of the Portuguese economy. We can perhaps draw satisfaction from this. After all, the more successful a stand-by the sooner should it make us redundant. Such a view would be too complacent, though. On our present calculations, the need for compensatory financing will again rise from US$150 million in 1979 to US$280 million in 1980. Commercial banks should not be relied on to finance the whole, at least not without some assurance that further adjustment is likely to eliminate the gap, within some reasonable horizon. Perhaps this is the sort of pitch we should make to the Portuguese at the Annual Meetings?

Attachment

cc: Mr. de Fontenay
Mrs. Ter-Minassian
Mr. Stuart
Mr. Mitra

Portuguese economic outlook brightens

By Jimmy Burns
In Lisbon

PORTUGAL yesterday signed a $300m syndicated loan which it has been negotiating with a group of international banks since May.

The loan is for ten years, with a grace period of five years, and will carry an interest rate of ⅞ per cent over Eurodollar interbank rates (Libor) for the first eight years and ⅞ per cent for the last two years.

The following banks have subscribed to the loan as equal managers: Bankers Trust International, Crédit Lyonnais, Dresdner Bank Aktiengesellschaft, Gulf International Bank, Al-Ubaf Group, IBJ International, Kreditbank Luxembourgeoise, Lloyds Bank International, L'Union Bank of Switzerland and Westdeutsche Landesbank Girozentrale.

The signature has coincided with the release by the Bank of Portugal of provisional figures confirming a substantial improvement in the country's balance of payments.

Portugal's current account deficit during the first quarter of this year was $67m compared with a deficit of $433m during the same period last year. This brought the overall balance of payments in this period to a surplus of $54m, compared with a deficit of $401m in the first quarter of 1978.

The latest figures are encouraging, since they cover a season during which Portugal's traditional inflows of tourism and immigrant remittances are at their lowest ebb. Tourism revenue in this period reached a surplus of $101m compared with a surplus of $53m in the first quarter of 1978. Private transfers (mainly immigrant remittances) showed a surplus of $475m against a surplus of $288m last year.

Portugal's trade position has also continued to improve. There was a trade deficit of $465m, compared with a deficit of $628m in the same period last year. Imports increased by 8 per cent, to $1.2bn, while exports increased by 35 per cent, to $756m.

The most dynamic sectors were textiles (up 42 per cent), which account for one-third of Portugal's total exports; leather goods (up 33 per cent) and agricultural products – mainly tomato concentrate and food – which moved up 47 per cent.

Oil imports, which are Portugal's

Oil imports, which are Portugal's second major import item, increased by 13 per cent over the year.

The figures suggest that Portugal is well in line with the official target for the overall current account deficit this year of around $800m. Tourist revenue and immigrant remittances are expected to increase substantially during the next two quarters, and this should largely compensate for a slackening in exports and an increase in imports.

While industrial output has been virtually stagnant during the first quarter of 1979, the forecast increase for the year is around 2.3 per cent. Moreover, companies are beginning to accumulate stocks to deal with the recession and inflationary pressures.

Mr Whittome

Office Memorandum

cc: SED

TO : Treasurer
Internal Auditor
Director, European Department
General Counsel

DATE: June 22, 1979
5.30 p.m.

FROM : The Secretary Katherine F. Magurn

SUBJECT : Portugal - Schedule of Repurchases

This is to advise you that within the time specified no Executive Director has expressed an objection to the matter set out in EBS/79/332 (6/19/79).

Accordingly, the Executive Board's approval is assumed and will be so recorded.

SEC-14
10-19-73

Mr. Whittome

Office Memorandum

TO : Mr. Dannemann

DATE: June 19, 1979

FROM : Hans Schmitt HS

SUBJECT : Portugal--Balance of Payments

May I draw your attention to the attached memorandum to illustrate one of the concerns I expressed to you during your recent meeting with European Department representatives.

Attachment

cc: Mr. Whittome
Mr. Stuart

What a dreadful mess

BR.
6/19

Mr. Schmitt

June 18, 1979

MEMORANDUM FOR FILES

Subject: Portugal—Balance of Payments and IFS

I received a phone call last week from Miss Santoro of Morgan Guarantee in New York. Like other close observers of the Portuguese economic situation, Miss Santoro had been under the impression that Portugal's external current account deficit had declined substantially in 1978, i.e., from US$1.5 billion in 1977 to US$776 million in 1978. At the time she was telling this story to senior people in her bank, a number of her colleagues were doing an intercountry comparison and given the nature of such an exercise, had reverted to the June issue of IFS. The balance of payments data presented there suggested a markedly different picture--i.e., a deterioration in the current account deficit from US$1,106 million in 1977 to US$1,479 million in 1978. Miss Santoro noted the upward revision in 1977 exports (from US$2,028 million in the May issue of IFS to US$2,558 million in the June issue) and the somewhat smaller revision in 1977 imports (from US$4,534 million in the May issue to US$4,676 million in the June issue) and asked if I had any details on these revisions. I indicated that, like her, I was not accustomed to using IFS as my primary source of data. I suspected that the revision in the export data was the result of the long awaited inclusion of gold sales by the monetary authorities as a merchandise export, but was at a loss to explain the revision in the import figure.

I subsequently contacted Mr. Simon Quin in the Bureau of Statistics and he confirmed that the market receipts from gold sales in both 1977 and 1978 had been included as merchandise exports. After further checking, he discovered that the Portuguese had included the sales of gold valued at official prices as a counterpart item in merchandise imports. I asked him why there was no correspondingly large number for line 78 c.d. "Counterpart to Monetization/Demonitization of Gold." Mr. Quin indicated that apparently the Portuguese had incorrectly interpreted the instructions supplied to them by the Bureau on the way to handle transactions in gold.

I tried to resist repeating our old arguments against including what should be a financing operation as a current account operation and recalled the statement from Mr. Bonter's January 23, 1979 to Mr. Schmitt "Portugal: Treatment of Gold Transactions in the Balance of Payments":

"The future implications of this for any RED paper are that, whatever summary presentation of the balance of payments is preferred, the current account should include, and, if necessary, clearly identify within it, any sales of gold by the monetary authorities to foreign buyers other than monetary authorities that were evidently undertaken for the purpose of increasing their foreign exchange holdings; the text could then discuss that current account balance as well as any alternative that was judged to be more relevant for the purpose of interpreting events."

I suggested to Mr. Quin that acceptance of this sort of compromise would require an additional line in the IFS presentation showing gold transactions, which could be included or excluded according to the user's preferences. Mr. Quin replied that this was not possible--there was a limit on the number of lines permitted by IFS. I then suggested that the gold operations should be included in line 79 K.D. "Total changes in Reserves" leaving the current account unaffected. Mr. Quin replied that this would not be possible, as that would be counter to the rules established in the Bureau's very own manual, which would apparently be worse than presenting highly misleading information. I told Mr. Quin that in my opinion the balance of payments data shown in the June issue of IFS were of less than no value.

The major reason for the discrepancy between the total of the 1978 column for the current account deficit in the June issue, US$1,479 million versus the official estimate of US$776 million, is that for the fourth quarter, only a net figure for lines 77 a.c.d. and 77 a.d.d. was provided by the Portuguese. This net figure, a deficit, was recorded as a debit item in line 77 a.d.d. As no credit figure for the fourth quarter was shown, the total figure for 1978 for the credit line was omitted. To be sure, a careful researcher would have been warned off the 1978 column by the three dots. But for purposes of completeness, an annual credit figure, consistent with the quarterly data available, should have been US$821 million, rather than the three dots shown. If this figure were included, the current account deficit shown would be US$658 million. The discrepancy between this figure and the official estimate is explained by the gold sales that occurred in the first half of 1978 and the way they are treated by the Bureau.

BCS.
Brian C. Stuart

cc: Mr. Schmitt
Mr. de Fontenay

Mr. Whittome o/r

June 13, 1979

MEMORANDUM FOR FILES

Subject: Bankers Trust on Portugal

Mr. Deschamps of Bankers Trust called me regarding Portugal. They are leading a consortium that is putting together a US$300 million loan for the Portuguese Government drawings on which are to be contingent on Portuguese "eligibility" to draw on the Fund. In response to his specific questions I told him that the old stand-by having run out the Portuguese are not now in a position to draw at all. The negotiations for a new one were interrupted by the fall of the Government. If a new government were to ask us to resume negotiations the government budget would again be an issue. I had no objection to Mr. Deschamps telling the Portuguese that he knew this. I stressed that the underlying position of the Portuguese economy remained sound for the present but that it needed consolidation.

HS

Hans Schmitt

cc: Mr. Whittome (o/r) ✓
Mr. Rose
Mr. de Fontenay
Mr. Stuart

Reply via RCA: call 212-248-7000

248331 IMF UR
RCA JUN 11 1005
248331 IMF UR

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INFUND PARIS, JUNE 11, 1979

1979 JUN 11 AM 10: 10

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CABLE
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INTERFUND
WASHINGTON DC

FOR BRIAN ROSE

CC: DE FONTENAY

1. SILVA LOPES TELLS ME THAT NEW GOVERNMENT HAVING SUPPORT OF THE PRESIDENT AND A MAJORITY IN THE ASSEMBLY WILL BE FORMED SHORTLY.

2. NEW GOVERNMENT WILL IMMEDIATELY INCREASE PRICES BUT WHETHER BY ENOUGH TO KEEP SUBSIDIES WITHIN TOLERABLE LIMITS REMAINS A QUESTION.

3. MOREOVER, SILVA LOPES WARNS THAT, AS PATRICK IS WELL AWARE, THE CONTROL OVER EXPENDITURE IS NOT AS STRONG AS DESIRABLE. MOREOVER, HE WARNS THAT WE MAY NOT YET HAVE REALIZED THAT THE REVENUE FIGURES ARE WEAKER THAN THEY SEEM.

4. FOR PRESENT, IF NEW GOVERNMENT IS APPOINTED AND IF PRICE MEASURES ARE TAKEN, WE MAY WELL BE INVITED BACK IN SAY FOUR TO SIX WEEKS. I HAVE SAID WE WOULD RESPOND POSITIVELY.

REGARDS

ALAN

INFUND PARIS

248331 IMF UR
INFUND PARIS

RCA Global Telegram

6011k basel ch
517ye tgptt ch
zczc kjb060 nsw771 lca107
washington dc 091/089 08 1750 page 1/55

Portugal

jgx5375
whittome
3 kings hotel
(4000)basle

constancio called (1) according to him damage to budget has been limited the only difference with what we had foreseen was an additional 1 billion for local authorities this is surprising given press report to the contrary and nunes resignation (2) eanes is trying to form a new government if

coll 3 (1) 1 (2)

lca107 whittome page 2/34

he does not succeed within two weeks elections will be called (3) the present government is unlikely to take price measures (4) he is joining silva lopes in basle best regards fontenay interfund wsh

coll (3) (4)

nnnn 09/06/79 0135

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Whittome

3 Kings Hotel

Basle

Switzerland

Constancio called. (1) According to him damage to budget has been limited: the only difference with what we had foreseen was an additional 1 billion for local authorities. This is surprising given press reports to the contrary and Nunes resignation. (2) Eanes is trying to form a new government; if he does not succeed within two weeks elections will be called. (3) The present government is unlikely to take price measures. (4) He is joining Silva Lopes in Basle.

Best regards.

Fontenay

Distribution

MESSAGE MUST END HERE

Drafted by: P. de Fontenay

Department: European

Date: June 8, 1979

P.de Fontenay

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~~Mr. L. A. Whittome~~

~~C/o Paris Office~~

Special Instructions

Patrick would like to talk to you about Portugal if you have time to telephone Friday.

Brian

Interfund

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Drafted by: Brian Rose

Department: European

Date: June 7, 1979

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Brian Rose	Brian Rose

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SEC-17/OCR
9-2-76

May 31, 1979

MEMORANDUM FOR THE FILES

Subject: Portugal

Mr. de Fontenay met yesterday with Mr. Syvrud and briefed him on the present position. We told him that any help that the U.S. Embassy could give would be useful. I later spoke to Mr. Pieske along similar lines. Mr. Syvrud telephoned me this morning to say that he had spoken to Mr. Bloomfield, the U.S. Ambassador to Portugal, who is presently in Washington.

Mr. Bloomfield said that he was very much in agreement with the line of thought that Mr. de Fontenay had followed and would on his return to Lisbon seek an immediate audience, probably with the President. Mr. Syvrud went on to say that he had spoken to Mr. Pieske and had agreed with him that it would useful if the German Ambassador in Lisbon would take a similar line.

L. A. Whittome

cc: Mr. de Fontenay

Office Memorandum

TO : Mr. Whittome

DATE: May 31, 1979

FROM : P. de Fontenay

SUBJECT : Portugal - Prices

Mr. Pieske was in the Board, but I spoke to Dr. Laske. I told him that we had not set specific targets for individual prices. We had required that price increases more than cover the cost increases incurred by the public enterprises and thereby be consistent with the reduction in the subsidies to those enterprises shown in the budget. We roughly calculated that this should involve a price increase of 25-30 per cent. Telephone prices have already been raised by 30 per cent. They now need to raise prices and rates for electricity, water, gas, urban transportation and railroad fares. We have also asked that they raise the price of oil products to more than cover recent increases in oil prices. The main reason for this is that the difference between the buying price of oil and the selling price to the consumer is used to subsidize a basket of basic consumer staples. There, also, the amount shown in the budget for subsidies to the "basket" is not consistent with the prices presently charged for gasoline and other oil products.

C S E H R

OFFICIAL MESSAGE

Portugal

cc: SED

COSEC

COMPANHIA DE SEGURO DE CRÉDITOS, E. P.

TELEX 12885, COSEC - P - TELEG. COSEC, LISBOA
AVENIDA DA REPÚBLICA, 58 TELEF. 76 01 31 - 76 70 75 LISBOA 1
RUA GONÇALO SAMPAIO, 329-3.º, DTO. TELEF. 69 60 39 - 69 69 67 PORTO

International Monetary Fund
19th and H. Street, N.W.
WASHINGTON, D.C.20431
U. S. A.

ORIG: EUR

SUA REFERÊNCIA	SUA COMUNICAÇÃO DE	NOSSA REFERÊNCIA	DATA
		RE-257/79/48.1	1 6 MAIO 1979

ASSUNTO :

Dear Sirs,

This is merely to inform you that the Management Board of our Company has ceased its functions as per the 30th April 1979, according to the Decree-Law nº72/76.

The members of the now appointed Management Board are the following:

- Dr. Alberto Regueira - Chairman
- Dr. Antônio Bagão Félix - Member of the previous Management Board
- Dr. José de Alarcão Troni - Member.

In a near future, there will be a personal contact of our Chairman with your Company.

With kindest regards, we remain,

Yours faithfully
THE MANAGEMENT BOARD

Alberto Regueira Antonio Felix

Portugal

OFFICIAL MESSAGE
INTERNATIONAL MONETARY FUND

Washington, D.C. 20431

DISPATCHED 22 PM 6 12

Cc: SED PdeF

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ADDRESS

MR. P. DE FONTENAY
HOTEL TIVOLI JARDIM
~~C/O BANCO DE PORTUGAL~~
LISBON, PORTUGAL
~~RUA DO COMERCIO 148~~

~~LISBON 2 PORTUGAL~~

Special Instructions

NO.

1. YOUR TELEX MAY 21, 1979. TO REQUEST POSTPONEMENT OF REPURCHASE ~~COMPENSATORY FINANCING PURCHASES~~, PORTUGUESE AUTHORITIES SHOULD SEND A CABLE ALONG FOLLOWING LINES TO FUND:

QUOTE

REFERENCE PORTUGAL'S PURCHASE EQUIVALENT TO SDR 58.5 MILLION COMPLETED ON JULY 2, 1976 UNDER COMPENSATORY FINANCING DECISION. (IN VIEW OF PORTUGAL'S BALANCE OF PAYMENTS DIFFICULTIES) WE PROPOSE THAT REPURCHASE IN RESPECT OF ABOVE PURCHASE BE MADE IN ACCORDANCE WITH THE FOLLOWING SCHEDULE: (INSERT SDR EQUIVALENTS OF INSTALLMENTS AND PRECISE DUE DATES). ~~S AND PRECISE DUE DATES)~~

UNQUOTE

2. TO PRECLUDE POSSIBILITY OF DELAY BEYOND FIVE YEAR PERIOD, FINAL INSTALLMENT SHOULD BE SCHEDULED AT LEAST TEN BUSINESS DAYS BEFORE ~~BEYOND~~ END OF FIVE YEAR PERIOD.

3. UPON RECEIPT OF PORTUGAL'S REQUEST, TREASURER'S /C

Distribution

CC: TRE
MD
DMD
MR. DINI
LEG
RES
EURO
ETR
SEC

MESSAGE MUST END HERE

Drafted by: MLPeery/ch
Department: TRE
Date: May 22, 1979

Anna Watkins NAME (TYPE) SIGNATURE

NAME (TYPE) SIGNATURE

FOR CABLE ROOM USE ONLY

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OFFICIAL MESSAGE
INTERNATIONAL MONETARY FUND
Washington, D.C. 20431

IMF
1979 MAY 22 PM 6 13
TIME RECEIVED

ADDRESS

MR. P. DE FONTENAY

PORTUGAL

- 2 -

DEPARTMENT WILL PREPARE ~~XXXXXX~~ PAPER FOR BOARD CONSIDERATION,

CONTAINING ECONOMIC JUSTIFICATION SUPPLIED BY AREA

DEPARTMENT.

TEST NO.

TREASURER'S

INTERFUND

Special Instructions

Distribution

MESSAGE MUST END HERE

Drafted by: MLPeery/ch

Department: TRE

Date: May 22, 1979

Anna Watkins
NAME (TYPE)

SIGNATURE

NAME (TYPE)

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FOR CABLE ROOM USE ONLY

No. of words: Log: Route: Operator:

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cc: SED

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1979 MAY 21 AM 8:54
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ROOM

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MRS ANNA WATKINS INTERFUND
WASHINGTONDC20431

ORIG: TRE
CC: MR. DINI
EURO

PORTUGAL WANTS TO SPREAD ITS COMPENSATORY
FINANCING REPURCHASES DUE JUNE 30 AND JULY 1 OVER THE
NEXT TWO YEARS DUE TO EXPECTED TIGHT FOREIGN EXCHANGE
SITUATION WOULD YOU PLEASE KINDLY CABLE ME THE PROCEDURE THEY MUST
FOLLOW AND INFORMATION THEY SHOULD PROVIDE IN ORDER TO

COL 20431 30 1

CD0005 MRS ANNA PAGE/2

APPLY FOR SUCH A POSTPONEMENT OF THEIR REPURCHASE OBLIGATIONS
BEST REGARDS
P. DE FONTENAY
HOTEL TIVOLI JARDIM LISSBON PORTUGAL
TELEX 12172

COL 12172

NNNN

RCA Global Telegram
Reply via RCA: call 212-248-7000

Office Memorandum

TO : Mr. Whittome

FROM : P. de Fontenay

DATE: May 15, 1979

SUBJECT : Portugal

Mr. Schmitt, Mr. Stuart and I attended a seminar at the Washington Center for Foreign Policy Research with Dr. Mário Soares, Secretary General of the Portuguese Socialist Party and former Prime Minister, as main speaker. Dr. Soares made a clever presentation for an American audience and a strong pitch for the line he is probably trying to sell to the U.S., namely that the current attempts by President Eanes to discredit the political parties are likely, in the long-run, to be detrimental to democracy in Portugal. He criticized the present Government as unable to pursue the policy of austerity which was necessary and in answer to a question by someone from the Center for Strategic and International Studies on the nefarious effects of the Fund's oppressive policies, he showed great understanding of our position. What was most interesting from our point of view was that he confirmed that the National Assembly intended to vote the present Government out of office as soon as the budget had passed. He hoped that an agreement could be reached between the President and himself on the formation of a new Government in which the Socialists would participate but failing that he saw no choice but anticipated elections, even though they would be unlikely to change very much the present composition of the Assembly. He realized also that a period of political instability was undesirable in the present circumstances.

We shall therefore be dealing with a Government which has only a short lease on life. We intend to press for taking now the various measures such as increases in administered prices which are clearly called for, on the grounds that it is likely to be very difficult, if not impossible, to take them later if the country goes through a period of electoral campaigning and political instability. Failing this, however, we shall have little choice but to settle for a first tranche arrangement.

cc: Mr. Pfeifer
SED

McWhittome
9-120

1. F.O.
2. LAW

1907 = PORTUGUESE COST OF LIVING RISES 3.1 PCT I
APRIL:

LISBON, MAY 16 -- PORTUGAL'S COST OF LIVING INDEX ROSE 3.1 PCT TO 185.1, BASE 1976, IN APRIL COMPARED WITH A RISE OF 1.8 PCT IN MARCH, THE NATIONAL STATISTICS INSTITUTE SAID.

THE YEAR-ON-YEAR RISE FOR APRIL WAS 21.5 PCT COMPARED WITH 23.1 THE PREVIOUS MONTH, THE INSTITUTE SAID.

2106 PORTUGUESE GOVERNMENT PRESENTS REVISED 197 BUDGET:

CC: SED

LISBON, MAY 15 - PORTUGAL'S NON-PARTY GOVERNMENT OF PRIME MINISTER CARLOS MOTA PINTO PRESENTED REVISED PROPOSALS TO PARLIAMENT TODAY FOR THE 1979 BUDGET THAT THE ASSEMBLY REJECTED IN ITS ORIGINAL FORM ON MARCH 22.

THE REVISED BUDGET'S MAIN CONCESSION WAS A REDUCTION OF THE CONTROVRSIAL LEVE ON THE 13TH MONTH ANNUAL SALARY BONUS FROM 56 PCT TO 35 PCT

MOST OTHER PROPOSED INCREASES IN DIRECT AND INDIRECT TAXATION REMAINED UNCHANGED FROM THE EARLIER PROPOSALS. THE TOTAL BUDGET WAS ALMOST UNCHANGED AT ABOUT 281 BILLION ESCUDOS.

2109 :REVISED BUDGET 2 LISBON:

THE PROPOSALS WOULD ALLOW THE GOVERNMENT TO RAISE OVER 91 BILLION ESCUDOS IN INTERNAL AND EXTERNAL LOANS, TO MEET THE BUDGET DEFICIT, COMPARED WITH THE 75 BILLION IT EARLIER SOUGHT.

THE REVISED ECONOMIC PLAN FOR 1979, TO ACCOMPANY THE BUDGET, HAS STILL TO BE RELEASED BUT A GOVERNMENT SPOKESMAN SAID IT WILL RAISE THE PROPOSED CEILING ON WAGE AND INFLATION INCREASES THIS YEAR FROM 18 TO 20 PCT.

VOTING ON THE REVISED BUDGET IS EXPECTED TOWARDS THE END OF MAY.

1143 :LISBON BUDGET RAISING INFLATION CEILING TARGET:

Cc: PauF
SED

LISBON, MAY 11 - AN OFFICIAL STATEMENT ON THE INTENDED PORTUGUESE BUDGET CONFIRMED THAT THE REVISED BUDGET AND ECONOMIC PLAN TO BE SUBMITTED TO PARLIAMENT ON MAY 15 WILL SET AN INFLATION AND WAGE RISE CEILING OF 20 PCT THIS YEAR INSTEAD OF THE ORIGINAL 18 PCT. THIS WAS DUE TO THE RECENT INCREASES IN OIL PRICES.

FINANCIAL SOURCES SAID IT WAS HARD TO SEE HOW THE GOVERNMENT COULD MEET THESE TARGETS, AS COST OF LIVING FIGURES FOR MARCH ALREADY SHOW AN INCREASE OVER A YEAR OF 23.1 PCT.

1146 :BUDGET 2 LISBON:

THE 1979 ECONOMIC PLAN MAINTAINS A PROPOSED THREE PCT INCREASE IN THE GROSS NATIONAL PRODUCT. THE GOVERNMENT HOPES TO REDUCE THE BALANCE OF PAYMENTS DEFICIT TO A TOTAL OF 850 MLN DOLLARS BY THE END OF THIS YEAR FROM 1.5 BILLION IN 1978.

Table 1. Portugal: External Debt Projections, 1979-83

(In millions of U.S. dollars)

	1979	1980	1981	1982	1983
1. External current account deficit	800	800	800	800	800
Of which:					
1a. Interest payments on outstanding (disbursed) debt	(380)	(462)	(551)	(641)	(731)
2. Repayments on outstanding debt (including Bank of Portugal's medium- and long-term debt)	839	940	1,092	1,237	1,519
3. Gross financing requirements (1 + 2)	1,639	1,740	1,892	2,037	2,319
4. Drawings on unutilized old loans	80	70	60	50	40
5. Foreign investment inflow (net)	50	55	60	65	70
6. Short-term trade-linked credit (net)	100	105	110	115	120
7. Net financing requirements (3-4-5-6)	1,409	1,510	1,662	1,807	2,089
8. Reserve target (net change)	--	...	...	...	...
9. Reserve-adjusted requirements (7 + 8) (= required drawings from new loan commitments)	1,409	1,510	1,662	1,807	2,089
10. New debt service payments from the year's drawings under item 9	201	216	239	258	298
11. Total debt service payments (1a + 2 + 10)	1,420	1,618	1,882	2,136	2,548
12. Overall debt service ratio (assuming 15 per cent annual increase in exports of goods and services)					
a. Including amortization payments by the Bank of Portugal	35.2	34.8	35.2	34.8	36.1
b. Excluding amortization payments by the Bank of Portugal	26.3	27.1	27.8	27.6	29.6

Source: Data provided by the Portuguese authorities; and Fund staff estimates.

Table 2. Portugal: Balance of Payments 1977-79

(In millions of U.S. dollars) 1/

	1977	1978	1979
	Estimate		Projection
Exports of goods and services	2,890	3,513	4,165
Unit value		6	8
Volume		15	10
Imports of goods and services	5,344	5,713	6,340
Unit value		6	9
Volume		1	2
Balance of trade and non-factor services	-2,454	-2,200	-2,175
Investment income	-179	-327	-415
Private transfers	1,134	1,585	1,790
Current account	-1,499	-942	-800
	(9)	(5)	(4)
Capital movements			
Medium-term and long-term capital, net	95	739	600
Of which:			
Government compensatory borrowing	(--)	(450)	(300)
Short-term and errors and omissions	-33	356	200
Balance on nonmonetary transactions	-1,437	153	--
Overall balance, including government compensatory borrowing	-1,437	-297	-300
Memorandum item:			
Growth in foreign markets	3.3	4.8	5.2

Sources: Data provided by the Portuguese authorities; and staff estimates.

1/ Numbers in parentheses are percentages of GDP.

4/17/79

Table 3. Portugal: National Accounts, 1970-79

	1970-73	1974	1975	1976	1977	1978 1/	1979 2/
	Annual percentage change						
Gross domestic expenditures	9.6	6.3	-8.9	8.2	6.8	0.4	0.7
Private consumption	9.7	9.7	-0.9	2.0	0.6	1.3	--
Public consumption	7.6	17.3	6.6	7.0	8.0	7.8	3.0
Investment	10.8	-8.5	-45.3	32.8	29.1	-6.2	1.6
Of which:							
Gross fixed capital formation	10.9	-7.0	-11.3	1.0	12.0	4.0	1.9
Exports of goods and services	10.9	-15.7	-15.6	--	6.1	15.3	10.0
Imports of goods and services	13.2	4.8	-25.2	3.4	9.6	0.2	2.0
GDP at market prices	8.6	1.1	-4.3	6.9	6.1	3.2	2.0
Memorandum items:							
Partner countries real GNP 3/	4.8	0.6	-1.3	4.2	2.2	3.2	3.3
GDP deflator	7.4	19.4	15.8	16.0	26.0	21.4	20.0
Savings ratio 4/	24.8	19.5	14.1	14.5	19.4	22.6	22.6
Contribution to growth rate of: 5/							
Domestic expenditure	10.2	6.9	-10.2	8.0	8.0	0.5	0.7
Of which:							
Changes in stocks	0.4	-0.8	-8.5	5.2	3.8	-2.4	--
Foreign balance	-1.5	-5.8	5.9	-1.1	-1.9	2.7	1.3

Sources: Bank of Portugal, Annual Reports; National Institute of Statistics, Monthly Bulletin of Statistics; and data provided by the Portuguese authorities.

1/ Preliminary estimate.
2/ Staff projection.
3/ Industrial countries, trade-weighted.
4/ Total national savings, including foreign remittances, as a percentage of total disposable income of households and businesses.
5/ Change in constant prices as a percentage of previous years GDP.

Table 4. Portugal: Comparison of Monetary Projections

	1978		1979		
			Through the Year		
				IMF	
	Average	Through the year 1/	Portuguese proposal	I 2/	II 3/
			Per cent change		
GDP (market prices)	3.2	--	6.0	3.0	4.0
GDP deflator	21.4	25.0	14.0	18.0	18.0
Velocity	-0.6	-2.6	-4.5	--	--
Average money stock	26.0	26.0	27.3	24.5	25.2
December/December money stock	28.3	28.3	26.4	21.5	22.7
Domestic credit expansion as a percentage of initial money stock, end-period	30.3	30.3	31.2	25.2	26.4
			Change in billions of escudos		
Net foreign assets 4/		15.2	-14.7 5/	--	--
Net domestic credit		172.0	233.8	183.6	192.4
Public sector		48.7	60.0	47.2	53.0
Private sector		123.3 6/	173.8	136.4	139.4
Money stock		160.7	198.7	156.5	165.3
Other items, net		26.5	20.4	27.1	27.1

Sources: Data provided by the Portuguese authorities; and staff estimates.

1/ Estimated.
2/ Program as presented to Portuguese.
3/ Maximum acceptable.
4/ Including effect of counting special compensatory borrowing by the Central Government as an above-the-line capital inflow.
5/ The Portuguese have indicated that the Central Government may increase its net foreign borrowing in 1979 by US$300 million or Esc 15 billion. To the extent that such borrowing actually takes place, the net foreign assets of the banking system could show no change, while domestic credit to the public sector could be reduced to Esc 45 billion.
6/ Including credit to public enterprises estimated at Esc 42.2 billion during 1978.

4/17/79

Table 5. Portugal: Public Sector Finances, 1977-79 1/

(In billions of escudos) 2/

	1977 3/	1978		1979	
		Budget forecast	Outturn 3/	Budget forecast	IMF 4/ alternative
Current receipts	173.6	225.9	210.5	279.9	271.0
Direct taxes and contributions to social security	80.5	107.2	103.0	136.3	127.4
Indirect taxes	82.1	106.3	97.4	123.5	123.5
Other	11.0	12.4	10.1	20.1	20.1
Current expenditures	182.1	222.6	238.7	279.3	276.0
Goods and services	87.0	105.8	112.4	136.3	133.0
Subsidies	21.7	28.3	30.5	31.8	31.8
Transfers	61.9	63.5	73.1	82.6	82.6
Interest payments	11.5	25.0	22.7	28.6	28.6
Current balance	-8.5	3.3	-28.2	0.6	-5.0
	(-1.4)	(0.4)	(-3.6)	(0.1)	(-0.5)
Capital receipts	5.3	3.7	3.4	3.9	3.9
Capital expenditures	41.9	54.6	55.1	74.6	74.6
Investmant and transfers	39.8	42.6	43.7	56.9	56.9
Net lending 5/	2.1	12.0	11.4	17.7	17.7
Capital balance	-36.6	-50.9	-51.7	-70.7	-70.7
Other Treasury operations, net	-2.1	-6.0	-4.1	-3.6	-3.6
Overall balance	-47.2	-53.6	-84.0	-73.7	-79.3
	(-7.5)	(-6.9)	(-10.7)	(-7.7)	(-8.3)
Memorandum items:					
Bank credit to public sector	47.8	37.0	48.7	47.2	53.0
Bank credit to Productive sector	138.1	104.7	123.3	145.2	139.4

Sources: Data provided by the Portuguese authorities; and staff estimates.

1/ The public sector is defined to include the central government autonomous funds and services, plus the local authorities and the social security system, but excluding public enterprises.
2/ Numbers in parentheses are per cent of GDP at market prices.
3/ Provisional.
4/ Maximum acceptable deficit.
5/ Net lending by the central administration to the productive sector.

4/17/79

INTERNATIONAL MONETARY FUND

~~Mr Whittome~~

~~Mr Pfeiffer~~

Mr G de Fontenay.

I fear my main trouble is with JG's interpretation as given to the Board for I still see no valid reason why a member with a 'large' financing gap should not use its SFF in the credit tranches & use the SFF in the subsequent years; the presumption would be that in year one finance from other sources would be necessarily available e.g. rollovers.

P. R. Narvekar

29/5

Mr Pfeifer

F.O.

Office Memorandum

TO : Mr. Whittome

DATE: May 15, 1979

FROM : P. de Fontenay

SUBJECT : Supplementary Financing

In connection with the briefing paper for Portugal, Mrs. Lachman commented that the supplementary financing facility could not ~~be used~~ by a country unless that country uses its four credit tranches. She quoted the sentence of the Decision which reads "A request by a member will be met under this decision only if the Fund is satisfied: (i) that the member needs financing from the Fund that exceeds the amount available to it in the four credit tranches..." I told her that I, and others, had understood that sentence as referring to the requirement of need but she insisted that this was the official interpretation of the Legal Department and she sent the attached material to back up her claim. I remain unconvinced but would welcome your own reaction as this will have some bearing on future operations with Portugal, as well, I am sure, with other countries.

Att.

cc: Mr.Pfeifer

The upcoming Peru case would appear at first sight to be inconsistent with this as Fund holdings arising from use of regular resources would remain below 200% of quota (167%, I think). However, this is because of repurchases due during the stand-by period. For this purpose — and this is the important point — purchases are to be considered <u>gross</u>; it does not matter if Fund holdings of currency fall below 200% because of repurchases so long as the gross drawings permitted under the program would permit the country to reach 200%.

PRN
May 25.

Office Memorandum

TO : Mr. Patrick B. de Fontenay DATE: May 14, 1979

FROM : Philine R. Lachman PL

SUBJECT : <u>Supplementary Financing Facility</u>

I am attaching some excerpts from documents of the Fund, which make it clear that use of supplementary financing in conjunction with use of the second credit tranche only would not be in accordance with the decision establishing the Supplementary Financing Facility, even if the unmet need exceeds the remaining part of the upper credit tranches. The Facility was established in order to enable the Fund to provide financing in amounts that would go beyond the four credit tranches.

Attachments: SM/79/84, page 2
EBM/77/121, pages 27-29

4. The amounts that could be purchased by a member qualifying to use the Supplementary Financing Facility under a stand-by or an extended arrangement would depend on a number of factors, including the member's need for balance of payments financing and the availability of supplementary resources to the Fund. The amounts available to a member under such an arrangement will be apportioned between ordinary resources and supplementary financing in proportions prescribed in the decision establishing the Facility, which, however, may be changed by the Fund following a review. The apportionment between ordinary resources and supplementary financing in accordance with the specified proportions will be made on the basis of the facts when the arrangement is granted by the Fund so that the amounts and the ratios established at that time will continue to govern purchases under the arrangement notwithstanding changes in the size of the member's quota or in the level of the Fund's holdings of the member's currency after the date of approval of the arrangement. 1/

5. In accordance with the prescribed proportions a member that has obtained a stand-by arrangement under the decision establishing the Facility permitting it to purchase the unused part of the four credit tranches 2/ would be able, given a balance of payments need, to make additional purchases up to a total equivalent to 102.5 per cent of its quota that would be financed with supplementary resources. 3/ Under an extended arrangement permitting a member to purchase up to 140 per cent of its quota, the member would be able to make additional purchases in an equal amount financed with supplementary resources. 4/ If a member has already used all or part of its credit tranches (whether the use was made before or after the effective date of the Facility), the stand-by arrangement will include the amount of supplementary financing that would have been available under the decision on supplementary financing if the earlier use of the credit tranches had been made under the decision. A similar principle will apply with respect to arrangements under the Extended Fund Facility.

1/ See SM/77/263, Supplement 1, pp. 8-9.
2/ I.e., the amount by which 200 per cent of the member's quota exceeds the level of the Fund's holdings of the member's currency other than those that must be excluded in accordance with a decision under Article XXX(c).
3/ Purchases under a stand-by arrangement will be met with supplementary financing as follows: The equivalent of 12.5 per cent of quota in conjunction with the first credit tranche and of 30 per cent of quota in conjunction with each of the upper credit tranches.
4/ Purchases under an extended arrangement will be met with ordinary resources and with supplementary financing in the ratio of one to one.

make it clear whether or not a country that was eligible to use supplementary financing would still have the option to refuse the supplementary financing and use only the ordinary resources of the Fund in the credit tranches.

The General Counsel responded that his understanding of the facility and the decisions, which was reflected in the drafting, was that if a member's problem was of the character that the supplementary financing facility was intended to cope with, and if the member came to the Fund for a smaller amount of assistance in order to use all the credit tranches first--and perhaps with the intention of using the supplementary financing later--the Fund would respond that it could not safely allow the member to make that more limited use of its resources. The Fund had a whole range of powers to safeguard its resources, and if it concluded that the amount of assistance that a member had requested would not be adequate to solve its problems, the Fund was entitled to refuse the member's request. One of the purposes of the Fund was to safeguard its resources by ensuring that members used them to solve their problems. If the Fund's assessment was that the amount available in the four credit tranches would be inadequate to assist the member in solving its problems, the Fund could say that the member should use supplementary financing at the same time that it used ordinary resources, in accordance with the proposed decision.

Mr. Pieske remarked that he had always understood that the supplementary financing was to be available to a member on an optional basis, so that the member could not be required by the Fund to request supplementary financing. When a member had requested supplementary financing and the Fund had granted the request, the precise amount of the supplementary financing to be available would no longer be at the option of the member. The amount would be based on a specific arithmetic relationship between the use of supplementary financing and the use of ordinary resources. Cf.

The General Counsel commented that the size of the member's problem was at the heart of the facility itself and of the thinking about the facility. In previous discussions there had been some question about the member's choice, that was to say, whether a member could use ordinary resources in the credit tranches, knowing at the outset that the size of its problems would require it to use supplementary financing later. And the question had been raised whether a member should observe a certain proportionality between ordinary resources and supplementary credit. It had been his understanding that those issues had been resolved on the basis of a statement by the Managing Director in which he had stressed that the clue to the whole concept of the new facility was indeed the size of the member's problem. The assumption was that the Fund and the member would be dealing with a massive problem, so that the member would not have the right to say that it wished to receive only a portion of the financing necessary to solve its problem and that the Fund had to provide that relatively limited assistance. The Fund would have to make an assessment of the member's problem, and if the assessment was that the amount of credit in the credit tranches would not suffice to solve the problem, it would then be a matter for discretion or judgment by the Fund whether it would take the risk of allowing the credit tranches alone to be used. If the problem was so large that it was clear that the member was exercising its option in order to avoid parallel use of supplementary financing with the intention of coming in later for supplementary financing, then the Fund was entitled to say to the member that its problem must be dealt with under the decision on the supplementary financing facility if the member wished to receive any assistance from the Fund.

Mr. Ruding remarked that the General Counsel's comments had clarified the situation for him, but he was worried that the draft text would not make the matter clear for other readers.

Mr. Kent noted that the General Counsel, in describing the kind of member that would not have the choice of using only ordinary resources in the credit tranches, had been careful to say that such a member would have known in advance that it needed supplementary financing later. However, the General Counsel had then gone on to describe the member as one that clearly needed a much larger amount of resources than would be available in the credit tranches, and he had implied that the member would not be qualified to use the ordinary resources in the regular credit tranches. He was concerned about the way that the General Counsel's opinion had been expressed; the supplementary financing facility was to be temporary, and the General Counsel's statement had included a slight hint that, in the period after the facility had been terminated, there might be a group of members that could not qualify to use the regular Fund facilities because their needs were larger than the Fund could satisfy. Such an understanding should of course be carefully avoided. In addition, it was obviously not intended that, in the period prior to the implementation of the new facility, the Fund would deny assistance to some members merely because the available amount of the assistance was not sufficient to solve all of the member's balance of payments difficulties. Use of Fund resources was often related to the flow of private capital to a particular member in a way that could not be precisely quantified beforehand, so that there was bound to be an area of doubt about precisely how much assistance the Fund would need to provide to cover a member's entire payments problem. He did not wish to challenge the basic idea that the Fund should encourage members to use supplementary financing together with ordinary resources, but the idea should be carefully expressed.

The General Counsel said that a large element of judgment would be required in the case of each request to use the supplementary financing facility. Access to supplementary financing would not be automatic. There would have to be an assessment. He did not wish to be taken to be suggesting that, in the period after the termination of the supplementary financing facility, a member could be turned away by the Fund because its need was quite large. Such a conclusion did not necessarily flow as a consequence from the establishment of the supplementary financing facility or from anything that he had said. Even after the supplementary financing facility was terminated it would still be possible for the Fund to grant a waiver and to go beyond the four credit tranches. In so doing, the Fund would of course be able to exercise its rights to safeguard its resources. If at the outset the Fund knew that a member's problem was so large that it could be dealt with only by means of ordinary resources plus supplementary financing, it could say that it was not possible for the member to come in for piecemeal assistance. That kind of response was well within the powers of the Fund, and he had assumed that it was part of the essential policy of the proposed decision.

The Deputy Director of the Exchange and Trade Relations Department added that the problem under discussion, namely the circumstances in which the Fund might require the member to request supplementary financing, was not likely to be of much practical significance during the operation of the facility. The staff would assess the program of each member requesting use of Fund resources to ascertain that the adjustment was sufficient and that the proposed use of resources covered in full the remaining problems. Only in rare cases was it likely that the program proposed by the member would be such as to reduce the balance of payments deficit so quickly that the resources available from the supplementary financing facility would not be desirable. In such rare cases, it was likely that the member would not have a payments need that was large in relation to quota and so would not meet the need requirement for use of the supplementary financing facility.

Mr. Drabble considered that the present text was reasonably clear, but it might be useful to include a statement to the effect that the decision was not meant to affect members' normal access to Fund resources in the regular credit tranches.

Mr. Kafka said that he agreed with Mr. Drabble. He had been worried that the Fund might be able to refuse to assist countries on the ground that the amount of resources available in the first credit tranche was insufficient to solve the member's entire payments problems. He had been reassured by the staff's comments that that was not to be the case, but some statement to that effect in the text itself might be useful.

Mr. Hollensen remarked that the General Counsel had emphasized that the size of a member's payments problem was a crucial factor in determining its eligibility to use supplementary financing. However, since a fair and substantial share of the supplementary financing was to be employed

Mr Pfeifer
F.O.

Office Memorandum

TO : Mr. Whittome

DATE: May 15, 1979

FROM : P. de Fontenay

SUBJECT : Portugal

Mr. Schmitt, Mr. Stuart and I attended a seminar at the Washington Center for Foreign Policy Research with Dr. Mario Soares, Secretary General of the Portuguese Socialist Party and former Prime Minister, as main speaker. Dr. Soares made a clever presentation for an American audience and a strong pitch for the line he is probably trying to sell to the U.S., namely that the current attempts by President Eanes to discredit the political parties are likely, in the long-run, to be detrimental to democracy in Portugal. He criticized the present Government as unable to pursue the policy of austerity which was necessary and in answer to a question by someone from the Center for Strategic and International Studies on the nefarious effects of the Fund's oppressive policies, he showed great understanding of our position. What was most interesting from our point of view was that he confirmed that the National Assembly intended to vote the present Government out of office as soon as the budget had passed. He hoped that an agreement could be reached between the President and himself on the formation of a new Government in which the Socialists would participate but failing that he saw no choice but anticipated elections, even though they would be unlikely to change very much the present composition of the Assembly. He realized also that a period of political instability was undesirable in the present circumstances.

We shall therefore be dealing with a Government which has only a short lease on life. We intend to press for taking now the various measures such as increases in administered prices which are clearly called for, on the grounds that it is likely to be very difficult, if not impossible, to take them later if the country goes through a period of electoral campaigning and political instability. Failing this, however, we shall have little choice but to settle for a first tranche arrangement.

cc: Mr. Pfeifer
SED

Mr. Whittome

cc: SED

Office Memorandum

TO : ~~Treasurer~~
~~Internal Auditor~~

Director, Exchange and Trade Relations Department
Director, European Department

DATE: April 23, 1979
5.30 p.m.

FROM : The Secretary

SUBJECT : Relations with the GATT - Consultations with CONTRACTING PARTIES - Indonesia and Portugal

This is to advise you that within the time specified no Executive Director has expressed an objection to the matter set out in EBD/79/82 Supplement 1 (4/19/79).

Accordingly, the Executive Board's approval is assumed and will be so recorded.

SEC-14
10-19-73

European Dept.

cc: SED

FO

Mr. Dini April 5, 1979

W. A. Beveridge

Technical Assistance--Portugal

In connection with the staff papers on the Fund technical assistance program (EBD/79/89 and EBD/79/86), you may find it helpful to be reminded of assistance in the fiscal field extended to one country in your constituency, Portugal.

In 1975, the Minister of Finance of Portugal requested Fund technical assistance in the tax field. Mr. Goode subsequently visited Lisbon to examine the possibilities of such assistance. It was agreed that the areas in which Fund assistance could usefully be provided were:

a. The assembly and analysis of statistics relating to the schedular income taxes and the complementary income tax;

b. The estimation of the distribution of the total tax burden by economic and social groups; and,

c. The analysis and evaluation of tax incentives for investment.

A staff member of the Fiscal Affairs Department carried out the first study, which was transmitted to the authorities in November 1975. Two staff members of the Fiscal Affairs Department visited Lisbon in February 1976 to undertake the second study. Their report was submitted to the Government in June 1976. The authorities indicated that the third phase of the program would be carried out in collaboration with the Fund at a later stage.

If you wish for any further information we would be pleased to provide it.

cc: European Department ✓

Mr. Pfeifer

Pf

F.O.

Office Memorandum

TO : Mr. McLenaghan

DATE: April 2, 1979

FROM : Brian C. Stuart BCS.

SUBJECT : Annual Report on Exchange Restrictions--Portugal

I would propose adding this sentence to line 22 on page 32 after "Among other measures affecting invisible payments,"

"Portugal raised the limits on foreign exchange sales for remittances of profits and dividends in July 1978, but the transfer abroad of dividends and profits continued to be subject to phasing for a period of less than six months."

This could be followed by a new sentence: "Balgladesh raised..." etc.

cc: Mr. Pfeifer ✓

cc: SED.

APR 2 1979

Dear Mr. Long:

This is to inform you that in connection with the forthcoming consultations in the Committee on Balance of Payments Restrictions with Indonesia and Portugal 45 copies of the following documents are being dispatched today, under separate cover via airprint, for the information and use of the CONTRACTING PARTIES.

Indonesia. Supplementary Background Material, dated March 22, 1979.

Portugal. Recent Economic Developments, dated December 22, 1978 and Decision.

Very truly yours,

Leo Van Houtven
Secretary

Enclosure

Mr. Olivier Long
Director-General
CONTRACTING PARTIES to the General Agreement on Tariffs and Trade
Centre William Rappard
Rue de Lausanne 154
CH-1211 Geneva 21, Switzerland

cc: EUR
ASD
SEC

BNowzad:ml
March 29, 1979

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Portugal - 1978 Consultation

Executive Board Decision - January 24, 1979

1. This decision is taken by the Executive Board in concluding the 1978 consultation with Portugal pursuant to Article XIV, Section 3, of the Articles of Agreement.

2. Portugal continues to apply limits on foreign exchange sales for remittances of profits and dividends which constitute a restriction requiring the approval of the Fund. The Fund welcomes the steps taken during 1978 to raise these limits and encourages Portugal to take further action to eliminate the remaining restriction. In the meantime, the Fund grants approval for retention by Portugal of the restrictions on payments and transfers for current international transactions as described in SM/78/304 until December 31, 1979.

CC: LOGGED

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ORIG: ETR
CC: MR. DINI
~~EURO~~
MR. HUGHES

INTERFUND WASHINGTON

IMPORT AND EXPORT OF PORTUGUESE BANK-NOTES

WITH REFERENCE TO OUR TELEX OF 28TH OCTOBER, 1975, WE INFORM YOU THAT ACCORDING TO THE REGULATIONS IN FORCE SINCE THE 9TH NOVEMBER, 1978, TRAVELLERS MAY TAKE IN AND OUT OF PORTUGAL UP TO AN AMOUNT OF ESC. 5,000 IN PORTUGUESE BANK-NOTES.

BANCO DE PORTUGAL-LISBON

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Washington, D.C. 20431

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ADDRESS

Mr. P. de Fontenay
Hotel Tivoli Jardim
Rue Julio Sesar
Marchado 7-9, Lisbon, Portugal

European Department figures show depreciation rate on target through February 23.

Regards.

Whittome
Interfund

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Drafted by: L. A. Whittome
Department: European
Date: February 27, 1979

L. A. Whittome
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SEC-17/OCR

Portugal
(Also filed under EC)

MEMORANDUM FOR THE FILES

February 26, 1979

SUBJECT: EC and Portugal

During my visit at the EC Commission in Brussels (January 25-30, 1979), I had meetings with Mr. Duchateau, Director for relations with non-EC European countries in the Directorate General I "External Relations", and one of his aides, Mr. von Schumann. The talks centered on problems relating to Portugal's application for membership in the EC but did not provide much information.

The negotiations with Portugal opened in September 1978 but proceeded only slowly, in particular because of personnel uncertainties on the Portugese side. Therefore, ideas with regard to financial aid to Portugal are of a very preliminary character. However, the Commission feels that the EC would have to give financial aid prior to Portugal's entry into the EC. Such aid could amount to 400 millions of EUA (1 EUA = approximately $1.35) and would be project-related; to a small extent, as a grant, for technical assistance. It would come from the EC as an institution as opposed to any aid which might be given by individual EC countries.

Mr. Duchateau would welcome information on the results of the ongoing talks between the Fund and Portugal.

Horst Ungerer

I am sure he would — so — ?

cc: Mr. Whittome
Mr. Schmitt
Mr. de Fontenay o/r

Western Union International, Inc. International Telex

HANS SCHMITT

LAST YEAR COMMA PORTUGUESE EXPORT UNIT VALUES ROSE BY 21 PER CENT
IN ESCUDO TERMS COMMA 5 PERCENT IN US DOLLAR TERMS AND DECLINED BY
3 PERCENT AFTER CORRECTING FOR DEPRECIATION OF ESCUDO OF 25 PERCENT
IN ESCUDO TERMS COMMA 6 PER CENT IN US DOLLAR TERMS AND DECLINED BY
2 PER CENT AFTER CORRECTING FOR EFFECTIVE DEPRECIATION STOP
FOR 1979 COMMA WEO SUGGESTS DECELERATION OF WORLD TRADE PRICE
INCREASES EXPRESSED IN US DOLLARS STOP
BECAUSE OF UNUSUALLY FAVORABLE PRICE DEVELOPMENTS RE PORTUGUESE
TRADE IN 1978 COMMA WE OFFERED 6 PER CENT INCREASE IN US DOLLAR
PRICES OF BOTH EXPORTS AND IMPORTS STOP
WEO PROJECTION SPECIFICALLY RELATED TO PORTUGAL SUGGESTS 8 PERCENT
INCREASE FOR US DOLLAR PRICE OF IMPORTS STOP PORTUGUESE ASKING FOR
11 PER CENT COMMA CLAIM OECD PARENTHESIS AND UNCTAD FOR RAW
MATERIALS PARENTESIS SUPPORT THEIR CLAIM OF A MAJOR ACCELERATION
IN WORLD TRADE PRICES STOP
ONCE AGAIN COMMA THESE FIGURES HAVE OBVIOUS POLICY IMPLICATIONS
STOP
COULD DEPPLER BE ASKED FOR LATEST RELEVANT ESTIMATES FOR 1979
BROKEN DOWN BY MAJOR GROUP OF EXPORTERS OR BY TYPES
OF EXPOTS COMMA AND COMMENT ON ANY DISCREPANCY WITH OECD
PROJECTIONS STOP
ALSO COMMA ARE THERE ANY SIGNS THAT QUOTE OTHER DEVELOPED COUNTRIES
QUOTE CAN AVOI D THE TERMS OF TRADE EFFECT OF OIL PRICE INCREASE
STOP
PATRICK WILL CALL WHITTOME AT 14:45 EST STOP
THANKS
BRIAN

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INTERNATIONAL MONETARY FUND

Washington, D.C. 20431

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Special Instructions

ADDRESS

Mr. P. de Fontenay
Hotel Tivoli Jardim
Rue Julio Sesar
Marchado 7-9, Lisbon, Portugal

Reurca dated February 12 Milo states that standard report forms for banks introduced early 1977 clearly separate outstanding credits to nonfinancial public enterprises. Please ask whether these are now consolidated with credit to business and individuals which increased to 563 billion in September 1978. Hans reports informal remark by Governor that credit floors rather than ceilings have been applied to public enterprises in the past and this implies that figures must be available. Portuguese own interest doubtless requires limits on them to safeguard adequate credit to private sector within overall credit ceiling.

Whittome

Interfund

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Drafted by: L. A. Whittome
Department: European
Date: February 13, 1979

L. A. Whittome
NAME (TYPE) SIGNATURE

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SEC-17/OCR
9-2-76

Mr. Whittome

Mr. Nose February 6, 1979

Hans Schmitt

Mr. Billoud's Report on Portugal

Thank you for letting us see Mr. Billoud's draft report. We have no comments except to reiterate our appreciation for the substantial contribution he has made.

cc: Mr. Whittome

SED have the report.

Mr. Whittome

Office Memorandum

TO : European Department Division Chiefs

DATE: February 2, 1979

FROM : A. P. Nose

SUBJECT : Mr. Billoud's Report on his Visit to Portugal

I attach the draft report by Mr. Billoud on his visit to Portugal under the Central Bank Bulletin Project. May I have your comments, if any, by February 8 so the report can be made final.

Attachment

Mr Schmitt, Would you take this over for me

5/2

(CC: SE)

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
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January 24, 1979

MEMORANDUM:

To: Treasurer
Internal Auditor
General Counsel
✓Director, European Department

From: The Secretary

Subject: Portugal - Review of Stand-By Arrangement

At EBM/79/14 (1/24/79) the Executive Board adopted the decision set forth in EBS/78/707 (12/26/78).

cc: SED

To: SEC
MD
DMD
Mr. Dini
EUR

January 15, 1979

From: Communications Division

Subject: Change in Governor - Portugal

We have now been informed that Dr. Jose da Silva Lopes, Governor, Banco de Portugal, has resumed his duties as Governor of the Fund for Portugal.

Dr. Vitor Manuel Ribeiro Constancio, Vice-Governor, Banco de Portugal, remains as Alternate Governor of the Fund for Portugal.

le 11 janvier 1979

Monsieur le Ministre:

Je vous remercie de votre lettre du 2 janvier et de votre aimable invitation à venir au Portugal. Je suis reconnaissant à René Larre d'avoir suggéré cette visite qui ne m'est malheureusement pas possible maintenant mais à laquelle je penserai certainement lorsque mes projets de voyage se préciseront.

Comme vous, Monsieur le Ministre, je souhaite que le Portugal et le Fonds Monétaire International continuent à coopérer étroitement et que cette coopération puisse contribuer à la solution des problèmes économiques de votre pays. En particulier, j'espère que les discussions qui doivent avoir lieu le mois prochain à Lisbonne entre les autorités portugaises et les services du Fonds Monétaire pourront aboutir à un accord qui permettra la poursuite de l'effort d'assainissement que vous avez entrepris. Il me semble que des mesures destinées à enrayer la dégradation des finances publiques devraient être un des points essentiels sur lesquels l'accord devra porter.

Veuillez agréer, Monsieur le Ministre, l'assurance de ma haute considération.

J. de Larosière

Dr. Manuel Jacinto Nunes
Vice-Premier Ministre pour les
Affaires Economiques et l'Intégration
Européenne et Ministre des Finances
et du Plan
Lisbonne, Portugal

P.deFontenay
January 11, 1979

CHRONOLOGICAL COPY

Country

MINISTÉRIO DAS FINANÇAS
E DO PLANO
GABINETE DO MINISTRO

Lisbon, 2nd January 1979

Mr. L.A. Whittome
Director
European Department
International Monetary Fund
WASHINGTON, D.C.20431

Dear Alain Whittome,

Please let me forget the fulfilling of my duties and that our warm personal relationship be in the same way as when I were in charge at Banco de Portugal.

I do remember our first meeting at Bank of England when you were Lord Obrien's Deputy Chief Cashier. Since then I have enjoyed your simpathy and understanding.

Simpathy and understanding that, more than ever, I need for the time being to help the economic recovery of my country.

For this reason, your kind letter of the 22nd November, last touched me very deeply, especially in the way you show your cordiality to me.

I hope Mr. Whittome to see you in a future not too distant. And, one day you come to Europe I shall be very pleased to enjoy your company as our guest of honour so long you may.

With my best regards,

Yours sincerely,

M. Jacinto Nunes

Manuel Jacinto Nunes
Vice-Premier for Economic Affairs
and European Integration and Minister
of Finance and Planning

MINISTÉRIO DAS FINANÇAS
E DO —— PLANO
GABINETE DO MINISTRO

Mr. [illegible] asks that we prepare a response

Lisbonne, le 2ème décembre 1979

Monsieur J. de Larosiere
Directeur Général et Président du
Conseil de l'Administration du
Fonds Monétaire International
<u>WASHINGTON</u>

Monsieur de Larosiere,

Je n'ai pas eu la chance dans le dernier Meeting du Fonds Monétaire International de faire votre connaissance.

Néanmoins, je vous connaissais il fait long temps quand vous réPresentait la France comme Directeur du Trésor dans le Comité de Politique Economique, où je participais aussi en répresentation de mon Pays.

Mais indirectement, mon connaissance à votre sujet résultait d'un ami commun, Monsieur René Larre à qui je suis très attaché et que dans les moments dificiles du Portugal en 1975, quand j'etais le Gouverneur du Banco de Portugal, m'a donné sa valuable aide.

Monsieur Larre a été recemment à Lisbonne justement quand j'avais assumé dans le Gouvernement Portugais mes fonctions de Vice Premier Ministre pour les Affaires Economiques et Intégration Européenne que j'accumule avec le portefeuille des Finances et du Plan.

MINISTÉRIO DAS FINANÇAS
E DO PLANO
GABINETE DO MINISTRO

Monsieur Larre m'a conseillé vivement de vous écrire en me permettant de vous dire que je le faisais selon ses indications.

Mais il arrive que j'avais déjà l'intention de le faire pour vous transmettre la forte determination du Gouvernement Portugais de maitriser l'activité economique portugaise et vous demander tout l'appui, pour nous fondamentel, de l'Institution que si distinctement vous dirigez.

Permets-moi que je vous exprime mon plaisir et l'honneur qu'il serait pour mon Pays que, dans une prochaine visite en Europe, vous resteriez ici, comme notre invité, le temps qu'il vous étiez possible.

En vous remerciant d'avance je vous prie d'agréer, Monsieur de Larosiere, mes salutations les plus distinguées.

Manuel Jacinto Nunes
Vice Premier Ministre pour les Affaires Economiques et Intégration Européenne et Ministre des Finances et du Plan