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C/Portugal/1760 Stand-by Arrangements

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C/Portugal/810	Mission de Fontenay and Mitchell September 1976
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C/Portugal/1760 Stand-by Arrangements 1976 - 1983

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C/Portugal/810 Mission de Fontenay, P. July 1979

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Portugal 1766

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WASHINGTON, D. C. 20431

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GOVERNOR JACINTO NUNES
BANK OF PORTUGAL
RUA DO COMERCIO, 148
LISBON, 2, PORTUGAL

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DEC 21 [illegible]

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THANK YOU FOR THE CABLE OF THE SECOND OF DECEMBER PROVIDING THE WEEKLY FOREIGN ASSETS AND LIABILITIES OF THE BANK OF PORTUGAL THROUGH NOVEMBER 22. WE HAVE, HOWEVER, NOT RECEIVED ANY OF THE MONTHLY INFORMATION WE HAD AGREED UPON AT THE TIME OF THE STAND BY ARRANGEMENT NEGOTIATIONS. IN PARTICULAR WE HAVE NOT RECEIVED THE SUMMARIZED MONTHLY BALANCE SHEETS OF THE BANKING SYSTEM NOR THE MONTHLY EXTERNAL DEBT STATISTICS. I WOULD APPRECIATE YOUR SENDING THIS INFORMATION AT YOUR EARLIEST CONVENIENCE.

IN ADDITION, I WOULD BE GRATEFUL IF REGULAR SHIPMENT OF THE INDICADORES DE CONJUNTURA COULD BE RESUMED AS SOON AS POSSIBLE. MANY THANKS AND KINDEST REGARDS.

TERESA TER-MINASSIAN
INTERFUND

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TELEX NO.: CABLE ADDRESS:

DRAFTED BY NAME (TYPE): D. Lachman EXT.: 60853 DEPT.: EUR DATE: Dec. 21,1983

AUTHORIZED BY NAME (TYPE): T. Ter-Minassian AUTHORIZED BY NAME (TYPE): (**)

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

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SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE

SEC. 48 REV 1 11-18-82

Portugal 1720

Banco de Portugal

No. 164 /DRI

RECEIVED
INTERNATIONAL
MONETARY FUND
1983 OCT 31 AM 11: 34
COMMUNICATIONS
DIVISION

Lisbon, October 27, 1983

Gentlemen

I acknowledge receipt of the text of the stand-by arrangement for Portugal kindly sent with your letter of October 18, 1983, Operations Division for General Resources.

Sincerely yours,

C. Saldanha do Valle

Carlos Saldanha do Valle
Director,
Relations with International Organizations

International Monetary Fund
Washington D.C. 20431
U. S. A.

Portugal 1120

OCT 18 1983

Gentlemen:

I am enclosing herewith the text of the stand-by arrangement for Portugal approved by the Executive Board on October 7, 1983.

Sincerely yours,

Anne Marie Al-Samarrie
Senior Operations Officer
Operations Division
for General Resources

Banco de Portugal
Rua do Comercio 148
1101 Lisbon, Portugal

CC: MR. LOVATO
EUR
TRE

/cw
10/18/83

Portugal 1760

October 14, 1983

To: Treasurer
Internal Auditor
Director, European Department
Director, Exchange and Trade Relations Department
Director, Legal Department
Director, Research Department

From: The Secretary (Signed) Leo Van Houtven

Subject: Portugal - Stand-By Arrangement, and Purchase Transaction - Compensatory Financing Facility

At EBM/83/148 (10/7/83), the Executive Board approved the decisions set forth in EBS/83/196, Supplement 1 (10/13/83) and EBS/83/197 (9/9/83).

KFriedman:gg Copy: C/1710

Portugal

1760

EBS/83/196
Supplement 1

CONFIDENTIAL

October 13, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Portugal - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Portugal agreed at Executive Board Meeting 83/148, October 7, 1983.

Att: (1)

Stand-By Arrangement - Portugal

Annexed hereto is a letter dated September 9, 1983 from the Minister of Finance and Planning and the Governor of the Bank of Portugal requesting a stand-by arrangement and setting forth the objectives and policies that the authorities of Portugal intend to pursue for the period of this stand-by arrangement.

To support these objectives and policies the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period from October 7, 1983 to February 28, 1985 Portugal will have the right to make purchases from the Fund in an amount equivalent to SDR 445 million, subject to paragraphs 2, 3, 4 and 5 below, without further review by the Fund.

2. Purchases under this stand-by arrangement shall not without the consent of the Fund exceed the equivalent of SDR 96.75 million until January 31, 1984, SDR 166.40 million until April 30, 1984, SDR 236.05 million until July 31, 1984, SDR 305.70 million until October 31, 1984, and SDR 375.35 million until January 31, 1985. None of these limits shall apply to purchases under the stand-by arrangement that would not increase the Fund's holdings of Portugal's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota.

3. Purchases under this stand-by arrangement shall be made from ordinary and borrowed resources in the ratio of 2 to 1 until purchases under this arrangement reach SDR 96.75 million, and thereafter in the ratio of 1 to 1.2, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Portugal will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Portugal's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of Portugal's currency resulting from purchases of borrowed resources beyond 12.5 percent of quota:

(a) during any period in which the data at the end of the preceding period indicate that (i) the limit on total domestic credit described in paragraph 12 of the attached letter; or (ii) the limit on credit to the public sector described in paragraph 12 of the attached letter; or (iii) either of the limits on external debt described in paragraph 16 of the attached letter, is not observed; or

(b) during any period through the end of February 1984 in which the net loss in foreign assets of the banking system exceeds the limit described in paragraph 17 of the attached letter; or

(c) after March 31, 1984 until the proposed policies for 1984 have been reviewed and suitable performance criteria have been established in consultation with the Fund as contemplated by paragraph 18 of the attached letter; or after such performance criteria have been established, while they are not being observed; or

(d) after March 31, 1984 if the intention on the rolling-back of the import surcharge mentioned in paragraph 15 of the attached letter is not being observed; or

(e) during the entire period of this stand-by arrangement, if Portugal (i) imposes new or intensifies existing restrictions on payments or transfers for current international transactions; or (ii) introduces multiple currency practices; or (iii) concludes bilateral payments agreements which are inconsistent with Article VIII; or (iv) imposes new or intensifies existing import restrictions for balance of payments reasons.

When Portugal is prevented from purchasing under this stand-by arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Portugal and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Portugal's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Portugal. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Portugal and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Portugal, the Fund agrees to provide them at the time of the purchase.

7. The value date of a purchase under this stand-by arrangement involving borrowed resources will be normally either the 15th day or the last day of the month, or the next business day if the selected day is not a business day. Portugal will consult the Fund on the timing of purchases involving borrowed resources.

8. Portugal shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

9. (a) Portugal shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Portugal's balance of payments and reserve position improves.

(b) Any reductions in Portugal's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this stand-by arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

10. During the period of the stand-by arrangement Portugal shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Portugal or of representatives of Portugal to the Fund. Portugal shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Portugal in achieving the objectives and policies set forth in the attached letter and annexed memorandum.

11. In accordance with paragraph 19 of the attached letter Portugal will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Portugal has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Portugal's balance of payments policies.

September 9, 1983
Lisbon, Portugal

CONFIDENTIAL

Dear Mr. de Larosière,

1. In the last two years, the current account deficit on Portugal's balance of payments deteriorated to a level that was clearly unsustainable over the medium term. This deterioration reflected in part factors beyond the Portuguese authorities' control, including the recession and high interest rates abroad. An important role was also played by the maintenance of a rate of growth of domestic demand substantially higher than abroad and by the lack of adequate flexibility in interest rate and exchange rate policies. Finally, the balance of payments continued to be affected by serious structural weaknesses, including high dependence on imports of energy and agricltural products and a relatively narrow export base.

The escalation of the current account deficit of the balance of payments from the equivalent of around 5 per cent of GDP in 1980 to 11 1/2 percent in 1981 and to 13 1/2 percent in 1982 resulted in a sharp increase in the external debt and its service burden, which reached 27 percent of foreign exchange earnings in 1982. The Government recognizes that, particularly in the present conditions of international capital markets, the maintenance of high current account deficits in the balance of payments would lead to acute financing difficulties and to large losses in international reserves of the country. Accordingly, it attaches high priority to a reduction in the current external deficit to US$2 billion (9 1/4 percent of GDP) in 1983 and to around US$ 1/4 billion (6 percent of GDP) in 1984.

2. The targeted improvement in the external accounts will be pursued through a comprehensive program of monetary and budgetary restraint, flexible and realistic policies with respect to interest rates, the exchange rate and administered prices, and through efforts to moderate the growth of nominal incomes. By promoting a sustained growth of exports and a decline in imports, these policies are expected to moderate the impact of the required cutback in domestic demand on output and employment. As a first step in its adjustment program the Portuguese Government introduced a package of financial and economic measures shortly after assuming office in June. These measures included a 12 percent effective devaluation of the escudo, substantial increases in the prices of a wide range of subsidized commodities (including bread, vegetable oils, feedstuffs, milk, sugar, fertilizers and oil products), the freezing of the public sector investment program pending review and the introduction of an extraordinary company profit tax.

The Government intends to complement its short-run adjustment efforts with policies aimed at correcting the structural weaknesses of the economy, also in preparation for its forthcoming entry into the EC. Accordingly, steps will be taken to promote the restructuring and diversification of public and private industry, to reduce energy dependence, to increase productivity in agriculture, and to modernize the financial and fiscal systems. Progress in these areas is essential to creating the conditions for resumption of a sustained growth of output and employment over the medium term within the constraint of the maintenance of a viable external position.

3. In support of its stabilization effort, the Government requests a stand-by arrangement from the International Monetary Fund. This arrangement will cover the period October 7, 1983 to February 28, 1985 and will be in the amount of SDR 445 million. Before making purchases under this arrangement the Bank of Portugal will consult with the Managing Director on the particular currencies to be purchased.

4. The main contribution to stabilization will come from fiscal restraint. The initial 1983 budget targeted an overall deficit of the General Government (Sector Publico Administrativo) on a cash basis equivalent to 9 1/2 percent of GDP as compared with 11 3/4 percent in 1982. However, slippages during the first half of the year would have substantially raised the deficit in the absence of remedial measures. The Government is determined to take the necessary measures to contain the deficit to below 10 percent of GDP. To this end a package of revenue-raising measures will be introduced in September.

5. Beyond 1983, the Portuguese Government is determined to secure a substantial and sustained reduction in the deficit of the General Government in relation to GDP. As a first step, the 1984 budget will target a reduction in the current account deficit of the General Government to below 1 percent of GDP and in the overall cash deficit to 7.3 percent of GDP. This is to be achieved through an increase of over 1 percentage point in the ratio of revenues to GDP and in a reduction of 1.4 percentage points in the ratio of expenditures to GDP (3 percentage points excluding interest payments). The main steps envisaged to secure the targeted revenue performance include adjustments in the rates of various indirect taxes and improved tax administration and enforcement. On the expenditure side the Government will contain the increase in wage rates for civil servants for 1984 and will extend the existing hiring freeze to categories of civil servants now exempted, while intensifying efforts to promote personnel mobility within the public administration. It will also review the system of social benefits with a view to limiting their growth within the economic capacity of the country and to eliminating abuses. The mechanism of determination of interest payments on public debt held by the Bank of Portugal has been modified to moderate the growth in this item of expenditure, which has more than doubled during the last two years. At the end of 1983 interest rates on government securities held by the Bank of Portugal will be rolled back to the level prevailing at the time of issue, instead of being adjusted to the current discount rate. Transfers to peripheral public entities, including the local authorities, will be strictly contained in the 1984 budget. The targeted reduction in public dissavings will be complemented by a determined effort to contain capital expenditures and extrabudgetary operations. In this respect a thorough review will be made of the investment

program of the Central Government, with the aim of containing its total amount to below the 1983 level.

6. The Government is firmly committed to taking necessary steps to improve expenditure control in all areas of the public sector, to modernize the structure of the tax system and to strengthen tax administration and enforcement. On the expenditure side, these steps will include: a firm control over Treasury operations, which will be limited to meeting temporary financing needs, to be reversed in the course of the year; the strict enforcement of the requirement that borrowing from the banking system by autonomous funds and services be authorized by the Ministry of Finance; a close monitoring of developments in the finances of local authorities, which will be required to submit timely quarterly accounts to the Central Government. In addition, a joint committee of the Ministry of Finance and the Bank of Portugal has been set up to monitor developments in domestic and external credit to the public sector and to ensure better coordination of credit policy with the borrowing requirements of the public sector.

7. The Government intends to begin promptly preparations for a comprehensive reform of the tax system, which remains overly complex and relatively income inelastic. The transactions tax and other indirect levies will be replaced with a value-added tax, which will represent the major source of indirect revenues for the State budget. To this end, the Government will complete the remaining technical and administrative steps to introduce the tax by the beginning of 1985. Moreover, the Government will promptly initiate a study on the reform of direct taxes, aimed at replacing the existing schedular income taxes with a global personal income tax and a single company income tax. Efforts will be continued over the medium term to broaden the tax base through reductions in fiscal benefits and exemptions and to provide additional own revenue-raising capacity to local and regional authorities.

8. The improvement in the finances of the General Government is to be complemented by a substantial strengthening of the position of the Supply Fund which serves as a mechanism for the cross subsidization of imported essential commodities. In this regard an important beginning was made in June with substantial increases in the prices of subsidized commodities. As a result of these measures the Supply Fund is expected to shift from a deficit of Esc 16 billion or 0.9 percent of GDP in 1982 to a surplus of Esc 18 billion or 0.8 percent of GDP in 1983. This surplus is to be utilized to repay arrears accumulated over the last few years by the Supply Fund to public enterprises that import the commodities subsidized by the Fund. In 1984 the Government intends to take measures to ensure that the surplus of the Supply Fund is increased to Esc 35 billion or almost 1 1/4 percent of GDP. On this basis the combined position of the General Government and the Supply Fund will improve from a deficit equivalent to 12.8 percent of GDP in 1982, to around 9 percent in 1983 and to around 6 percent in 1984.

9. The Government attaches high priority to a substantial and sustained improvement in the financial position of public sector enterprises. For this purpose a comprehensive effort will be made to contain the borrowing requirements of these enterprises and to increase their self-financing. This effort will involve a thorough review of their investment program to ensure the allocation of scarce financial resources to projects with the largest and quickest payoff in terms of foreign exchange earnings or savings. The review of the 1983 program was completed at the end of August, and the Government intends to limit gross capital formation by state-owned enterprises in 1983 to around Esc 135 billion (of which about Esc 27 billion reflects the delivery of new aircraft purchased by the national airline company in 1980), as compared with Esc 107 billion in 1982, which implies a decline in real terms. The investment program for 1984 will be defined during the last quarter of this year, with the total amount being constrained by the need to ensure a substantial deceleration in domestic bank credit to the public enterprises and to limit their resort to external borrowing along the lines described in paragraphs 12 and 16 below. Preliminary projections suggest that this would involve a substantial decline in real terms in investment by public enterprises.

The effort to improve the self-financing of public enterprises will be articulated on several fronts. Realistic pricing policies will be pursued with respect to those enterprises which are not subject to international competition by, as a minimum, allowing the full pass through of cost increases onto prices. In some areas price increases higher than those of costs may be necessary. As steps in this direction, public transport fares were raised by 30 percent on September 1, 1983 while electricity tariffs will be significantly raised again before the end of the year, following a 10 percent increase in July 1983. Realistic pricing policies will be complemented by a determined effort to contain costs and raise productivity. The Government intends to keep wage increases in public enterprises below the rate of inflation in both 1983 and 1984. In enterprises declared in financial difficulties wage increases will be kept below the average and the Government will take other necessary measures to ensure the economic viability of these enterprises over the longer term. Appropriate income support mechanisms will be instituted to moderate the impact of these measures on the workers affected.

In shaping its policies with respect to the public enterprises sector, the Government intends to draw on the advice and expertise of the IBRD.

10. Monetary policy will be geared to securing the targeted improvement in the balance of payments and a deceleration of inflation from around 29 percent at the end of 1983 to around 20 percent by end-1984. Accordingly, the monetary program of the Bank of Portugal will target a significant deceleration in the growth of the monetary and credit aggregates from the high rates recorded in recent years. This deceleration will be facilitated by the expected improvement in the finances of the General Government and of the public enterprises. In addition, the rate of growth of credit to the private sector will be contained through both a more

effective enforcement of the credit ceilings set by the Bank of Portugal and an increase in the effective cost of credit. The latter will be raised not only through increases in nominal lending rates as described in paragraph 11 below, but also through a reduction in interest rate subsidies provided by the Bank of Portugal and by the budget. As a first step in this direction the existing interest rate subsidies to exports will be eliminated effective end-1983. No new interest rate subusidies will be approved by the Bank of Portugal under the housing and investment incentive schemes. The Government also intends to undertake before the end of the year a thorough review of the incentive schemes with a view to making them more selective and substantially reducing their cost to the budget.

11. The Government is committed to maintaining a flexible stance with respect to interest rate policy in order to ensure the relative attractiveness of holding domestic financial assets and to control the demand for credit. Deposit and lending rates which were raised by between 4 and 5 percentage points in March 1983, were increased by a further 2 to 2.5 percentage points in August 1983. Rates prevailing in the interbank bond market were increased by more and will continue to be raised in the next few months in order to strengthen the profit position of banks, and to improve incentives to comply with the credit ceilings. Following these moves, which restored rates on the main domestic financial assets to positive levels in real terms, interest rates will be managed in a flexible manner, both in an upward and a downward direction, to adjust for developments in domestic inflation and in interest rates abroad. The Government intends to promote the development of domestic financial markets so as to raise the share of nonbank financing of the public sector deficit as well as to channel savings into productive investments.

12. In order to give effect to the monetary policy outlined above, the authorities have set the following binding ceiling on domestic bank credit for December 31, 1983 and indicative ceiling for December 31, 1984. Total domestic credit extended by the banking system (which stood at Esc 2,148.9 billion on December 31, 1982) is not to exceed Esc 2,786.5 billion as of December 31, 1983 and Esc 3,416.5 billion as of December 31, 1984. Within this ceiling it is intended to limit domestic bank credit to the public sector (which stood at Esc 462.3 billion on December 31, 1982) to Esc 629.3 billion by December 31, 1983 and to Esc 779 billion by December 31, 1984. The limits for 1983 are predicated on the assumption that the net increase in external credit to the Government will reach Esc 60 billion in 1983. The ceilings on domestic bank credit to the public sector and on total domestic bank credit for 1983 will be automatically adjusted upward (downward) for any shortfall (excess) of external credit to the Government with respect to the targeted amount up to Esc 12 billion. The limits on total bank credit and on credit to the public sector for 1984 will be subject to the review scheduled to take place by March 31, 1984 as mentioned in paragraph 18 below, at which time quarterly ceilings and subceilings will be agreed upon. At that time agreement will also be reached with the Fund on an indicative target for domestic credit expansion to the public enterprises.

13. Financial policies will need to be complemented by policies aimed at moderating labor costs, if the desired deceleration of inflation is to be obtained without unduly sacrificing the growth of output and employment. The wage policy for the public sector described in paragraphs 5 and 9 above will set an example for wage negotiations in the private sector. The effort to moderate wage increases will be accompanied by structural measures to improve labor productivity through enhanced labor mobility, training programs and other steps to promote a more flexible utilization of the workforce.

14. In the external area, the Government regards the maintenance of a competitive exchange rate as an essential condition for the attainment of the desired improvement in the external accounts. The 12 percent effective devaluation of the escudo in June has resulted in a substantial improvement in competitiveness. The Portuguese authorities intend to continue the policy of depreciating the effective exchange rate vis-à-vis a weighted basket of partner countries' currencies at the rate of 1 percent a month which is deemed to be sufficient in present circumstances to ensure Portugal an adequate competitive position. The authorities will keep the evidence on the competitive position under review, especially in the light of the trade and relative inflation performance, and will be prepared to make further adjustments in the rate of monthly depreciation if, in consultation with the Fund, such adjustments are deemed necessary.

15. The Government of Portugal is committed to the maintenance of a trade and payments system virtually free of restrictions on payments and transfers for current international transactions. During the course of the program, the Government will refrain from the introduction of any new restriction or the intensification of existing ones either on payments and transfers for current international transactions or on imports for balance of payments reasons. In the 1984 budget and, in any event no later than March 31, 1984, the import surcharge will be rolled back to 10 percent from the 30 percent to which it was raised in January 1983.

16. The Government intends to limit resort to external borrowing to levels consistent with a reduction in the ratio of external debt service to foreign exchange earnings over the medium term. To this end, the authorities will limit Portugal's disbursed external debt outstanding (including short-term and nonguaranteed debt but excluding foreign liabilities of the Bank of Portugal and short-term liabilities of the banking system) which amounted to US$12,864 million at the end of 1982 to no more than US$13,800 million at the end of 1983 and US$15,000 million at the end of 1984. Within this ceiling, short-term external debt disbursed, excluding foreign liabilities of the Bank of Portugal and of the banking system, which stood at US$3,756 million at the end of 1982, will not exceed US$3,800 million at the end of 1983 and US$4,000 million at the end of 1984. The indicative limits on the external debt for the end of 1984 will be reviewed during the review scheduled to take place by March 31, 1984, at which time quarterly ceilings will also be established.

The restraint on external borrowing will be accompanied by a strengthening of the official control mechanism through the creation of an interministerial committee, with the participation of the Bank of Portugal, which will be in charge of defining the criteria for access to external borrowing and of reviewing and authorizing major operations. Moreover, the Bank of Portugal will intensify its ongoing efforts to improve the statistical reporting system on the external debt, with a view to shortening the time lags in the collection and processing of relevant data.

17. The Government expects that the determined implementation of the adjustment program described above, with the support of the IMF, will strengthen confidence and improve the access of Portugal to external financing. Accordingly, the cumulative loss in the net foreign assets of the banking system since the beginning of 1983, which amounted to US$981 million during the first half of 1983, should not exceed US$1.6 billion at any time from October 7, 1983 to the end of February 1984. Appropriate tests on the net foreign assets of the banking system during the rest of 1984 will be agreed with the Fund, if deemed necessary, at the time of the review in March 1984.

18. The Government of Portugal believes that the policies set forth in this letter are adequate to achieve the objectives of the program but it will take any further measures that may become appropriate for this purpose. Portugal will consult with the Fund in accordance with the policies of the Fund on the adoption of any measures that may be appropriate. Portugal will refrain from making purchases after March 31, 1984 until understandings have been reached with the Fund on the limits referred to in paragraphs 12, 16 and 17 for calendar year 1984 as well as on any other performance clauses that may be deemed appropriate. In addition, after the period of the stand-by arrangement and while any Fund holdings of escudos above the first credit tranche include currency resulting from purchases under the stand-by arrangement, the Government will consult with the Fund, at the initiative of the Government or at the request of the Managing Director, concerning Portugal's balance of payments policies.

Sincerely yours,

Ernani Rodrigues Lopes
Minister of Finance and Planning

Manuel Jacinto Nunes
Governor
Bank of Portugal

Portugal 1760

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MR. LOVATO
EUR
MR. S. COLLINS

MR. JACQUES DE LAROSIERE
MANAGING DIRECTOR AND CHAIRMAN OF THE EXECUTIVE
BOARD OF THE INTERNATIONAL MONETARY FUND
WASHINGTON D.C.

IN MY CAPACITY AS GOVERNOR OF THE FUND FOR PORTUGAL AND IN MY OWN NAME I WISH TO EXPRESS OUR GREAT SATISFACTION AT THE APPROVAL OF THE DECISIONS REGARDING PORTUGAL AND TO THANK YOU AND THROUGH YOU THE BOARD OF MANAGEMENT AND YOUR STAFF FOR ALL YOUR FINE COOPERATION.

SINCERELY YOURS,

MANUEL JACINTO NUNES
GOVERNOR
BANCO DE PORTUGAL - LISBOA

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Portugal 1760

INTERNATIONAL MONETARY FUND

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PRESS RELEASE NO. 83/69

FOR IMMEDIATE RELEASE
October 7, 1983

The International Monetary Fund has approved the use of its resources totaling SDR 703 million by the Government of Portugal. Of the total, SDR 445 million, equivalent to 172.5 percent of quota, will be available over the period through February 1985 under a stand-by arrangement to support the Government's economic and financial program. The first drawing under the stand-by arrangement in the amount of SDR 96.75 million will be available immediately. In addition, SDR 258 million, equivalent to 100 percent of quota, is also available immediately under the compensatory financing facility. Currently, Portugal has no outstanding financial obligations to the Fund.

The easing of financial policies that began in 1980 stimulated real domestic demand which, coupled with relatively inflexible exchange and interest rate policies, contributed to a deterioration in the current account balance of payments. These policies were exacerbated by exogenous factors, including a 10.5 percent decline in the terms of trade between 1979 and 1982, the international recession, high interest rates abroad, and adverse weather which triggered additional agricultural and energy imports. As a result, the current account, which had been in near-balance in 1979, had moved to a deficit equivalent to 13.2 percent of gross domestic product (GDP) in 1982.

The economic and financial program, which the present stand-by arrangement supports, is primarily designed to reduce the current account deficit to a level that does not give rise to financing difficulties over the short-run, and that will allow a reduction in the debt service burden over the longer term. The envisaged improvement in the current account is to be secured through a combination of policies aimed at curbing domestic demand and at diverting resources toward the export sector. The main contribution to the stabilization program is to come from fiscal restraint. The combined position of the General Government and the Supply Fund, which subsidizes essential commodities, is targeted to move from a deficit equivalent to 12-1/2 percent of GDP in 1982 to a deficit of 9 percent in 1983 and 6 percent in 1984. The improvement in the finances of the General Government is to be complemented by a comprehensive effort to contain the borrowing requirement of public enterprises. At the same time, monetary policy is to be geared toward securing a scaling down of the growth of the monetary and credit aggregates consistent with the targeted improvement in the balance of payments and a deceleration of inflation.

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As the first steps in implementing these policies, the authorities have undertaken a number of measures including an effective 12 percent devaluation of the escudo in June, substantial increases in prices of a wide range of subsidized products, a cutback in the public sector investment program, and the introduction of new revenue raising measures. In addition, interest rates have been increased to levels that are significantly positive in real terms.

The drawing under the compensatory financing facility is in respect of a shortfall in earnings from merchandise exports, tourism, and workers' remittances experienced in the 12-month period ended March 1983. The primary cause of the shortfall was the adverse impact of the world recession on Portugal's export receipts and service income. The stagnation of real growth in the industrial countries not only weakened demand for exports and depressed commodity prices, but also affected travel abroad, decreasing tourist receipts, and reduced real wages and employment opportunities for emigrant Portuguese workers.

Portugal

1960

FOR AGENDA

EBS/83/196

CONFIDENTIAL

September 9, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Portugal - Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is a paper on a request from Portugal for a stand-by arrangement equivalent to SDR 445 million. A draft decision appears on page 15.

It is proposed to bring this subject, together with Portugal's request for a purchase under the compensatory financing facility (EBS/83/197, 9/9/83), to the agenda for discussion on Friday, October 7, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mrs. Ter-Minassian, ext. 60853.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Portugal--Request for Stand-by Arrangement

Prepared by the European and Exchange and Trade Relations Departments

(In consultation with the Legal and Treasurer's Departments)

Approved by L. A. Whittome and Subimal Mookerjee

September 9, 1983

I. Introduction

In the attached letter dated September 9, 1983 to the Managing Director from the Minister of Finance and Planning and the Governor of the Bank of Portugal, the Portuguese authorities request a stand-by arrangement to cover the period October 7, 1983 to February 28, 1985 in the amount of SDR 445 million (37 1/2 percent of present quota for 1983 and 135 percent of present quota for 1984). The stabilization program that forms the basis for this request was discussed with the Portuguese authorities in Lisbon during the period July 18 to August 8 by a staff mission consisting of Mrs. T. Ter-Minassian, Messrs. D. Lachman, E. Spitaeller, T. Catsambas (all EUR), Mr. E. Kalter (ETR) and as secretary Miss P. Emerson (EUR). The Portuguese authorities have also requested a purchase under the Compensatory Financing Facility in the amount of SDR 258 million or 100 percent of present quota. This request is dealt with in a separate document (EBS/83/197, 9/9/83) which is circulated jointly with this paper.

In June 1983, Portugal purchased the balance of its reserve tranche and the Fund's holdings of Portuguese escudos stand at present at 100 percent of Portugal's quota of SDR 258 million (Annex I provides a fuller description of the Fund's relations with Portugal). Full utilization of the requested stand-by arrangement would raise the Fund's holdings of escudos to the equivalent of SDR 703 million or 272.5 percent of quota. Including the full purchase requested under the Compensatory Financing Facility, the Fund's total holdings of escudos would amount to 372.5 percent of Portugal's present quota. The last stand-by arrangement with Portugal in the amount of SDR 57.35 million expired in May 1979. The last consultation with Portugal was concluded on June 13, 1983 (SM/83/88, 5/18/83).

II. Background

Following the successful implementation of a stabilization program supported by a stand-by arrangement with the Fund in 1977-78, the Portuguese economy experienced a marked improvement in the balance of payments in 1979 while growth remained above the trade-weighted average of OECD countries. The restoration of external balance encouraged the Portuguese authorities to relax the stance of financial policies in 1980 with the principal objectives of stimulating investment and of securing a recovery in real disposable income. The recent staff report on the 1983 Article IV discussions with Portugal (SM/83/88) described how the easier stance of financial policies accommodated a rate of growth of real domestic demand in Portugal some 15 percentage points in excess of the OECD average over the period 1980-82. Moreover, the relative inflexibility of interest rate and exchange rate policies reduced incentives for Portuguese residents to hold domestic financial assets, contributing to capital outflows through the current account. The adverse impact of these policies on Portugal's external accounts was compounded by exogenous factors. These included a 10 1/2 percent deterioration in the terms of trade between 1979 and 1982, the international recession, high interest rates abroad, and adverse weather conditions which necessitated a sharp increase in energy and agricultural imports. As a result, the current account of the balance of payments shifted from near equilibrium in 1979 to deficits of US$1,250 million or 5 percent of GDP in 1980, US$2,850 million or 11.5 percent of GDP in 1981 and US$3,239 million or 13.2 percent of GDP in 1982 (Table 1). Preliminary indications point to an improvement in the current account during the first half of 1983 with the deficit tentatively estimated at around US$1.4 billion (compared with US$2.2 billion during the first half of 1982). The main factor underlying this improvement was a sharp drop in imports especially of oil and agricultural commodities, associated in part with the difficulties of public sector enterprises in obtaining external financing.

The current account deficits over the past three years were largely financed through substantial external borrowing, especially by public enterprises. By end-1982, Portugal's total external debt had risen to US$13 1/2 billion of which some US$4 billion was of a maturity of less than one year. The debt service ratio (excluding the rollover of short-term debt) reached 27 1/2 per cent in 1982 (Table 2). The deterioration in economic performance in 1982, together with the political uncertainties connected with the fall of the Government and the subsequent elections at the end of April 1983, caused considerable uneasiness in international capital markets in the first half of 1983. There was a significant deterioration in the terms obtained on a US$300 million medium-term loan to the Treasury while some difficulty was experienced in renewing part of the short-term external debt of the public sector enterprises. Foreign exchange reserves of the Bank of Portugal declined to less than two weeks' imports, forcing the Bank to request two BIS loans secured by gold collateral in the amount of US$700 million. These BIS loans were repaid in July and August with the proceeds of gold sales, and a further gold-guaranteed loan of US$300 million through the end of

1983 was contracted with the BIS. During the first half of 1983 net foreign assets of the banking system declined by US$980 million. Unpledged reserves of the Bank of Portugal amounted to around US$8.5 billion at the end of June 1983 with gold valued at current market prices.

The principal source of weakness in economic management in Portugal over the past several years has been in the area of the public sector's finances, including the operations of the public sector enterprises (SM/83/88). The deficit of the General Government on a cash basis amounted to 11.7 percent of GDP in 1982 (Table 3). Moreover, sizable arrears, equivalent to 0.9 percent of GDP, continued to be run up by the Supply Fund (which subsidizes essential commodities) toward the public enterprises that import those commodities. The initial budget presented to Parliament at the beginning of 1983 sought to maintain the cash deficit of the General Government in nominal terms at the level set in the initial 1982 budget, which would have implied a reduction in terms of GDP of over 2 percentage points to around 9 1/2 percent. The budgetary targets were to be attained through an increase of 2 percentage points in the tax ratio and through a small decline in the ratio of public expenditure (other than interest payments) to GDP. Wide ranging tax increases, mainly in the form of surcharges on existing taxes and including the raising of the import surcharge from 10 percent to 30 percent, were introduced in the 1983 budget. However, there were delays in the implementation of these tax increases and more importantly there were substantial slippages in expenditure control during the first half of 1983 coinciding with the period of a caretaker Government. As a result, the deficit of the General Government for 1983 would have significantly exceeded the initial budget target, possibly reaching 11 percent of GDP, in the absence of the remedial measures introduced by the new Government which are described in Section III of this paper.

The large financing requirements of the public sector have contributed importantly to the rapid expansion in the credit and monetary aggregates in recent years (Table 4). However, domestic credit to the private sector and the public enterprises also increased by over 25 percent in 1982, or by about 4.5 percent in real terms. In March 1983 the Bank of Portugal raised interest rates by between 4 and 5 percentage points restoring these rates to positive levels in real terms. This increase in interest rates contributed to some moderation in the expansion of credit to the private sector which through the 12 months ended June 1983 slowed to around 23 1/2 percent, despite an acceleration of inflation to over 21 percent during the same period. In addition, there was a sharp decline in external financing to the public sector enterprises. As a result, total domestic and external financing to the economy decelerated markedly from around 30 percent at the end of 1982 to 24 percent by June 1983.

The expansionary stance of financial policies in recent years was reflected in strong increases in real domestic demand and in the maintenance of inflation at a relatively high level. Real domestic demand is estimated to have increased by nearly 3 1/2 percent in 1982 following increases of 3.8 percent and 6.7 percent in the preceding two years (Table 5). Preliminary indications for the first half of 1983 suggest that, while consumer demand continued to grow albeit at a significantly slower rate, investment especially in construction declined, and there was a sizable rundown of inventories, particularly of oil and agricultural commodities. Inflation accelerated in the first few months of the year to a 12-month rate in excess of 21 percent, partly reflecting adjustments in several administered prices at the beginning of the year.

III. The Program

1. The overall strategy

The Portuguese authorities' primary economic objective is to reduce the current account deficit in the balance of payments to a level that does not give rise to financing difficulties in the short run and that allows a reduction in the debt service burden over the longer run. The achievement of this objective is recognized to be an essential condition for the resumption of a sustained rate of growth of output and employment in the medium term. Accordingly, the authorities attach high priority to containing the current external deficit to at most US$2 billion (9 1/4 percent of GDP) in 1983 as compared with US$3.2 billion (13.2 percent of GDP) in 1982, and to reducing it to around US$1 1/4 billion (just under 6 percent of GDP) in 1984. Projections of the debt service burden through the end of this decade made by the staff suggest that, if the current account deficit were kept on average at the level targeted for 1984 during the rest of the 1980s, the debt service ratio excluding amortizations of short-term debt would decline moderately to below 25 percent. The total debt service ratio would fall from 71 percent in 1983 to below 50 percent by 1990. The maintenance of the deficit at around US$1 1/4 billion would be consistent with a moderate real growth of imports and consequently of demand over the medium term (Table 6).

The targeted improvement in the current account during the program period is to be secured through a combination of policies aimed at curbing domestic demand and at switching resources toward the export sector. Domestic demand is projected to decline by a cumulative 7 percentage points between 1982 and 1984. In the light of the expected continued moderation in foreign demand, the decline in domestic demand is unlikely to be fully compensated for by an improvement in the real external balance. Thus, GDP is expected to show some decline and unemployment to rise significantly in both 1983 and 1984 (Table 5). Inflation will be boosted to around 29 percent by the end of 1983 as a result of the recent sharp increases in administered prices and of the recent devaluation of the escudo, but it is targeted to be substantially reduced in the course of 1984, to around 20 percent by year-end.

The strategy to achieve the targeted adjustment in the external position is centered on budgetary restraint, complemented by measures to strengthen the financial position of the public enterprises. The decline in the financing requirements of the broadly defined public sector should allow a deceleration in the growth of the monetary and domestic credit aggregates in the course of the program period without excessively restricting credit to the private sector. The restraint in domestic credit is to be complemented by a stricter control over resort to external credit, especially by public enterprises. Interest rate policy is to be operated more flexibly, with a view to maintaining adequate incentives to the holding of domestic financial assets and to moderating the demand for credit. The Government intends to continue its efforts to moderate the growth of wages and to preserve an adequate competitive position through a flexible exchange rate policy. Steps will also be taken to reduce rigidities in the labor market.

As a first step in its adjustment program, the Portuguese Government introduced a package of financial and economic measures shortly after assuming office in June. These measures included a 12 percent effective devaluation of the escudo, substantial increases in the prices of a wide range of subsidized commodities, the freezing of the public sector investment program pending review and the introduction of an extraordinary company profit tax. Subsequently, on August 9, interest rates on deposits were raised by 2 percentage points and those on loans by 2.5 percentage points, to levels which are positive in real terms. Additional revenue raising measures will be presented to Parliament in mid-September, to ensure the containment of the 1983 budget deficit at its target level. The details of budgetary and other financial policies for 1984 will be defined in the next few months within the framework outlined in the attached letter of intent and will be reviewed with the Fund during the first quarter of 1984.

2. Fiscal policy

The main contribution to the adjustment effort is to come from fiscal restraint. The cash deficit (including Treasury operations) of the General Government is to be contained at Esc 229 billion (just under 10 percent of GDP) in 1983 and is to be reduced to Esc 207 billion (7.3 percent of GDP) in 1984. The targeted improvement in the finances of the General Government is more substantial when account is taken of the changes in arrears of the Supply Fund toward public enterprises. After adjustment for the latter the deficit is to decline (as a ratio to GDP) from 12.6 percent in 1982 to around 6 percent in 1984.

The reduction in the deficit is to be achieved through a wide ranging set of measures, some of which have already been implemented. In 1983 the main contribution to the adjustment is to come from an increase in the tax burden and from the recent adjustments in administered prices. Reference was made in section II above to the increases in various direct and indirect taxes enacted in the 1983 budget. In order to compensate for the revenue loss due to the delayed implementation of the budget and to absorb purchasing power of households, the Government introduced in September an additional package of tax measures designed to yield an estimated Esc 12 billion (2.6 percent of tax revenue). These measures include increases in the rates of selected indirect taxes (the stamp tax and various excises) and a once-over tax on incomes for the rest of 1983. The adjustments in administered prices announced in June included increases of 22-24 percent for bread, 15 percent for sugar, 45 percent for milk, 50 percent for wheat, 55 percent for corn, 58 percent for vegetable oils and 85 percent for fertilizers. Petroleum product prices were raised on average by 13 percent in July following substantial increases at the beginning of the year. As a result of these measures, which are expected to boost the consumer price index by around 5 percentage points, the Supply Fund is expected to shift from a deficit equivalent to 0.9 percent of GDP in 1982 to a surplus of 0.8 percent of GDP in 1983. In addition to the revenue-raising measures and the price increases, the authorities intend to contain the public deficit through a tighter control of expenditure, in particular of Treasury operations which escalated in 1982 and during the first half of 1983.

Preparations have begun for the 1984 budget, which is scheduled to be presented to Parliament in the second half of October. Preliminary projections point to a further small increase in the tax burden, mainly in reflection of the full-year impact of the increases in indirect taxes enacted in September 1983 and of fiscal drag. The Portuguese authorities regard the scope for further increasing the tax burden over the short run to be limited. At nearly 32 percent of GDP, the tax ratio is in line with (indeed slightly above) those prevailing in most countries at comparable levels of development. However, the tax burden remains unevenly distributed, with tax evasion and avoidance being widespread among nonwage earners. Moreover, the tax system is overly complex and the tax base has been eroded by a proliferation of exemptions. Therefore, the authorities attach high priority to a comprehensive restructuring of the tax system and a strengthening of tax administration and enforcement. Preparatory work is well advanced for the introduction of the value-added tax, targeted for 1985. It also is intended to proceed quickly with a study for the replacement of the existing schedular income taxes with global personal and company taxes. Steps will be taken in the 1984 budget significantly to reduce fiscal incentives and exemptions.

On the expenditure side, a comprehensive effort is envisaged to secure a significant reduction in public spending in relation to GDP. Total expenditure, excluding changes in arrears of the Supply Fund, is targeted to decline from 43.5 percent of GDP in 1982 to under 41 percent in 1984 (Table 3). Wage increases for civil servants in 1984 are expected to be contained at around 17 percent as in 1983, implying a substantial reduction in real terms. The existing hiring freeze is to be extended to categories of civil servants currently exempt from it, such as teachers and medical personnel, while efforts will be intensified to promote mobility within the public administration. Transfers to peripheral public entities, in particular the local authorities, will be strictly contained. This may require a modification of the existing law on local finances, which automatically links transfers to certain receipts of the state budget. The adjustment of pensions at the beginning of 1984 is expected to be graduated, and to involve a reduction in purchasing power of pensions on average. On the other hand, a significant increase is to be expected in payments for unemployment compensation, in reflection of the likely increase of unemployment in 1983 and 1984. The mechanism of determination of interest payments to the Bank of Portugal will be modified to moderate the growth of this item of expenditure which has risen most rapidly in recent years, to the equivalent of 3.3 percent of GDP in 1983. As of the end of 1983, interest rates on government securities held by the Bank of Portugal, which since 1980 has been adjusted in line with the discount rate, will be rolled back to the levels prevailing at the time of issue of each security. Despite this adjustment, interest payments to the Bank of Portugal are expected in 1984 to increase further in relation to GDP by 1/2 percentage point, reflecting the continued growth of the public debt. The growth in capital spending, excluding repayments of arrears by the Supply Fund, is also to be strictly contained, especially through a careful scrutiny of projects included in the investment plan for the central administration (PIDDAC).

A further substantial improvement is targeted for the finances of the Supply Fund, which is expected to run a surplus equivalent to 1.3 percent of GDP. This is to be achieved through a new series of substantial price increases for subsidized commodities and for petroleum products at the beginning of 1984. These increases will be designed to eliminate subsidies for cereals and vegetable oils and to halve those for fertilizers and milk. In addition, receipts from taxes on oil products are targeted to increase by over 40 percent.

The improvement in the position of the financial General Government is to be complemented by a strengthening of the finances of public sector enterprises, which have represented an increasingly weak area of the Portuguese economy over the last few years (SM/83/88 and SM/83/94, 5/25/83). This effort will be aimed at containing their resort to domestic and external credit through a cutback in their investment program and through measures to increase their self-financing. A review of the 1983 investment program was conducted in the last two months, and the decision was taken to freeze some large investments, such as the planned expansion of capacity in steel, pending a more thorough scrutiny of the longer-term prospects for the projects. Following the review of the public enterprises' investment program (PISEE), fixed investment by the latter will be limited in 1983 to around Esc 135 billion, as compared with Esc 107 billion in 1982. The authorities were limited in their scope for reducing the total amount of investment expenditure by public enterprise in 1983 by the fact that Esc 27 billion of these expenditure reflected the delivery of new aircraft purchased by the national airline company in 1980. Excluding the aircraft expenditure, investment by public enterprises is expected to decline by 20 percent in real terms in 1983. The investment program for 1984 will be defined during the last quarter of this year, with the total amount being constrained by the need to ensure a substantial deceleration in domestic bank credit to the public enterprises and to limit their resort to external borrowing. Preliminary projections suggest that this would again involve a substantial decline in real terms in investment by public enterprises. In the selection of projects, priority will be given to those with the largest and quickest payoff in terms of foreign exchange earnings or savings. The authorities intend to draw in this process on the advice of the IBRD.

The effort to improve the self-financing of public enterprises will be articulated on several fronts. Realistic pricing policies will be pursued with respect to those enterprises which are not subject to international competition by, as a minimum, allowing the full pass through of cost increases into prices. In some areas, price increases higher than those of costs may be necessary. As steps in this direction, public transport fares were raised by 30 percent on September 1, 1983 while electricity tariffs will be significantly raised again before the end of the year, following a 10 percent increase in July 1983. Realistic pricing policies will be complemented by a determined effort to contain costs and raise productivity. The Government intends to keep wage increases in public enterprises significantly below the rate of inflation in both 1983 and 1984. In enterprises declared in financial difficulties wage increases will be kept below the average and the Government will take other measures, including reductions in capacity and workforce, required to ensure the economic viability of these enterprises over the longer term. To this end, proposed legislation has just been unveiled authorizing the management of both public and private enterprises declared in financial difficulties to lay off redundant workers for a period of up to two years. It is envisaged that these workers would receive compensation equivalent to two thirds of their salary and the costs of this compensation would be equally shared by the unemployment fund and the enterprise concerned.

3. Monetary policy

Monetary policy will be geared to attaining the targeted improvement in the balance of payments and deceleration of inflation. Accordingly, the monetary program agreed with the Portuguese authorities envisages a deceleration in the rate of growth of total domestic credit from over 29 percent in 1982 to 27.5 percent in 1983 and to around 21.5 percent in 1984 (Tables 4 and 7). In real terms the rate of growth of total domestic credit is expected to fall from around 9 percent in 1982 to -1 percent in 1983 before recovering to around 1 percent in 1984. The deceleration in total financing to the economy (including external credit) is significantly more pronounced, namely from around 30 percent in 1982 to 23 percent in 1983 and to about 20 percent in 1984. This deceleration will be facilitated by the targeted improvement in the finances of the public sector. Domestic bank credit to the public sector is targeted to increase by 26.5 percent in 1983, compared with 33.3 percent in 1982, and by around 19 percent in 1984. The ceilings on total domestic credit and on credit to the public sector for 1983 are predicated on the assumption that net external financing to the Government will amount to Esc 60 billion (about US$550 million) in 1983. The ceilings will be adjusted for any shortfall (excess) with respect to the latter amount up to a maximum of Esc 12 billion. This limited flexibility in the ceilings was introduced in the light of the uncertainty regarding the amount of the Euroloan expected to be raised by the Government of Portugal in the fourth quarter of this year. The domestic credit targets for 1984, which are indicative ones, are predicated on an assumed decline in velocity of M2 which is significantly smaller than those recorded in most of the recent years and will need to be reviewed early in 1984, particularly in the light of the response of quasi-money to the recent increases in interest rates.

The Portuguese authorities intend to pursue the targeted deceleration in the credit aggregates through both a more effective enforcement of the credit ceilings set by the Bank of Portugal and an increase in the effective cost of credit. To this end penalties for noncompliance with the ceilings will be raised to 100 percent and rates in the interbank bond market will be increased by several percentage points over the next few months to provide commercial banks with a more attractive outlet for their excess liquidity and to reduce incentives to exceed the credit ceilings. In order to curb the demand for credit, in August the authorities raised lending rates by 2.5 percentage points, following a 4 percentage point increase in March 1983. As a result, lending rates are now substantially positive in real terms. 1/ The authorities intend to complement the increase in lending rates with a substantial reduction in interest subsidies. They will eliminate the existing interest rate subsidies to exports by the end of the year and review other incentive schemes with a view to making them more selective and reducing their cost to the budget.

Following the recent interest rate adjustments, rates on deposits have also risen to levels currently positive in real terms (Table 4) and will be managed in a flexible manner to adjust for developments in domestic inflation and in interest rates abroad. The authorities intend to take further steps to promote the development of domestic financial markets in order to raise the share of nonbank financing of the public sector deficit, which in 1982 amounted to only 1 percent of the total financing, and to channel savings into the financing of productive public and private investments.

4. External policies

The Portuguese authorities recognize the importance of the maintenance of a competitive exchange rate in achieving the targeted external adjustment. The 12 percent effective devaluation of the escudo in June has placed the competitive position of Portugal at a level significantly above its previous peak in 1979 (EBS/83/135, 6/28/83 and Chart 1). The Portuguese authorities intend to continue the policy of depreciating

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1/ Lending rates range from 29.5 percent for operations of less than three months to 32.5 percent for those over five years. However, since interest on loans with maturity less than one year is paid up front, the effective rates on those loans are substantially higher.

the exchange rate vis-à-vis a weighted basket of partner countries' currencies at the rate of 1 percent a month. Such a rate of depreciation, although implying some loss of competitiveness over the next few months, would appear sufficient to maintain an adequate level of competitiveness provided wage settlements can be held at around the Government's objective of 20 percent in both 1983 and 1984. The authorities intend to keep the development of the competitive position under review and to adjust the rate of crawl if, in consultation with the Fund, such an adjustment is found necessary.

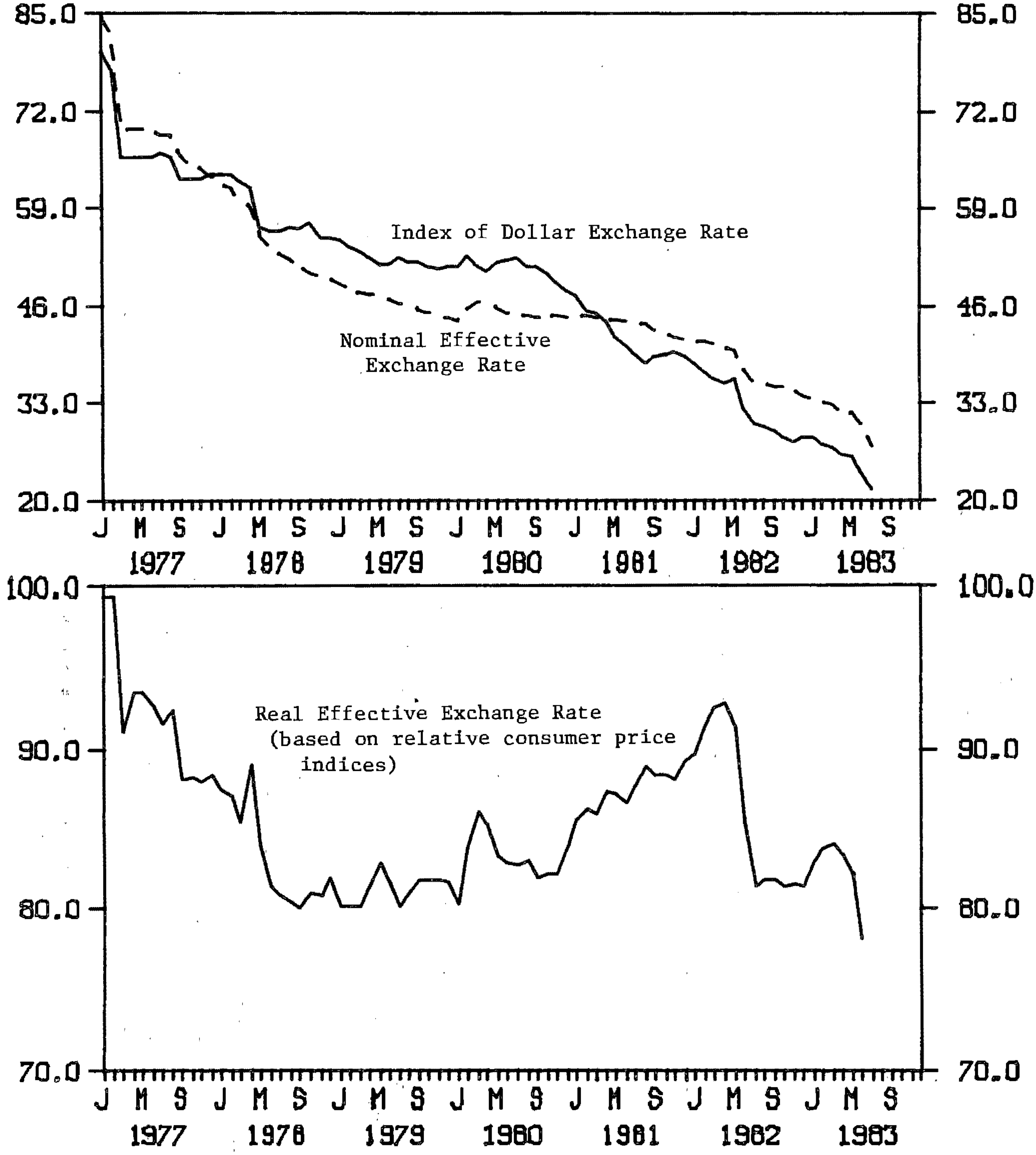
The authorities are also committed to the maintenance of an exchange system free of restrictions on payments and transfers for current international transactions. They will refrain from introducing new restrictions on trade and from intensifying existing ones for balance of payments reasons, and will enact in the 1984 budget the rollback of the import surcharge to 10 percent from the 30 percent to which it was raised in January 1983. This measure is estimated to entail a revenue loss of about Esc 4 billion.

The Portuguese authorities recognize that a more effective control over resort to external borrowing is essential to ensure a reduction in the debt service burden to a level sustainable over the medium term and to containing total financing to the economy to levels consistent with the targeted improvement in the current account and inflation. To this end, they intend to limit disbursed external debt outstanding (including short-term and nonguaranteed debt but excluding foreign liabilities of the Bank of Portugal and short-term liabilities of the banking system) which amounted to US$12,864 million at the end of 1982 (Table 2) to at most US$13,800 million at the end of 1983. According to preliminary information, external debt so defined stood at around US$13.3 billion at the end of May 1983. In order to improve the maturity structure of the debt the authorities intend to limit the increase in the short term (less than one-year maturity) portion of the debt to at most US$50 million in 1983. In the first five months of the year short-term debt declined by an estimated US$240 million.

Indicative targets, subject to the review scheduled to take place with the Fund by March 1984, have been set for end-1984. In the course of next year the increase in external debt is to be limited to at most US$1.2 billion and that in the short-term portion of the debt to at most US$200 million. The overall debt ceiling is broadly consistent with the current account target and with no loss in net foreign assets of the banking system. The Portuguese authorities' objective would be to maintain the short-term portion of the debt unchanged or even to reduce it slightly. However, in view of the uncertainties regarding the scope for access to foreign capital markets and of the amount of amortization payments on medium- and long-term debt due in 1984 (over US$1.5 billion) a relatively small increase in the short-term debt, such as the one referred to above may prove necessary. Such an increase would in any event allow a reduction for the third consecutive year in the share of the short-term debt in total debt, to below 26 percent.

Chart 1. Portugal: Exchange Rate Indices

(1975 = 100)



The authorities expect that the implementation of the adjustment program, with the support of the Fund, will strengthen confidence about Portugal in international capital markets. Accordingly, the cumulative loss in the net foreign assets of the banking system since the beginning of 1983, which amounted to nearly US$1 billion in the first half of 1983, should not exceed US$1.6 billion at any time from the inception of the stand-by arrangement until the end of February 1984. Although the loss in net foreign assets for 1983 as a whole is expected to be limited to around US$1.15 billion, it is likely to exceed that amount by a significant margin during the third quarter, in reflection of the timing of disbursements of foreign loans. This has been allowed for in setting the net foreign assets floor.

5. Prospects

The stabilization program outlined in the preceding section, if implemented with determination, should result in a significant decline in domestic demand in both 1983 and 1984 (Table 5). This decline is likely to involve all components of demand, albeit at different rates. Private consumption is expected to decline by more than 3 percentage points over the period, in reflection of the expected fall in real disposable income of households. If the authorities are successful in holding the line on wage demands, real wages can be expected to decline significantly in both 1983 and 1984. Preliminary indications on wage settlements so far suggest that they have remained in general below 20 percent, or well below the 25 percent rate of inflation expected on average in 1983. The main test of the Government's determination in this area is likely to come at the beginning of 1984, following the acceleration in consumer prices in the second half of 1983 due to the wide-ranging increases in administered prices. Purchasing power of households will also be absorbed by the sharp increase in taxes and by the moderation in the growth of social transfers envisaged in the program. The savings ratio is expected to decline in both years, as households attempt to cushion the impact of the fall in disposable income on consumption.

Fixed investment will probably show sizable declines in 1983 and especially 1984. In the latter year the decline is likely to be particularly sharp in the broadly defined public sector, including the public enterprises. It is hoped, however, that the maintenance of a sustained growth of exports will provide some incentive to expansion of capacity in that sector. Stockbuilding is likely to make a large negative contribution to GDP in both years, with the decline being especially pronounced in 1983, partly in reflection of difficulties experienced by some public enterprises in securing external financing for their imports.

Exports of goods are expected to continue to score gains in market shares, in reflection of the favorable competitive position. However, some leveling off is expected in the growth of new exports, such as petrochemicals and assembled vehicles from the new Renault plant (EBS/83/197). On the other hand, a recovery is expected in exports of services from the depressed level of 1982. Imports are likely to show a significant decline in both 1983 and 1984. A sizable reduction of imports of oil and agricultural products in 1983, reflecting the above-mentioned rundown of stocks, will be partly offset by the delivery of several aircraft imported by the national airline (TAP). On the whole, the real foreign balance is expected to make a significant contribution to GDP in both years. Nevertheless, output growth is likely to remain negative, leading to a significant decline in employment. Unemployment, as measured by the new survey of the Statistical Institute, may well exceed 12 percent of the labor force, particularly if action is taken to reduce overmanning in some public enterprises.

The projections for the balance of payments (Table 1) are predicated on the assumed behavior of the real balance and on an improvement in the terms of trade in both 1983 and 1984. The latter reflects in part some reversal of the disguised capital outflows through over- and underinvoicing which appear to have occurred on a sizable scale over the last couple of years. It is also assumed that tourism receipts and emigrants' remittances will respond favorably to the re-establishment of realistic exchange rate and interest rate levels, as well as of more stable political conditions.

6. Performance criteria

The program, in support of which Portugal is requesting a stand-by arrangement, contains the following performance criteria for December 31, 1983 as well as indicative ceilings for December 31, 1984, as reflected in Table 7: (a) ceilings on total domestic credit extended by the banking system, (b) ceilings on domestic bank credit to the public sector, (c) ceilings on total disbursed external debt of the nonmonetary sector, (d) ceilings on short-term disbursed external debt. In addition, the program contains the following performance criteria: (a) a net foreign asset test for the period from the beginning of the arrangement through February 29, 1984, and (b) the usual provisions regarding the exchange and trade system as well as the requirement that the import surcharge be rolled back from 30 percent to 10 percent in the 1984 budget and in any event no later than March 31, 1984. In addition, Portugal has undertaken to refrain from making purchases after March 31, 1984 until understandings have been reached with the Fund on the quarterly ceilings for 1984 as well as on any other performance clauses that may be deemed appropriate. At the time of this review of the program, the adequacy of interest rate, exchange rate, administered price and fiscal policies will also be reviewed.

IV. Staff Appraisal

In the view of the staff, the adjustment program outlined by the Portuguese authorities in the attached letter of intent represents a comprehensive effort which, if carried out with determination in both 1983 and 1984, should allow the restoration of a sustainable external position and lay the foundation for a resumption of growth over the medium term. The program lays emphasis on the reduction of domestic demand as the maintenance of an excessive rate of growth of the latter in recent years was in large measure responsible for the weakness in the balance of payments. The restraint on demand is, however, complemented by policies aimed at promoting a shift of resources into the export sector and at restoring the attractiveness of holding domestic financial assets.

A major role in the adjustment program is to be played by the targeted improvement in the finances of the public sector, including the public enterprises. This improvement is to be achieved first of all through a comprehensive effort to reduce public dissavings. The measures envisaged by the authorities to increase revenues and contain the growth of current expenditures will require a considerable degree of determination but the Government has already provided evidence of it by taking a number of important steps, particularly in the areas of taxation and subsidies. The formulation of the 1984 budget will constitute an important additional test of the Government's commitment. Inevitably, the magnitude of the adjustment contemplated in the public sector finances will require a cutback in public investments. It is important that these cuts be concentrated on projects that have a smaller prospective payoff in terms of foreign exchange earnings or savings and, to the extent possible, a smaller impact on employment. The staff welcomes the authorities' intention to seek the advice of the IBRD in this area.

The monetary program agreed with the Portuguese authorities represents a considerable tightening of the stance of domestic credit policy and is to be supported by a tighter control over resort to external credit, especially by public entities. The monetary program for 1984 is based on relatively cautious assumptions about the response of the demand for money to the recent increases in interest rates and may need to be reviewed in the course of next year in the light of the available evidence. The staff welcomes the flexibility shown by the Portuguese authorities in interest rate policy in recent months and their intention to continue to adjust this policy in the future in the light of developments in domestic inflation and in interest rates abroad. The maintenance of an adequate level of renumeration on escudo-denominated financial assets is crucial to promote the targeted reflow of capital and to moderate the decline in the private savings ratio. It is also important that the effective real cost of credit be maintained at a level sufficient to contain the demand for credit. In this respect the staff welcomes the authorities' intention to review and substantially reduce existing interest rate subsidies before the end of this year.

The tightening of financial policies will be accompanied by efforts to moderate the growth of nominal wages. In its economic program presented to Parliament in June, the Government indicated the need to contain the growth of wages significantly below the rate of inflation in both 1983 and 1984. The authorities have not set a specific guideline for wage increases because they believe that it would be regarded by the unions as a floor rather than as a ceiling for wage demands. However, through a firm policy with respect to wages in the public sector including the public enterprises, as well as through a tight stance of financial policies, the authorities hope to contain wage increases on average at around 20 percent in both years. In the view of the staff any significant excess over these objectives would seriously jeopardize the achievement of the inflation target especially for 1984, and would require adjustments in exchange rate and interest rate policies. In this respect, the staff regards as important the commitment of the authorities to keep the recent and prospective development of competitiveness under review and to make timely adjustments in the rate of monthly effective depreciation, if necessary.

The staff shares the Portuguese authorities view that the implementation of the program should restore confidence and ease Portugal's access to foreign capital markets over the next few months. In this repect Portugal's record in servicing its external debt and the relatively high level of its reserves including gold give ground for cautious optimism. The net foreign asset test agreed with the authorities does, however, provide a safeguard that would lead to a reassessment of the program in the event that such optimism were to prove unfounded.

The staff welcomes the authorities' committment to an open exchange and trade system and to a rollback of the import surcharge in the 1984 budget.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Government of Portugal has requested a stand-by arrangement for the period October 7, 1983 to February 28, 1985, for an amount equivalent to SDR 445 million.

2. The Fund approves the stand-by arrangement attached to EBS/83/196.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Table 1. Portugal: Summary of the Balance of Payments, 1981-84

(In millions of U.S. dollars)

	1981	1982 1/	1983 2/	1984 2/
Exports, f.o.b.	4,088	4,119	4,535	5,000
Imports, f.o.b.	9,282	8,972	8,385	8,340
Merchandise trade balance	-5,194	-4,853	-3,850	-3,340
Services, net	-544	-1,047	-880	-860
Of which:				
Tourism, net	777	611	670	770
Investment income, net	-975	-1,223	-1,250	-1,400
Transfers, net	2,888	2,661	2,730	2,950
Of which:				
Emigrants' remittances	2,832	2,599	2,660	2,878
Current balance	-2,850	-3,239	-2,000	-1,250
As per cent of GDP	(11.5)	(13.2)	(9.3)	(6.0)
Medium- and long-term capital	1,853	2,192	1,075	1,300
Short-term capital 3/	848	1,137	-215	-50
Overall balance	-149	90	-1,140	--
Change in net foreign assets of commercial banks 4/	43	18	--	--
Change in official net foreign assets 4/	106	-108	-1,140	--
Memorandum items: (percentage change)				
Market growth	1.1	1.1	3.0	4.7
Effective exchange rate	-3.6	-13.9	-22.3	-16.3
U.S. dollar/escudo rate	-18.7	-22.6	-36.0	-23.0
Export, f.o.b., unit value (in escudos) 5/	13.2	16.5	37.5	26.5
Export, f.o.b., volume 5/	-2.0	11.2	8.5	6.5
Import, c.i.f., unit value (in escudos) 5/	21.2	16.9	32.0	25.5
Import, c.i.f., volume 5/	5.7	6.4	-3.4	-3.0

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

1/ Provisional estimates.
2/ Staff forecast.
3/ Includes errors and omissions and SDR allocation.
4/ Negative sign denotes an increase.
5/ Merchandise trade, customs basis.

Table 2. Portugal: External Debt Outstanding and Debt Service Ratio, 1980-83

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

	1980		1981		1982		1983 (Proj.)	
	Total	Of which: Short-term	Total	Of which: Short-term	Total	Of which: Short-term	Total	Of which: Short-term
General Government	1,691	--	2,195	--	2,856	--	3,365	--
Bank of Portugal	1,116	220	962	250	670	120	807	100
Other monetary institutions and nonmonetary financial sector	737	3	882	23	1,377	50	1,649	50
Public enterprises	4,603	1,939	5,974	2,754	7,686	3,565	7,794	3,500
Nonfinancial private sector	831	235	1,002	262	993	182	865	200
Total	8,978	2,397	11,015	3,289	13,582	3,917	14,480	3,850
Of which:								
Public and publicly guaranteed	3,785	220	4,120	251	4,725	176		
Bank guaranteed	1,085	68	926	13	833	7		
Memorandum items: (in per cent)								
Share of short-term debt	26.7	...	29.9	...	28.8	...	26.6	...
Ratio of debt to GDP	39.5	...	49.7	...	64.6	...	76.8	...
Ratio of debt to foreign exchange earnings 1/	92.1	...	120.5	...	161.1	...	159.7	...
Ratio of debt to gross official reserves 2/	61.1	...	111.8	...	117.9	...	...	...
Ratio of debt service 3/ to foreign exchange earnings	14.6	...	22.5	...	27.3	...	27.8	...

Sources: Bank of Portugal; and staff estimates.

1/ Foreign exchange earnings from exports of goods and nonfactor services plus remittances.

2/ With gold valued at the official price of SDR 35 per ounce until December 31, 1979 and at the quarterly average London market price thereafter.

3/ Excluding amortizations of short-term debt.

Table 3. Portugal: General Government Accounts, 1981-84

(In billions of escudos)

	1981	1982	1983 1/	1984 2/	1983 Percent change	1984 Percent change
Current revenue	449.7	563.7	774.0	979.0	37.3	26.5
Direct	107.9	138.8	196.0	248.0	41.2	26.5
Indirect	212.0	261.1	361.0	452.0	38.3	25.2
Social security contributions	114.3	140.3	167.0	204.0	19.0	22.2
Nontax revenue	15.5	23.5	50.0	75.0	112.8	50.0
Current expenditure	526.3	643.6	818.0	990.0	27.1	21.0
Wages and purchases	228.8	280.3	340.0	405.0	21.3	19.1
Subsidies	69.4	79.9	90.0	76.0	12.5	-15.6
Transfers	148.4	182.3	227.0	271.0	24.5	19.4
Interest payments	79.7	101.1	161.0	238.0	59.4	47.8
Current balance	-76.6	-79.9	-44.0	-11.0		
Capital revenue	8.3	14.8	13.0	15.0	-12.2	15.4
Capital expenditure	76.5	98.6	132.0	158.0	33.9	19.7
Investment	62.5	71.6	78.0	74.0	8.9	-5.2
Transfers	14.0 3/	27.0 3/	54.0 4/	84.0 4/	...	...
Net lending	18.2	25.9	27.0	30.0		
Overall balance (national accounts basis)	-163.0	-189.6	-190.0	-184.0		
Treasury operations	-10.7	-35.3	-26.0	-15.0		
Other adjustments	1.4	4.7	-13.0	-8.0		
Overall cash balance	-172.3	-220.2	-229.0	-207.0		
Financed by:						
Domestic bank credit	133.6	162.9	167.0	150.0		
Domestic nonbank credit	4.1	2.4	2.0	2.0		
External credit	34.6	54.9	60.0	55.0		
Memorandum items: (In per cent)						
Ratio of revenue to GDP	30.6	30.7	33.9	35.1		
Of which:						
Tax revenue	29.0	28.7	31.2	31.9		
Ratio of total expenditure 5/ to GDP	42.2	42.6	43.3	42.1		
Same after adjustment for changes in arrears of Supply Fund	46.0	43.5	42.5	40.9		
Same excluding interest payments to the Bank of Portugal	43.8	39.6	39.2	37.0		
Ratio of current deficit to GDP	-5.1	-4.2	-1.9	-0.4		
Ratio of overall cash deficit to GDP	-11.5	-11.7	-9.9	-7.3		
Ratio of overall cash deficit to GDP after adjustment for changes in arrears of Supply Fund	-15.3	-12.6	-9.0	-6.0		

Source: Data provided by the Portuguese authorities.

1/ Estimates.

2/ Preliminary forecast.

3/ Excluding Esc 55 billion increase in arrears of Supply Fund toward public enterprises in 1981 and Esc 17 billion in 1982.

4/ Including Esc 18 billion repayments of arrears of Supply Fund in 1983 and Esc 35 billion in 1984.

5/ Including Treasury operations.

Table 4. Portugal: Monetary Survey, 1982-84

(In billions of escudos; end of period)

	1982	1983	1984	1983	1984
				Percent change	
Change in net foreign assets of the banking system	569.5	624.5	624.5		
Total domestic credit	2,148.9	2,786.5 1/	3,416.5 2/	27.5 3/	21.3 3/
Of which:					
To the public sector	462.3	629.3 1/	779.0 2/	26.5 3/	18.8 3/
To enterprises and households	1,633.9	2,100.2	2,577.5	28.5	22.7
To nonmonetary financial institutions	52.8	57.0	60.0		
Total assets	2,718.4	3,411.0	4,041.0	24.0 2/	17.6 2/
M1	599.9	660.0	726.0	10.0	10.0
Time deposits of residents	1,066.3	1,337.0	1,635.0	25.4	22.3
M2	1,666.2	1,997.0	2,361.0	19.9	18.2
Emigrants' deposits	488.8	667.0	895.0	36.5	34.2
Nonmonetary financial institutions	23.1	18.0	15.0		
M2*	2,178.1	2,682.0	3,271.0	23.1	22.0
Nonmonetary liabilities	122.1	192.0	233.0		
Exchange rate valuation	231.2	347.0	347.0		
Other items, net	187.1	190.0	190.0		
Memorandum items:					
Percent change in total domestic and external credit 4/	29.8	23.1	19.8		
Percent change in velocity of M2* 5/	-3.0	0.8	-1.0		
Interest rate on six-month deposits 6/	21.5	28.0	...		

Source: Data provided by the Portuguese authorities.

1/ Performance clauses.

2/ Indicative targets.

3/ Percentage changes calculated including in total domestic credit (credit to the public sector) Esc 168.7 billion as counterpart of revaluation of gold reserves in February 1980.

4/ The percent changes in the external credit component are calculated by reference to the flow of borrowing in each year converted at average exchange rates.

5/ Percentage change in nominal GDP (IV quarter-IV quarter)/percentage change in M2*.

6/ End of period.

Table 5. Portugal: Selected Economic Indicators, 1979-84

(Annual percentage change)

	1981	1982 1/	1983 2/	1984 2/
Real demand and output				
Gross domestic expenditures	3.8	3.4	-3.7	-3.6
Private consumption	2.8	2.3	-1.6	-1.8
Public consumption	5.3	5.1	2.0	--
Gross fixed investment	5.1	3.7	-3.5	-8.0
Increase in inventories 3/	0.2	0.6	-2.6	-0.5
Foreign balance 3/	-3.0	-0.4	2.6	2.3
GDP at market prices	0.8	3.0	-1.1	-1.3
Labor market				
Employment	0.7	-0.8	-1.0	-1.5
Unemployment rate (level)	8.2	7.4	11.0 4/	12.0 4/
Wage per man in manufacturing	20.0	19.8	20.0	20.0
Unit labor costs in manufacturing	18.0	17.5	20.0	20.0
Prices				
Consumer prices (average)	20.0	22.4	25.0	23.5
Consumer prices (through the year)	25.0	18.8	28.5	20.0
GDP deflator (average)	19.8	22.3	24.4	23.6
Savings and investments (ratios to GDP)				
Foreign savings 5/	11.5	13.2	9.3	6.0
Private domestic savings 6/	29.6	27.6	26.2	25.7
Public savings 7/	-5.1	-4.2	-1.9	-0.4
Private investment 6/	31.7	32.7	30.3	28.7
Public investment 7/	4.3	3.9	3.3	2.6

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

1/ Provisional estimates.
2/ Forecasts.
3/ Contribution to GDP growth.
4/ Based on a new methodology in the labor force survey adopted by the Institute of Statistics since January 1983.
5/ Current account of the balance of payments.
6/ Includes the public enterprises.
7/ Refer to the General Government.

Table 6. Portugal: Medium-Term Projection of the Balance of Payments and of External Debt, 1982-90

	1982	1983	1984	1985	1986	1988	1990
	(In millions of U.S. dollars)						
Current account projection							
Foreign exchange earnings	8,431	9,065	9,950	11,095	12,370	15,380	19,120
(Rate of growth)	(-7.0)	(7.5)	(9.8)	(11.5)	(11.5)	(11.5)	(11.5)
Exports of goods	4,119	4,535	5,000	5,575	6,215	7,725	9,605
Exports of services	1,651	1,800	2,000	2,230	2,485	3,090	3,840
Emigrants' remittances and other transfers	2,661	2,730	2,950	3,290	3,670	4,565	5,675
Foreign exchange payments	11,670	11,065	11,200	12,345	13,620	16,630	20,370
Imports of goods and services other than interest payments	10,326	9,767	9,843	10,878	12,103	14,935	18,519
(Rate of growth)	(-4.3)	(-5.5)	(0.8)	(10.5)	(11.3)	(11.2)	(11.4)
Interest payments	1,344	1,298	1,357	1,467	1,517	1,695	1,851
Current account balance	-3,239	-2,000	-1,250	-1,250	-1,250	-1,250	-1,250
(As per cent of GDP)	(13.2)	(9.3)	(6.0)	(5.5)	(5.0)	(4.1)	(3.4)
External debt projections							
Total debt service payments	4,722	6,475	6,996	7,003	7,089	8,594	9,484
Amortization	3,378	5,177	5,639	5,536	5,572	6,898	7,633
Of which: Short-term	(2,397)	(3,957)	(4,000)	(4,000)	(4,000)	(4,380)	(4,780)
Interest payments	1,344	1,298	1,357	1,467	1,517	1,695	1,851
Total debt at end of period	13,582	14,480	15,134	16,104	17,034	18,774	20,324
	(In per cent)						
Total debt service ratio	56.0	71.4	70.3	63.1	57.3	55.9	49.6
Debt service ratio excluding amortization of short-term debt	27.6	27.8	30.1	27.1	25.0	27.4	24.6
Memorandum items:							
Assumed international inflation	...	5.2	4.6	6.5	6.5	6.5	6.5
Interest rate in international capital markets	...	10.5	10.0	10.0	9.5	9.5	9.5

Sources: Bank of Portugal; and staff estimates.

Table 7. Portugal: Quantitative Performance Criteria

	Ceilings for December 31, 1983	Indicative Ceilings for December 31, 1984
Credit ceilings		
Total domestic credit extended by the banking system 1/	Esc 2,786.5 billion	Esc 3,416.5 billion
Domestic bank credit to the public sector 1/	Esc 629.3 billion	Esc 779.0 billion
External debt ceilings		
Total disbursed external debt to the nonmonetary sector 2/	US$13,800 million	US$15,000 million
Short-term disbursed external debt 3/	US$3,800 million	US$4,000 million
Net foreign asset test		
Cumulative loss in net foreign assets of the banking system since the beginning of 1983	US$1.6 billion 4/	...

Source: Portugal's letter of intent to the Managing Director, September 1983.

1/ The ceilings on domestic bank credit to the public sector and on total domestic bank credit through December 31, 1983 are to be automatically adjusted upward (or downward) up to Esc 12 billion for any shortfall (excess) of external credit to the Government with respect to the targeted amount of Esc 60 billion for 1983.

2/ Includes short-term and nonguaranteed debt but excludes foreign liabilities of the Bank of Portugal and short-term liabilities of the banking system.

3/ Excludes foreign liabilities of the Bank of Portugal and the banking system.

4/ The net foreign asset test covers the period through February 1984.

Table 8. Portugal: Schedule of Proposed Purchases and Repurchases, 1983-84

(In millions of SDRs)

	Oct. 1983	Jan. 1984-Mar. 1984	Apr. 1984-June 1984	July 1984-Sept. 1984	Oct. 1984-Dec. 1984	Jan. 1985-Feb. 1985
Purchases	354.75	69.65	69.65	69.65	69.65	69.65
Stand-by arrangement	96.75	69.65	69.65	69.65	69.65	69.65
Ordinary resources	(64.50)	(31.66)	(31.66)	(31.66)	(31.66)	(31.66)
Borrowed resources	(32.25)	(37.99)	(37.99)	(37.99)	(37.99)	(37.99)
Compensatory financing	258.0	--	--	--	--	--
Repurchases	--	--	--	--	--	--
Stand-by arrangement	--	--	--	--	--	--
Compensatory financing	--	--	--	--	--	--
Net purchases	354.75	69.65	69.65	69.65	69.65	69.65
			(In percent of quota)			
Total Fund holdings (cumulative)	237.5	264.5	291.5	318.5	345.5	372.5
Excluding compensatory	137.5	164.5	191.5	218.5	245.5	272.5

Source: International Monetary Fund.

Fund Relations with Portugal

(As at end-July 1983)

Quota:	SDR 258 million.
Proposed new quota:	SDR 376.6 million.
Fund's holdings:	SDR 258 million or 100.0 percent of quota.
Holdings of SDRs:	SDR 1.7 million or 3.19 percent of net cumulative allocation.
Distribution of profits from gold sales:	US$18.6 million.
Gold distribution:	100,131.9 fine ounces.
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 flows, tourism, and emigrants' remittances). Following a 9.4 percent devaluation in 1982, the competitive position of Portugal was restored to the level prevailing at the end of 1980, but a further erosion took place subsequently as the rate of monthly depreciation was maintained at 0.75 percent, or less than the inflation rate differential between Portugal and its main trading partners. On March 24, 1983 the monthly rate of depreciation was increased to 1 percent and the escudo was also depreciated by 2 percent in effective terms. Following continuous pressure on foreign exchange reserves, on June 22, 1983 the authorities announced a further devaluation of the escudo by 12 percent in effective terms. This move placed Portugal's competitive position at a level significantly above its previous peak in 1979 which appeared warranted in view of the structural changes that have affected the balance of payments over the last few years. The escudo continues to be depreciated at the rate of 1 percent a month. On August 31, 1983, US$1 was worth Esc 122.
Last consultation:	March 1983. The staff report (SM/83/88, 5/17/83) was discussed by the Executive Board on June 13, 1983.

Portugal: Main Targets, Assumptions and Elements of the Financial Program

I. Targets

1. A reduction in the current account deficit of the balance of payments from US$3.2 billion or 13.2 percent of GDP in 1982 to US$2.0 billion or 9.3 percent of GDP in 1983 and to US$1.25 billion or 6.0 percent of GDP in 1984.

2. The net foreign assets of the banking system, which declined by US$980 million in the first half of 1983, are targeted to decline by no more than US$160 million in the second half of 1983 and are targeted to remain unchanged in 1984.

3. A reduction in the rate of consumer price inflation from the 29 percent expected at the end of 1983, due to the recent sharp inreases in administered prices and the recent devaluation of the escudo, to 20 percent by the end of 1984.

4. A reduction in the combined deficit of the General Government and the Supply Fund from the equivalent of 12.6 percent of GDP in 1982 to 9.0 percent in 1983 and to 6.0 percent in 1984.

II. Assumptions

1. Real GDP is projected to decline by 1 percent in 1983 and by 1 1/4 percent in 1984 reflecting a contraction of real domestic demand of over 3 1/2 percent in both years, partially offset by an improvement in the real foreign balance.

2. Total foreign exchange receipts in U.S. dollars are projected to increase by 7.5 percent in 1983 and by 9.8 percent in 1984. This projection assumes a recovery in export market shares on the basis of an improved competitive position as well as some reversal of disguised capital flows through under-invoicing. It is also assumed that tourism receipts and emigrants' remittances will respond favorably to the reestablishment of realistic exchange rate and interest rate levels as well as of more stable political conditions.

3. The U.S. dollar value of imports is projected to fall by 6.6 percent in 1983 and by 0.5 percent in 1984. Oil imports which account for almost 30 percent of total imports are projected to decline by 17 percent in 1983 and by 2 percent in 1984 in part reflecting a significant drawdown of inventories. Agricultural imports are also assumed to be constrained through a reduction in stocks. The U.S. dollar values of the remaining categories of imports are projected to decline by 5 percent in 1983 and to be maintained at that level in 1984, in reflection of the expected contraction in real domestic demand.

4. The velocity of M2* (money and quasi-money including emigrants' deposits) is assumed to increase by 0.8 percent in 1983. In 1984 the velocity of M2* is assumed to decline by 1 percent as economic agents react to the increase in real interest rates.

III. Main Elements of the Program

1. Public sector policies

(a) The targeted improvement in the combined position of the General Government and the Supply Fund is to be achieved through a wide ranging set of measures, some of which have already been taken. In 1983 the main contribution is to come from an increase in the tax burden and from the recent sizable increases in administered prices. In addition the public sector deficit in 1983 is to be contained through a tight control of expenditures and in particular of Treasury operations. For 1984 there is to be a further increase in the tax burden mainly in reflection of fiscal drag and of the full year impact of some increases in indirect taxes enacted in September 1983. A further improvement in the position of the Supply Fund is also to be attained in 1984 through a new series of substantial price increases for subsidized commodities and for petroleum products at the beginning of the year. On the expenditure side, a comprehensive effort is envisaged for 1984 including the containment of wage increases for civil servants to 17 percent, the extension of the existing hiring freeze, the containment of transfers to peripheral public entities, a reduction in the Central Government investment program, and a modification of the mechanism for determining interest payments to the Bank of Portugal.

(b) The improvement in the position of the General Government is to be complemented by a strengthening of the finances of the public sector enterprises. This effort will be aimed at containing their resort to domestic and external credit through a cutback in their investment program and through measures to increase their self-financing.

(c) Consistent with the targeted improvement in the overall position of the General Government, ceilings are set on domestic bank credit to the General Government. These ceilings would imply a deceleration in the growth of such credit from 33.3 percent in 1982 to 26.5 percent in 1983 and to 18.8 percent in 1984.

2. Money and credit

a. Ceilings are set on total domestic bank credit consistent with a deceleration in such credit from over 29 percent in 1982 to 27.5 percent in 1983 and to 21.5 percent in 1984. This deceleration is to be achieved through the targeted improvement in the finances of the public sector and through both a more effective enforcement of the credit ceilings set by the Bank of Portugal and an increase in the effective cost of credit.

b. Interest rates on both deposits and on lending operations, which are currently positive in real terms, are to be managed in a flexible manner to adjust for developments in domestic inflation and in interest rates abroad. In addition, existing interest rate subsidies to exports are to be eliminated by the end of 1983 and other incentive schemes and to be reviewed.

3. Prices and wages

a. Prices of subsidized imported commodities, which were substantially raised in June 1983, are to be further increased at the beginning of 1984 with a view to improving the financial position of the Supply Fund. These prices are to be kept under review during 1984 in light of the developments in their costs.

b. Wage increases in both 1983 and 1984 are to be contained significantly below the rate of inflation. In this regard wage settlements in the public sector enterprises in both 1983 and 1984 are targeted not to exceed 20 percent.

4. External policies

a. The system of depreciating the exchange rate vis-à-vis a weighted basket of partner countries currencies at the rate of 1 percent a month is to be continued in order to maintain an adequate level of competitiveness. The development of the competitive position is to be kept under review.

b. The exchange system is to be kept free of restrictions on payments and transfers for current international transactions. In addition, the import surcharge will be rolled back in the 1984 budget from 30 percent to 10 percent.

c. More effective control is to be sought over resort to external borrowing in order to improve the debt service burden. To this end ceilings have been set on the total disbursement of external debt as well as on the short-term component of such debt.

5. Review

Prior to March 31, 1984 there will be a review of the program and of the adequacy of interest rate, exchange rate, administered prices, and fiscal policies.

Stand-By Arrangement - Portugal

Annexed hereto is a letter dated September 9, 1983 from the Minister of Finance and Planning and the Governor of the Bank of Portugal requesting a stand-by arrangement and setting forth the objectives and policies that the authorities of Portugal intend to pursue for the period of this stand-by arrangement.

To support these objectives and policies the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For the period from October 7, 1983 to February 28, 1985 Portugal will have the right to make purchases from the Fund in an amount equivalent to SDR 445 million, subject to paragraphs 2, 3, 4 and 5 below, without further review by the Fund.

2. Purchases under this stand-by arrangement shall not without the consent of the Fund exceed the equivalent of SDR 96.75 million until January 31, 1984, SDR 166.40 million until April 30, 1984, SDR 236.05 million until July 31, 1984, SDR 305.70 million until October 31, 1984, and SDR 375.35 million until January 31, 1985. None of these limits shall apply to purchases under the stand-by arrangement that would not increase the Fund's holdings of Portugal's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 percent of quota.

3. Purchases under this stand-by arrangement shall be made from ordinary and borrowed resources in the ratio of 2 to 1 until purchases under this arrangement reach SDR 96.75 million, and thereafter in the ratio of 1 to 1.2, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Portugal will not make purchases under this stand-by arrangement that would increase the Fund's holdings of Portugal's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of Portugal's currency resulting from purchases of borrowed resources beyond 12.5 percent of quota:

(a) during any period in which the data at the end of the preceding period indicate that (i) the limit on total domestic credit described in paragraph 12 of the attached letter; or (ii) the limit on credit to the public sector described in paragraph 12 of the attached letter; or (iii) either of the limits on external debt described in paragraph 16 of the attached letter, is not observed; or

(b) during any period through the end of February 1984 in which the net loss in foreign assets of the banking system exceeds the limit described in paragraph 17 of the attached letter; or

(c) after March 31, 1984 until the proposed policies for 1984 have been reviewed and suitable performance criteria have been established in consultation with the Fund as contemplated by paragraph 18 of the attached letter; or after such performance criteria have been established, while they are not being observed; or

(d) after March 31, 1984 if the intention on the rolling-back of the import surcharge mentioned in paragraph 15 of the attached letter is not being observed; or

(e) during the entire period of this stand-by arrangement, if Portugal (i) imposes new or intensifies existing restrictions on payments or transfers for current international transactions; or (ii) introduces multiple currency practices; or (iii) concludes bilateral payments agreements which are inconsistent with Article VIII; or (iv) imposes new or intensifies existing import restrictions for balance of payments reasons.

When Portugal is prevented from purchasing under this stand-by arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Portugal and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Portugal's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Portugal. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Portugal and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Portugal, the Fund agrees to provide them at the time of the purchase.

7. The value date of a purchase under this stand-by arrangement involving borrowed resources will be normally either the 15th day or the last day of the month, or the next business day if the selected day is not a business day. Portugal will consult the Fund on the timing of purchases involving borrowed resources.

8. Portugal shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

9. (a) Portugal shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchase as Portugal's balance of payments and reserve position improves.

(b) Any reductions in Portugal's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) The value date of a repurchase in respect of a purchase financed with borrowed resources under this stand-by arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that repurchase will be completed not later than seven years from the date of purchase.

10. During the period of the stand-by arrangement Portugal shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Portugal or of representatives of Portugal to the Fund. Portugal shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Portugal in achieving the objectives and policies set forth in the attached letter and annexed memorandum.

11. In accordance with paragraph 19 of the attached letter Portugal will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the arrangement and while Portugal has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Portugal's balance of payments policies.

September 9, 1983
Lisbon, Portugal

CONFIDENTIAL

Dear Mr. de Larosière,

1. In the last two years, the current account deficit on Portugal's balance of payments deteriorated to a level that was clearly unsustainable over the medium term. This deterioration reflected in part factors beyond the Portuguese authorities' control, including the recession and high interest rates abroad. An important role was also played by the maintenance of a rate of growth of domestic demand substantially higher than abroad and by the lack of adequate flexibility in interest rate and exchange rate policies. Finally, the balance of payments continued to be affected by serious structural weaknesses, including high dependence on imports of energy and agricltural products and a relatively narrow export base.

The escalation of the current account deficit of the balance of payments from the equivalent of around 5 per cent of GDP in 1980 to 11 1/2 percent in 1981 and to 13 1/2 percent in 1982 resulted in a sharp increase in the external debt and its service burden, which reached 27 percent of foreign exchange earnings in 1982. The Government recognizes that, particularly in the present conditions of international capital markets, the maintenance of high current account deficits in the balance of payments would lead to acute financing difficulties and to large losses in international reserves of the country. Accordingly, it attaches high priority to a reduction in the current external deficit to US$2 billion (9 1/4 percent of GDP) in 1983 and to around US$ 1/4 billion (6 percent of GDP) in 1984.

2. The targeted improvement in the external accounts will be pursued through a comprehensive program of monetary and budgetary restraint, flexible and realistic policies with respect to interest rates, the exchange rate and administered prices, and through efforts to moderate the growth of nominal incomes. By promoting a sustained growth of exports and a decline in imports, these policies are expected to moderate the impact of the required cutback in domestic demand on output and employment. As a first step in its adjustment program the Portuguese Government introduced a package of financial and economic measures shortly after assuming office in June. These measures included a 12 percent effective devaluation of the escudo, substantial increases in the prices of a wide range of subsidized commodities (including bread, vegetable oils, feedstuffs, milk, sugar, fertilizers and oil products), the freezing of the public sector investment program pending review and the introduction of an extraordinary company profit tax.

The Government intends to complement its short-run adjustment efforts with policies aimed at correcting the structural weaknesses of the economy, also in preparation for its forthcoming entry into the EC. Accordingly, steps will be taken to promote the restructuring and diversification of public and private industry, to reduce energy dependence, to increase productivity in agriculture, and to modernize the financial and fiscal systems. Progress in these areas is essential to creating the conditions for resumption of a sustained growth of output and employment over the medium term within the constraint of the maintenance of a viable external position.

3. In support of its stabilization effort, the Government requests a stand-by arrangement from the International Monetary Fund. This arrangement will cover the period October 7, 1983 to February 28, 1985 and will be in the amount of SDR 445 million. Before making purchases under this arrangement the Bank of Portugal will consult with the Managing Director on the particular currencies to be purchased.

4. The main contribution to stabilization will come from fiscal restraint. The initial 1983 budget targeted an overall deficit of the General Government (Sector Publico Administrativo) on a cash basis equivalent to 9 1/2 percent of GDP as compared with 11 3/4 percent in 1982. However, slippages during the first half of the year would have substantially raised the deficit in the absence of remedial measures. The Government is determined to take the necessary measures to contain the deficit to below 10 percent of GDP. To this end a package of revenue-raising measures will be introduced in September.

5. Beyond 1983, the Portuguese Government is determined to secure a substantial and sustained reduction in the deficit of the General Government in relation to GDP. As a first step, the 1984 budget will target a reduction in the current account deficit of the General Government to below 1 percent of GDP and in the overall cash deficit to 7.3 percent of GDP. This is to be achieved through an increase of over 1 percentage point in the ratio of revenues to GDP and in a reduction of 1.4 percentage points in the ratio of expenditures to GDP (3 percentage points excluding interest payments). The main steps envisaged to secure the targeted revenue performance include adjustments in the rates of various indirect taxes and improved tax administration and enforcement. On the expenditure side the Government will contain the increase in wage rates for civil servants for 1984 and will extend the existing hiring freeze to categories of civil servants now exempted, while intensifying efforts to promote personnel mobility within the public administration. It will also review the system of social benefits with a view to limiting their growth within the economic capacity of the country and to eliminating abuses. The mechanism of determination of interest payments on public debt held by the Bank of Portugal has been modified to moderate the growth in this item of expenditure, which has more than doubled during the last two years. At the end of 1983 interest rates on government securities held by the Bank of Portugal will be rolled back to the level prevailing at the time of issue, instead of being adjusted to the current discount rate. Transfers to peripheral public entities, including the local authorities, will be strictly contained in the 1984 budget. The targeted reduction in public dissavings will be complemented by a determined effort to contain capital expenditures and extrabudgetary operations. In this respect a thorough review will be made of the investment

program of the Central Government, with the aim of containing its total amount to below the 1983 level.

6. The Government is firmly committed to taking necessary steps to improve expenditure control in all areas of the public sector, to modernize the structure of the tax system and to strengthen tax administration and enforcement. On the expenditure side, these steps will include: a firm control over Treasury operations, which will be limited to meeting temporary financing needs, to be reversed in the course of the year; the strict enforcement of the requirement that borrowing from the banking system by autonomous funds and services be authorized by the Ministry of Finance; a close monitoring of developments in the finances of local authorities, which will be required to submit timely quarterly accounts to the Central Government. In addition, a joint committee of the Ministry of Finance and the Bank of Portugal has been set up to monitor developments in domestic and external credit to the public sector and to ensure better coordination of credit policy with the borrowing requirements of the public sector.

7. The Government intends to begin promptly preparations for a comprehensive reform of the tax system, which remains overly complex and relatively income inelastic. The transactions tax and other indirect levies will be replaced with a value-added tax, which will represent the major source of indirect revenues for the State budget. To this end, the Government will complete the remaining technical and administrative steps to introduce the tax by the beginning of 1985. Moreover, the Government will promptly initiate a study on the reform of direct taxes, aimed at replacing the existing schedular income taxes with a global personal income tax and a single company income tax. Efforts will be continued over the medium term to broaden the tax base through reductions in fiscal benefits and exemptions and to provide additional own revenue-raising capacity to local and regional authorities.

8. The improvement in the finances of the General Government is to be complemented by a substantial strengthening of the position of the Supply Fund which serves as a mechanism for the cross subsidization of imported essential commodities. In this regard an important beginning was made in June with substantial increases in the prices of subsidized commodities. As a result of these measures the Supply Fund is expected to shift from a deficit of Esc 16 billion or 0.9 percent of GDP in 1982 to a surplus of Esc 18 billion or 0.8 percent of GDP in 1983. This surplus is to be utilized to repay arrears accumulated over the last few years by the Supply Fund to public enterprises that import the commodities subsidized by the Fund. In 1984 the Government intends to take measures to ensure that the surplus of the Supply Fund is increased to Esc 35 billion or almost 1 1/4 percent of GDP. On this basis the combined position of the General Government and the Supply Fund will improve from a deficit equivalent to 12.8 percent of GDP in 1982, to around 9 percent in 1983 and to around 6 percent in 1984.

9. The Government attaches high priority to a substantial and sustained improvement in the financial position of public sector enterprises. For this purpose a comprehensive effort will be made to contain the borrowing requirements of these enterprises and to increase their self-financing. This effort will involve a thorough review of their investment program to ensure the allocation of scarce financial resources to projects with the largest and quickest payoff in terms of foreign exchange earnings or savings. The review of the 1983 program was completed at the end of August, and the Government intends to limit gross capital formation by state-owned enterprises in 1983 to around Esc 135 billion (of which about Esc 27 billion reflects the delivery of new aircraft purchased by the national airline company in 1980), as compared with Esc 107 billion in 1982, which implies a decline in real terms. The investment program for 1984 will be defined during the last quarter of this year, with the total amount being constrained by the need to ensure a substantial deceleration in domestic bank credit to the public enterprises and to limit their resort to external borrowing along the lines described in paragraphs 12 and 16 below. Preliminary projections suggest that this would involve a substantial decline in real terms in investment by public enterprises.

The effort to improve the self-financing of public enterprises will be articulated on several fronts. Realistic pricing policies will be pursued with respect to those enterprises which are not subject to international competition by, as a minimum, allowing the full pass through of cost increases onto prices. In some areas price increases higher than those of costs may be necessary. As steps in this direction, public transport fares were raised by 30 percent on September 1, 1983 while electricity tariffs will be significantly raised again before the end of the year, following a 10 percent increase in July 1983. Realistic pricing policies will be complemented by a determined effort to contain costs and raise productivity. The Government intends to keep wage increases in public enterprises below the rate of inflation in both 1983 and 1984. In enterprises declared in financial difficulties wage increases will be kept below the average and the Government will take other necessary measures to ensure the economic viability of these enterprises over the longer term. Appropriate income support mechanisms will be instituted to moderate the impact of these measures on the workers affected.

In shaping its policies with respect to the public enterprises sector, the Government intends to draw on the advice and expertise of the IBRD.

10. Monetary policy will be geared to securing the targeted improvement in the balance of payments and a deceleration of inflation from around 29 percent at the end of 1983 to around 20 percent by end-1984. Accordingly, the monetary program of the Bank of Portugal will target a significant deceleration in the growth of the monetary and credit aggregates from the high rates recorded in recent years. This deceleration will be facilitated by the expected improvement in the finances of the General Government and of the public enterprises. In addition, the rate of growth of credit to the private sector will be contained through both a more

effective enforcement of the credit ceilings set by the Bank of Portugal and an increase in the effective cost of credit. The latter will be raised not only through increases in nominal lending rates as described in paragraph 11 below, but also through a reduction in interest rate subsidies provided by the Bank of Portugal and by the budget. As a first step in this direction the existing interest rate subsidies to exports will be eliminated effective end-1983. No new interest rate subusidies will be approved by the Bank of Portugal under the housing and investment incentive schemes. The Government also intends to undertake before the end of the year a thorough review of the incentive schemes with a view to making them more selective and substantially reducing their cost to the budget.

11. The Government is committed to maintaining a flexible stance with respect to interest rate policy in order to ensure the relative attractiveness of holding domestic financial assets and to control the demand for credit. Deposit and lending rates which were raised by between 4 and 5 percentage points in March 1983, were increased by a further 2 to 2.5 percentage points in August 1983. Rates prevailing in the interbank bond market were increased by more and will continue to be raised in the next few months in order to strengthen the profit position of banks, and to improve incentives to comply with the credit ceilings. Following these moves, which restored rates on the main domestic financial assets to positive levels in real terms, interest rates will be managed in a flexible manner, both in an upward and a downward direction, to adjust for developments in domestic inflation and in interest rates abroad. The Government intends to promote the development of domestic financial markets so as to raise the share of nonbank financing of the public sector deficit as well as to channel savings into productive investments.

12. In order to give effect to the monetary policy outlined above, the authorities have set the following binding ceiling on domestic bank credit for December 31, 1983 and indicative ceiling for December 31, 1984. Total domestic credit extended by the banking system (which stood at Esc 2,148.9 billion on December 31, 1982) is not to exceed Esc 2,786.5 billion as of December 31, 1983 and Esc 3,416.5 billion as of December 31, 1984. Within this ceiling it is intended to limit domestic bank credit to the public sector (which stood at Esc 462.3 billion on December 31, 1982) to Esc 629.3 billion by December 31, 1983 and to Esc 779 billion by December 31, 1984. The limits for 1983 are predicated on the assumption that the net increase in external credit to the Government will reach Esc 60 billion in 1983. The ceilings on domestic bank credit to the public sector and on total domestic bank credit for 1983 will be automatically adjusted upward (downward) for any shortfall (excess) of external credit to the Government with respect to the targeted amount up to Esc 12 billion. The limits on total bank credit and on credit to the public sector for 1984 will be subject to the review scheduled to take place by March 31, 1984 as mentioned in paragraph 18 below, at which time quarterly ceilings and subceilings will be agreed upon. At that time agreement will also be reached with the Fund on an indicative target for domestic credit expansion to the public enterprises.

13. Financial policies will need to be complemented by policies aimed at moderating labor costs, if the desired deceleration of inflation is to be obtained without unduly sacrificing the growth of output and employment. The wage policy for the public sector described in paragraphs 5 and 9 above will set an example for wage negotiations in the private sector. The effort to moderate wage increases will be accompanied by structural measures to improve labor productivity through enhanced labor mobility, training programs and other steps to promote a more flexible utilization of the workforce.

14. In the external area, the Government regards the maintenance of a competitive exchange rate as an essential condition for the attainment of the desired improvement in the external accounts. The 12 percent effective devaluation of the escudo in June has resulted in a substantial improvement in competitiveness. The Portuguese authorities intend to continue the policy of depreciating the effective exchange rate vis-à-vis a weighted basket of partner countries' currencies at the rate of 1 percent a month which is deemed to be sufficient in present circumstances to ensure Portugal an adequate competitive position. The authorities will keep the evidence on the competitive position under review, especially in the light of the trade and relative inflation performance, and will be prepared to make further adjustments in the rate of monthly depreciation if, in consultation with the Fund, such adjustments are deemed necessary.

15. The Government of Portugal is committed to the maintenance of a trade and payments system virtually free of restrictions on payments and transfers for current international transactions. During the course of the program, the Government will refrain from the introduction of any new restriction or the intensification of existing ones either on payments and transfers for current international transactions or on imports for balance of payments reasons. In the 1984 budget and, in any event no later than March 31, 1984, the import surcharge will be rolled back to 10 percent from the 30 percent to which it was raised in January 1983.

16. The Government intends to limit resort to external borrowing to levels consistent with a reduction in the ratio of external debt service to foreign exchange earnings over the medium term. To this end, the authorities will limit Portugal's disbursed external debt outstanding (including short-term and nonguaranteed debt but excluding foreign liabilities of the Bank of Portugal and short-term liabilities of the banking system) which amounted to US$12,864 million at the end of 1982 to no more than US$13,800 million at the end of 1983 and US$15,000 million at the end of 1984. Within this ceiling, short-term external debt disbursed, excluding foreign liabilities of the Bank of Portugal and of the banking system, which stood at US$3,756 million at the end of 1982, will not exceed US$3,800 million at the end of 1983 and US$4,000 million at the end of 1984. The indicative limits on the external debt for the end of 1984 will be reviewed during the review scheduled to take place by March 31, 1984, at which time quarterly ceilings will also be established.

The restraint on external borrowing will be accompanied by a strengthening of the official control mechanism through the creation of an interministerial committee, with the participation of the Bank of Portugal, which will be in charge of defining the criteria for access to external borrowing and of reviewing and authorizing major operations. Moreover, the Bank of Portugal will intensify its ongoing efforts to improve the statistical reporting system on the external debt, with a view to shortening the time lags in the collection and processing of relevant data.

17. The Government expects that the determined implementation of the adjustment program described above, with the support of the IMF, will strengthen confidence and improve the access of Portugal to external financing. Accordingly, the cumulative loss in the net foreign assets of the banking system since the beginning of 1983, which amounted to US$981 million during the first half of 1983, should not exceed US$1.6 billion at any time from October 7, 1983 to the end of February 1984. Appropriate tests on the net foreign assets of the banking system during the rest of 1984 will be agreed with the Fund, if deemed necessary, at the time of the review in March 1984.

18. The Government of Portugal believes that the policies set forth in this letter are adequate to achieve the objectives of the program but it will take any further measures that may become appropriate for this purpose. Portugal will consult with the Fund in accordance with the policies of the Fund on the adoption of any measures that may be appropriate. Portugal will refrain from making purchases after March 31, 1984 until understandings have been reached with the Fund on the limits referred to in paragraphs 12, 16 and 17 for calendar year 1984 as well as on any other performance clauses that may be deemed appropriate. In addition, after the period of the stand-by arrangement and while any Fund holdings of escudos above the first credit tranche include currency resulting from purchases under the stand-by arrangement, the Government will consult with the Fund, at the initiative of the Government or at the request of the Managing Director, concerning Portugal's balance of payments policies.

Sincerely yours,

Ernani Rodrigues Lopes
Minister of Finance and Planning

Manuel Jacinto Nunes
Governor
Bank of Portugal

Portugal 1760

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MR. VAN HOUTVEN

SECRETARY

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EXECUTIVE BOARD TOOK FOLLOWING DECISION JANUARY 24:

QUOTE:

THE CABLE DATED NOVEMBER 20, 1978 FROM THE MINISTER OF FINANCE AND PLANNING AND THE GOVERNOR OF THE BANK OF PORTUGAL SHALL BE ATTACHED TO THE STAND-BY ARRANGEMENT FOR PORTUGAL (EBS/78/228, SUPPLEMENT 2), AND THE LETTER OF INTENT OF MAY 8, 1978 SHALL BE READ AS MODIFIED BY THE CABLE DATED NOVEMBER 20, 1978.

UNQUOTE

VAN HOUTVEN SECRETARY INTERFUND

Distribution

MESSAGE MUST END HERE

Drafted by: ~~KFriedman:gag~~ KF
Department: SEC
Date: 1/24/79

Leo Van Houtven
Secretary
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SEC-17/OCR
9-2-76

Portugal 1980

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).

K KFriedman/gag

Portugal 1760

1. UNAUTHORIZED DISCLOSURE OF INFORMATION

Mr. Schneider made the following statement:

> I would like to refer to yesterday morning's press summary, which carried excerpts of an article in the Frankfurter Allgemeine Zeitung of January 17, 1979 under the headline "IMF Annoyed with Turkey." I am very concerned about the fact that this article seems to be based on an internal Fund report that apparently has been leaked to the press. Although such leaks have occurred in the past, I cannot let this event go by without expressing my deep concern about this indiscretion. It should be unacceptable to all of us that the exchange rate policy of an individual country has been discussed in a newspaper on the basis of a judgment allegedly expressed in an internal document of the Fund. Such leaks are harmful not only to the country but also to the credibility of the Fund as a center for confidential information. Consequently, I would urge you, Mr. Chairman, to do everything possible as far as the Fund is concerned to avoid such damaging leaks in the future.

The Chairman remarked that he deeply regretted the unauthorized disclosure of information and would attempt to detect the source of the leak.

2. PORTUGAL - 1978 ARTICLE IV CONSULTATION, AND REVIEW OF STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1978 Article IV consultation with Portugal and a draft decision pursuant to Article XIV (SM/78/304, 12/26/78), together with a report on the staff review of the stand-by arrangement with Portugal (EBS/78/707, 12/26/78; and Sup. 1, 1/22/79). They also had before them a report on recent economic developments in Portugal (SM/78/305, 12/29/78).

The staff representative from the European Department said that the Portuguese Government, which had taken office in November 1978, had confirmed its intention to begin negotiations with the Fund for a new stand-by arrangement. A staff mission to conduct the negotiations was scheduled to arrive in Lisbon on February 6, 1979.

Mr. Dini made the following statement:

> During 1978 Portugal has gone through with a tough stand-by program. Its toughness is demonstrated by the difficult adjustment policies pursued, which comprised a further sizable depreciation of the currency, raising interest rates to historically high levels, strict limitations on wage increases and the consequent fall in real wages, and reductions in the few import and other restrictions still maintained by Portugal.

The Portuguese authorities have implemented this program with considerable success, and they are satisfied with the results obtained in line with the program objectives, especially the marked slowdown in the rate of inflation, and the significant reduction in the current external deficit which is confirmed by the latest figures provided by the Portuguese authorities.

Balance of payments developments have been satisfactory in many respects. Exports responded better than anticipated to cost competitiveness, which has been fully restored, and to reduced growth of demand in the domestic markets, while the unwinding of speculative inventories induced by tight monetary conditions and changes in expectations contributed to slow growth of imports. Substantial improvements were also recorded in net receipts on invisible transactions, including tourism and remittances, as well as in the capital account where there has been a turnaround that reflects in part interest rate differentials in favor of domestic financial assets, and confidence factors.

An area where performance was below expectations in 1978 is public finances. The current account of the government budget did not improve as foreseen under the program. There were expenditure overruns that reflected mainly an increase in transfers tied directly or indirectly to social programs designed to reduce the heavy burden of the adjustment process, particularly on low income earners. There were also revenue shortfalls, especially in receipts from import duties, sales taxes, and social security contributions by private and public companies that suffered from a liquidity squeeze.

The Portuguese authorities are of the view that targets set in the program were basically complied with. By the end of 1978, although the ceiling on credit to the public sector had been exceeded by about 7 per cent despite foreign borrowing, the overall ceiling on net domestic credit had been exceeded only by a negligible percentage. At the same time, the net foreign liabilities of the banking system had declined sharply rather than increasing steadily as anticipated under the program.

Two remarks are in order with respect to the tightness of monetary and credit conditions in 1978. The first regards the ceiling on the expansion of net domestic credit which, as the staff has pointed out on page 3 of EBS/78/707, assumed an increase in income velocity of money of 7.5 per cent and which did not materialize; therefore, fuller compliance with the credit ceilings set in the stand-by program would have resulted in an overly restrictive monetary policy. Second, the degree of restrictiveness of monetary policy is reflected not only by the high interest rates but also by the fact that the increase in the domestic component of money supply remained close to the GDP deflator, leaving little room for financing output growth.

The effects on domestic activity of the tight monetary conditions began to be felt increasingly in the course of the year. The decline, indicated in the staff report, in the rate of growth of output at factor cost from 5.7 per cent in 1977 to some 3.8 per cent in 1978 does not provide the full picture of the current situation. On the basis of the latest figures that have become available since the visit of the Fund mission in November, the Portuguese authorities have reduced the estimated growth of real output to 3 per cent in 1978. Moreover, the latest indicators show that economic activity stagnated during the final months of 1978. Already, in September, the index of industrial production was 1 per cent below the previous year's level, and the latest survey on industry opinion shows an extremely low level of demand.

In concluding these remarks on 1978, I would also like to note that, largely because of timely disbursement of loans by foreign governments, additional official borrowing, as well as the other favorable developments in the capital account, no drawings were made under the stand-by arrangement. Actually, with the repurchase of earlier drawings and other transactions, the Fund's holdings of escudos, excluding those arising from CFF and oil facility drawings, have declined within the reserve tranche.

The Portuguese authorities are aware that further progress in reducing both inflation and the balance of payments deficit is desirable, and they intend to continue pursuing policies consistent with this objective. They also wish to maintain close cooperation with the Fund in designing financial policies, and to request a new stand-by arrangement for 1979. In this regard a central question will be the definition of the objectives that will be appropriate for 1979 and thus the degree of policy stringency that the new program should have.

The Portuguese authorities are of the view that, although the current external deficit is still relatively large and should be reduced further, its main determinants are now structural in nature and cannot be expected to be corrected in the short run by a reasonable management of domestic demand. Among the factors behind the deficit are the loss of market outlets associated with the decolonization process; the effects of the oil crisis, which hit Portugal very severely; the sharp fall in agricultural output and the consequent rise in foodstuff imports, which has ensued from the attempts at land reform; and, not least important, the restrictions that are applied by other countries to Portugal's exports. The effects of these factors on the trade balance can only be corrected in the medium term, mainly through policies designed to increase agricultural output and to restructure and enlarge the export sector, which is still too small to sustain the growth of the economy and at the same time a liberal system of trade and payments.

It is clear that at present Portugal cannot be expected to generate domestically the resources required to support the investment effort. There is indeed a need for additional medium-term and long-term foreign financing at appropriate terms, and for devising as rapidly as possible a more specific medium-term development strategy. To this end, Portugal will be reappraising, with the assistance of the IBRD, its investment programs and will be seeking appropriate financing from bilateral and multilateral sources. In the course of 1979, the Portuguese authorities also expect to be able to make progress in the preparation of a more fundamental medium-term program, which could become the basis for further Fund financial support.

Consistent with this analysis of the problems now confronting the economy and the broad actions required to cope with them, the Portuguese authorities, as part of the policies for 1979, are prepared to continue pursuing a flexible exchange rate policy in order to maintain, among other things, full cost competitiveness of exports. They are also determined to introduce the measures that are required to eliminate the deficit in the current budget of the public sector and to reduce the financial imbalance of public sector enterprises, but they do not consider it realistic to aim at achieving a current budget surplus as early as 1979.

More generally, the Portuguese authorities are determined to pursue policies consistent with the objective of reducing further the rate of inflation and the relative size of the balance of payments deficit. They cannot consider, however, a further tightening of demand management policies, as they are likely to produce recessionary conditions which will have intolerable economic and social effects. It is their considered judgment, based on the latest available indicators, that the momentum of present policies is such as to bring about in 1979 not only a slowdown in the rate of inflation below 20 per cent, but also the risk of a fall in the level of real GDP. They cannot, therefore, share the staff's view on page 5 of EBS/78/707 that the outlook on present policies is for a renewed deterioration of the current external deficit in 1979.

Moreover, the Portuguese authorities do not fully share the staff's views on pages 11-12 of SM/78/304 on the significance of the adjustment effort and the degree of policy stringency that a 3 per cent growth target and a current external deficit of $1 billion would call for in 1979. Such a growth target will be the minimum needed to prevent a further increase in unemployment. Although with the increase in oil prices and larger interest payments on foreign debt the containment of the external deficit within $1 billion would be tight, they wish to point out that such a deficit would be below that of 1978 in absolute terms, and even more so in relation to exports and GDP.

Portugal is making good progress in adjusting its economy to the situation that has emerged since 1974, but it must be recognized that existing problems cannot reasonably be resolved in the very short run. The situation seems to call for a stand-by program for 1979 that will be sufficiently flexible to take into account the structural elements which are now at the root of the present financial imbalances and that will help to move toward their elimination. My Portuguese authorities and I trust that such expectations will be met.

He wished to thank the staff, Mr. Dini added, for the excellent analysis and clear exposition of the reports. His Portuguese authorities wished to record their appreciation for the highly professional manner in which the staff had conducted the consultation and the discussions on the use of Fund resources. A cordial relationship based on confidence and mutual respect had been established.

According to the latest figures, Mr. Dini said, the current account deficit in 1978 was estimated at $925 million, compared with the target under the stand-by program of $1.2 billion and the estimate of $1.1 billion contained in EBS/78/707, Supplement 1. Moreover, during 1978 the net foreign liabilities of the banking system had declined by more than $100 million, rather than having risen by $1 billion as had been expected, and at the end of 1978 they had totaled $1,106 million. The overall credit performance had also been slightly better than the figure shown in Table 1 of EBS/78/707, Supplement 1. At the end of December 1978 net domestic credit totaled Esc 791.5 billion, a figure within the ceiling of Esc 792.9 billion indicated in the stand-by arrangement.

Mr. Muns considered that the authorities were to be congratulated for having reversed the downward trend of the economy; the achievement was particularly significant because it had involved significant political and economic costs. The Government had clearly achieved the main objectives set out in the stand-by arrangement, namely, strengthening the balance of payments, reducing inflation, and maintaining a positive rate of economic growth to check unemployment. The performance in some fields had been unexpectedly successful. For instance, the rate of inflation had been reduced from 27 per cent in 1977 to 22 per cent in 1978, the current account deficit had fallen from $1.5 billion in 1977 to less than $1 billion in 1978, and the rate of growth had fallen by only one third, from an average of around 6 per cent in 1976-77 to almost 4 per cent in 1978. The necessary adjustments in the economy had taken the form of a depreciation of the escudo, an increase in foreign debt, and a rise in unemployment.

Any analysis of the Portuguese economy, Mr. Muns remarked, had to take into account the relatively delicate political situation, the need to revive confidence in the private sector, the cuts in real wages over the previous three years, and the fact that the unemployment rate was 8 per cent, while only 22 per cent of the unemployed were eligible for unemployment benefits. In the circumstances, the authorities had to continue their stabilization effort, and their recent decision to maintain policies to reduce further both the rate of inflation and the size of the public sector and external deficits was welcome. As the staff had concluded, the public sector had a decisive contribution to make to the stabilization effort, and the authorities should avoid the temptation to offer excessive subsidies and to adopt an overmoderate fiscal policy. In addition, they should proceed with the program for dismantling trade restrictions and internal economic controls.

At the same time, Mr. Muns continued, the authorities had understandably expressed the wish to reduce somewhat the pace of the adjustment effort. As Mr. Dini had emphasized, there were significant structural limitations on the extent to which the adjustment effort could be continued at a relatively rapid pace. The adjustment in 1979 favored by the staff seemed to be rather severe; the projections in Table 5 in SM/78/304 should be seen as merely the first step of a medium-term program. Finally, the case of Portugal suggested that, if all the main macroeconomic and policy objectives of a stand-by arrangement had been achieved, but certain ceilings had not been respected in part because of incorrect assumptions about the behavior of key variables, it was unfair to refuse the member a certificate of eligibility to draw on Fund resources.

Mr. Laske commented that the authorities had made remarkable progress during the period of the stand-by arrangement and were to be complimented for the courage and perseverance they had shown in implementing the stabilization program. He had no difficulty with the revision of the various ceilings under the stand-by arrangement; the proposed revisions were merely technical in nature. Moreover, at present Portugal had a reserve position in the Fund and with the inclusion of the first credit tranche and could use more Fund resources than were available under the stand-by arrangement.

The most striking economic improvement, Mr. Laske considered, was the reduction in the current account deficit to a much lower figure than had been expected, although he wondered whether it had not been achieved at the expense of limiting growth somewhat more than would have been necessary. The international competitiveness of the Portuguese economy had also been restored and a gain in market shares had been registered, something that was of critical importance for future developments in the external field. The fact that the velocity of money in circulation had apparently remained constant signified a return of confidence among the Portuguese people in the national currency.

A number of areas were still unsatisfactory or worrying, Mr. Laske commented. Reducing inflation, a major objective of the program, continued to be essential for further external improvements and a revival of domestic economic activity. The rate of inflation had apparently fallen from 27 per cent in 1977 to 22 per cent in 1978, which was still a rather high rate. The information provided in EBS/78/707, Supplement 1, gave the impression that the rate might have accelerated during the final quarter of 1978.

The most troublesome area, Mr. Laske continued, was the public sector: the lack of progress in reducing its deficit was the root cause of the nonobservance of the two performance criteria relating to credit expansion. In fact, the public sector deficit had expanded, rather than contracted as originally envisaged. Another disappointment was the fact that the public enterprises had continued to be a drain on the budget; their substantial subsidy and credit needs had left little room for the credit needs of the private sector.

In the case of Portugal, Mr. Laske said, the main question was what kind of policies the authorities should adopt to protect the gains they had made thus far and to provide the basis for a medium-term program that would create new employment and restore the momentum of economic growth. Mr. Dini's opening statement gave the impression that there were differences of opinion between the staff and the authorities. He tended to agree with the staff that it was highly desirable to achieve a drastic reduction in the public sector deficit, and particularly in the current account, but the authorities seemed to feel that, in the circumstances, no significant action could be taken. They believed that a 3 per cent rate of real growth and no more than a $1 billion current account deficit could be achieved in 1979, even with some relaxation in their interest rate and exchange rate policies. On the other hand, the staff felt that, even with the continuation of the present policies, an improvement in the general position was unlikely, and a deterioration in the public sector finances would probably occur. Mr. Dini had argued that the structure of Portugal's current account made a further reduction in the external deficit possible only at the cost of foregoing necessary real growth. He wondered whether the staff agreed with that line of reasoning.

He tended to feel, Mr. Laske remarked, that further decisive action in the public sector was urgently needed to control current spending and increase savings. In addition, the authorities should follow interest rate and exchange rate policies in a way that would safeguard Portugal's international competitive position and ensure that the Government could obtain the necessary external financing for the current account deficit expected in 1979. Some flexibility in the overall firm policy stance would be advisable to take account of developments affecting growth and employment, but the policy stance would, of course, have to be fairly stringent if wage increases in 1979 exceeded those recorded in 1978. The pronounced economic slowdown that had apparently occurred toward the end of 1978 could have unfortunate consequences for employment, but he was confident that the authorities, with the assistance of the staff, could formulate policies that would enable Portugal to continue its promising stabilization efforts.

Mr. Mentré de Loye noted that the overall condition of the economy had clearly improved during the period of the stand-by arrangement, and a reasonably conservative forecast showed that the economy was headed in the right direction. On the other hand, a number of problems remained. The most pressing internal economic difficulty was inflation; the authorities had succeeded in reducing the rate from 27 per cent in 1977 to 22 per cent in 1978, but the present rate was still high. There were, however, some grounds for optimism in viewing the counterinflation effort; for instance, real wages had declined substantially in 1977 and 1978. Although such a development was, of course, not entirely welcome from the social point of view, the purchasing power of wage earners in 1978 was on average no less than it had been in 1973, so that, on the whole, wage earners had benefited from the growth of the economy. Another positive sign was the trend in the demand for money, as reflected in the stability in the velocity of circulation of money in 1978.

The public sector deficit in 1978 had increased rather than decreased as expected, Mr. Mentré de Loye observed, and it would undoubtedly be one of the main topics of the discussion in February 1979 between the staff and the authorities. On the whole, he agreed with the staff that additional restraint should be placed on public expenditure.

As Mr. Dini had reported, Mr. Mentré de Loye said, the decline in the current account deficit in 1978 had been more pronounced than the authorities had anticipated. Although the behavior of imports, especially during the final part of 1978, had been uncertain, the performance of exports had been strong, with the exception of agriculture. In the services account, the improvement in tourist receipts, which had moved into line with the level of economic activity, was significant. The restoration of confidence in the economy was apparent in the increase in capital inflows from both private and public sources, which had enabled the authorities to build up official reserves. On the whole, the authorities had adopted courageous policies, and the country, which had already encountered many difficulties, was taking on additional social and economic burdens in the effort to achieve stability.

Management and the authorities had wisely decided to discuss a new stand-by arrangement covering 1979 rather than to try adjusting the existing arrangement, Mr. Mentré de Loye remarked. Monetary policy under the new stand-by arrangement should be carefully designed; the evolution of economic data in Portugal suggested that the monetary aggregates under the new program should be different from those under the existing one. The discussion with the authorities should cover the medium-term program that they intended to develop and implement after the present adjustment effort. Much remained to be done to reorganize industry, reduce the country's dependence on external energy sources, and improve the competitiveness of agriculture.

Mr. Kafka considered that the Portuguese authorities and people had made commendable efforts in 1978 to achieve a substantial reduction in the economic imbalances, especially in the external sector. Given the limited amount of assistance that was available from its European partners, Portugal had unavoidably moved forward at the cost of a slowdown in the rate of economic growth. In contrast to the previous two years, in 1978 the rate of growth of GDP had exceeded the rate of growth of gross domestic expenditure, thereby reducing the resource gap. The outstanding achievement was the substantial reduction in the balance of payments deficit. Private transfers had increased considerably, and the nonmonetary inflow of capital had accounted for 35 per cent in the improvement of the balance of payments position; both achievements had apparently been the result of the introduction of relatively attractive domestic interest rates and of a strengthening of confidence. The authorities were aware that there was still a long way to go, and that the effort to achieve external balance had to be supported by an increase in agricultural output and exports and by a further diversification of export production.

The restrained monetary and credit policies had played an important role in the stabilization effort, Mr. Kafka noted. The marked interest rate adjustment, together with some deceleration of inflation, had made domestic money balances unexpectedly attractive and had led to a serious underestimation of the appropriate rates of growth of the money stock and domestic credit; a compensatory adjustment had been made by excluding allowances for bad debts from the domestic credit ceilings.

The overall public sector financial position had deteriorated, Mr. Kafka said, as a result of revenue shortfalls and an increase in transfers to ease the burden of adjustment on low-income groups. The authorities would have to guard against any further deterioration in the position, but in a case like Portugal's he doubted whether it was sensible to have both a separate public sector credit ceiling and an overall credit ceiling.

In the future, Mr. Kafka remarked, a flexible exchange rate policy and cautious wage management would certainly play an important role in preserving the international competitiveness of the Portuguese economy, but he agreed with the authorities that further tightening of monetary policy could produce a recession and social unrest. He, like Mr. Muns, disagreed with the harsh staff attitude on the appropriate pace of the adjustment effort in 1979 and felt that economic stabilization in Portugal should be attained over a relatively long period. As Mr. Dini had stated, the current account deficit could not be corrected, in the short run, by appropriate domestic demand management alone; the structural causes of the imbalance would have to be dealt with. The effects on Portugal's economy of the protectionist policies of other countries, the oil crisis, and domestic structural adjustments could be dealt with only in the medium run. Medium-term and long-term financing on appropriate terms and in sufficient amounts to support a medium-term development program was the cornerstone of Portugal's economic growth effort, and he hoped that it would become available on both a bilateral and multilateral basis.

Mr. Schneider considered that Mr. Dini's opening statement and the staff reports clearly showed the remarkable progress the authorities had made during the previous two years in their efforts to stabilize the economy and restore confidence. Despite the radical changes in the political and economic situation in Portugal since 1974, a great deal had been achieved. Nevertheless, much more had to be done if the economy was in the long run to reach a level of development and competitiveness that would compare favorably with its future EC partners.

That internal confidence had clearly improved, Mr. Schneider remarked, was indicated by the renewed willingness of the Portuguese people, including Portuguese citizens working abroad, to hold money balances in escudos; that favorable development should be supported by continuing the fight against inflation. The restraint shown by workers in their wage claims seemed to show that labor had recognized the immediate danger of inflation at a time when savings had increased again after a period of high consumption.

Confidence, Mr. Schneider noted, had been improved by the reduction of the current account deficit during the period of the stand-by arrangement. From a psychological point of view, much would be achieved by the relatively minor action of abolishing the remaining restrictions on remittances of profits and dividends abroad. As to the exchange rate policy, the authorities' courageous depreciation of the escudo and their successful incomes policy had restored the competitiveness of Portuguese industry.

To maintain the momentum toward stabilization, Mr. Schneider said, the authorities apparently had to continue the flexible exchange rate policy and complement it with strict control of domestic credit expansion and an improvement in the public sector finances, including the position of the public enterprises. Since at present a large-scale increase in private investment could not be expected, Portugal's public sector would have to bear the main burden of financing investments. In the circumstances, a tax increase was probably out of the question, and the public sector would have to rely primarily on public savings in addition to the foreign borrowing that would certainly be needed.

He was fully aware, Mr. Schneider commented, that the goals he had mentioned were difficult to achieve, but the longer a country lived beyond its means, the harder was the unavoidable adjustment. At the same time, the possible political and social costs of relatively short-term adjustments should not be overlooked; he agreed with Mr. Dini that a number of problems in the Portuguese economy were of a structural nature and deserved special attention. Because of the crucial importance of productive investment for Portugal's future, he was not gravely concerned about the size of either the public sector deficit or the foreign debt burden, as long as there was no further misallocation of resources. Portugal simply could not afford to squander funds on unproductive ventures, as it seemed to have done in the past. As the staff had wisely emphasized, an urgent task of the authorities was to implement a medium-term investment program as soon as possible to ensure that resources were used mainly for productive investment.

He welcomed the intention of the authorities to request a new stand-by arrangement for 1979, Mr. Schneider said, but he, like the staff, regretted the existing restrictions in Portugal. The staff reports did not contain a clear description of either the Portuguese exports that were subject to restrictions by other countries or the impact of those restrictions on the Portuguese economy. Finally, both draft decisions were acceptable.

Mr. Ryrie remarked that considerable progress had clearly been made in Portugal during the previous year. One of the most satisfactory accomplishments was the restoration of confidence, as evidenced by the increase in holdings of escudos by Portuguese citizens. The Government's substantial achievements had been widely commented on, and he merely wished to touch on some of the remaining problem areas.

The authorities had reduced the rate of inflation by a moderate amount in 1978, Mr. Ryrie noted, but the present rate was still rather high and inflation had apparently accelerated during the final months of 1978. Labor had exercised commendable restraint in its wage demands, but he doubted whether the restraint could be continued for long, and fiscal and monetary policies would have to make a larger contribution to the counterinflation effort than had been the case thus far. In that connection, the main concern was the size and composition of the fiscal deficit.

The authorities should attempt to achieve a surplus on central government current transactions, Mr. Ryrie remarked, and the effort to control the growth in current expenditure should be given a high priority; in that connection, it might be appropriate to adopt new measures to increase tax revenue to provide some of the funds needed for public investment projects. In all likelihood, good investments by the public sector would encourage private sector activity. Unfortunately, in the recent past public enterprises had been borrowing to finance their current expenditure and to restructure their equity position, a practice that should not be continued for long. Indeed, the large size of the public sector deficit, which represented 13 per cent of GNP in 1978, threatened to undo some of the recent policy achievements and would undoubtedly be a major topic of discussion when a new stand-by arrangement was discussed in February 1979. For the moment, he was inclined to agree with the staff that the authorities should aim to keep the central government deficit to a maximum of about 7 per cent of GNP.

In the monetary field, Mr. Ryrie commented, new controls on commercial bank lending had been introduced to help restrain the growth of the money supply, which he hoped that the authorities would continue to monitor closely. Setting money supply targets was certainly difficult when the velocity of money was as unpredictable as it was in Portugal, but the authorities should be encouraged to use policy instruments if necessary to prevent excessively rapid growth of the money supply.

The reduction in the current account deficit was welcome, Mr. Ryrie said, but much of the improvement had apparently stemmed from an unexpectedly rapid growth in receipts from tourism and emigrants' remittances, rather than from either a fundamental increase in exports or a reduction in imports. In any event, the current account deficit in 1978, about $1 billion, seemed quite large, and a deficit of approximately the same size was expected in 1979. Thus far, Portugal had succeeded in financing the deficit in a more satisfactory way than had been foreseen a year previously, but the related burden of interest payments had been growing.

Mr. Dini felt that the balance of payments problem was structural in nature and could not be solved by demand management alone. In his view, some contribution to solving the external imbalance should be made by demand management and exchange rate policies as well as a program for structural change.

His authorities, Mr. Ryrie remarked, felt that the restrictions in Portugal on remittances of profits and dividends were contrary to the fundamental interests of Portugal itself, as they tended to discourage investment in the country. He was not opposed to the proposed decision approving the restrictions on a temporary basis, but he hoped that the restrictions would be eliminated in a fairly short period.

Mr. Blöndal said that he agreed with the staff that the authorities had achieved considerable success during the previous two years, especially in reducing the current account imbalance. The rate of economic growth had been relatively high until fairly recently, and the rate of unemployment, about 8 per cent, was still uncomfortably high; but the authorities were to be credited for the success they had had in handling the difficult problem of creating jobs for a large number of refugees from Portugal's former territories in Africa. The rate of inflation had fallen somewhat in 1978 but was still well over 20 per cent. Future wage settlements could pose serious problems, especially as real wages had fallen considerably in the previous few years. For those and other reasons there should be no slackening of the demand management policy in the near future.

He agreed with the staff, Mr. Blöndal commented, that the weakness in the financial position of the public sector was one of the most pressing problems facing the authorities. Unfortunately, neither the staff nor the authorities saw much scope for improvement in the public finances in the near future, and for that reason the staff had concluded that, while there was some room for making the tax burden more equitable than hitherto, overall taxes could not be increased. Nor did there seem to be much scope for reducing expenditure significantly, since for the most part its trend was related to movements in wages and salaries of public officials. Still, he was not convinced that the major burden of the stabilization effort should continue to rest with the exchange rate and interest rate policies. The overall public sector deficit had risen from 7 per cent of GNP in 1977 to no less than 9 per cent in 1978. Around half of the increase was attributable to central government lending to public enterprises and nationalized manufacturing enterprises. The staff had little to say about the price policy of those enterprises, and he wondered whether there was not some room for improving their efficiency so that they would become less of a burden on central government finances. An effort in that direction through the overall stabilization program might leave some room for easing the monetary policy to stimulate private sector activity.

It would be interesting, Mr. Blöndal said, to learn more about the exchange rate policy, under which the authorities publicly announced that the exchange rate would be devalued by a certain percentage each month. For instance, what was the effect on the demand for imports? Was there a connection between the exchange rate policy and the need to impose import restrictions? Finally, he approved both draft decisions.

Mr. Drabble considered that the authorities were to be congratulated for the important progress they had made; despite the difficult circumstances in Portugal during the previous few years, advances in several areas had been better than anticipated. He agreed with the general thrust of the staff appraisal.

The authorities certainly could not afford to stop the forward movement they had made thus far, Mr. Drabble stated. Indeed, no time should be lost in making further progress so that by 1980 the authorities might be in a position to implement a medium-term program. He hoped that the Fund would be able to assist the authorities in that effort, and that Fund resources would be available on a larger scale than under the existing stand-by arrangement.

To be in a good position to adopt a medium-term program, Mr. Drabble continued, the authorities should make further progress on certain fronts. It was not clear to him that the effort to reduce inflation had been very successful. A wage policy had been implemented, and the level of real wages had fallen significantly during the previous several years, but the wage restraint that had been shown thus far could not be expected to continue indefinitely. There seemed to be some risk in the wage and inflation fields, and the authorities needed to make a further determined effort in 1979 in both the monetary and fiscal policy fields. On the other hand, monetary policy should not be left to do most of the job of stabilizing the economy. Given the need for prudent restraint in the overall credit policy, it was particularly important to provide incentives for, and establish priorities with respect to, existing and potential export production in both the public and private sectors. Improving the performance of agriculture should also be given a high priority; the problems in that sector probably helped to account for the rather slow progress that had been made in improving the merchandise trade account, and the authorities might wish to examine carefully the credit situation in the agriculture sector. There was apparently a need for the authorities to be selective within their overall framework of credit restraint.

The staff's advice concerning the public sector was certainly sensible, Mr. Drabble said, but the limited prospects for improvement in the near term were discouraging. There was a clear need to reduce the public sector deficit and to reorder priorities within the sector to increase the attention paid to raising public sector investment and to curbing current expenditure. The authorities should strive to achieve those objectives as vigorously as possible in the period ahead to ensure that the pace of progress was sustained and to reach a point where it would become feasible to develop a medium-term program.

The staff figures showed that only a little of the improvement in the overall current account balance in 1978 was attributable to merchandise trade, Mr. Drabble observed; most of the improvement had been in tourism and private transfers, the latter resulting from the effort to introduce more realistic exchange rates and interest rates. The advance in those areas was a welcome sign that confidence was being restored, but the fact that, despite the more realistic exchange rate, little progress had been made toward reducing the trade imbalance--which remained at about $2.5 billion--was worrying. The situation had perhaps improved somewhat in recent months, but to prepare for the needed medium-term effort, priority in the short run should be given to the export sector and to agriculture to take advantage of Portugal's improved competitive position.

He was pleased, Mr. Drabble said, with the increase in 1978 in the extent to which the overall external deficit was financed by inflows of medium-term and long-term capital, but he suspected that the overall figure, which included errors and omissions, understated the amount of short-term borrowing in Portugal. Information available to his authorities suggested that the recourse to bank borrowing alone--most of it in short-term forms--was somewhat larger than the net figure provided in the staff report. In addition, there were unconfirmed reports that in 1978 Portugal had understandably taken advantage of the rise in the price of gold to raise additional foreign exchange from gold already pledged; such means of financing the overall external position were clearly unsustainable and could not be counted on in the long run. Hence, the authorities would have to pay close attention to what could be done in 1979 to improve further the current account position, especially by enhancing exports in line with their understandable wish to avoid introducing policies that would have an excessively depressing effect on the level of economic activity and employment.

Mr. de Vries commented that on the whole he agreed with Mr. Dini's opening statement. He too had been impressed by the reversal of the trends in the Portuguese economy; the authorities had achieved some of their important objectives for the balance of payments, inflation, growth, and confidence in the private sector. The latest data showed that they had largely observed the performance criteria under the stand-by arrangement.

The time was ripe, Mr. de Vries considered, for the authorities to consider restructuring the economy to give it a sound foundation for sustainable development in the future, and he was pleased that the authorities were reappraising the economic situation with the assistance of the IBRD. The restructuring effort would enable Portugal to become an effective member of the European Communities. In the light of the need to restructure the economy, he, like Mr. Ryrie and Mr. Schneider, was less concerned about the large size of the imbalances in the economy than about the need to avoid any misallocation of resources. He was not strongly in favor of lowering general demand; as Mr. Laske had noted, the reduction in the balance of payments deficit had been due in part to a slowdown in economic activity and a lowering of the rate of economic growth. For the moment, the need to reallocate resources should receive more attention than the overall size of the public sector deficit.

Because inflation caused resource allocation to be inefficient, Mr. de Vries remarked, the effort to reduce the rate was certainly important. It was true that, since real wages had fallen substantially during the previous several years, there might be some upward pressure on wages in the future, but a relatively low rate of inflation would certainly provide the optimum environment in which to attempt to maintain a reasonable trend in real wages.

The restructuring of the domestic economy, Mr. de Vries said, would eventually have an effect on the balance of payments, but the external situation had changed considerably, and a restructuring of exports in response to the new circumstances in Portugal would take some time. The authorities should aim for a thorough restructuring of the economy, and their intention of maintaining a flexible exchange rate policy was welcome. Given the present circumstances, the authorities had understandably introduced a small number of restrictions on current payments; he hoped that they would review them to see whether they might not be counterproductive in the long run. Finally, he had no difficulty in accepting the proposed decisions. The change in the stand-by arrangement seemed to be merely technical in nature.

Mr. Cross considered that the staff had made a fair assessment of the Portuguese economy. It had fully described the successes and weaknesses of the performance in 1978 and had outlined the major macroeconomic and other issues facing the authorities. As Mr. Dini had emphasized, the notable progress achieved thus far had entailed considerable sacrifice by the Portuguese people.

The fiscal developments were somewhat worrying, Mr. Cross commented, and given Portugal's economic prospects, there appeared to be little economic justification for moderating the pace of the stabilization effort. It would be most unfortunate if the progress that had been achieved was undermined by a premature modification of the present policy stance. Therefore, the authorities should continue their close cooperation with the Fund, especially as it would provide the basis for the eventual development of a medium-term program to restructure the economy.

The considerable progress achieved by the authorities in improving the balance of payments and checking the rate of inflation was the result of courageous measures affecting the exchange rate and domestic interest rates, Mr. Cross considered. The staff reports clearly showed that the new credit measures had begun to take hold. Nevertheless, while the overall credit projections should now be seen in the light of the unexpectedly low rate of money velocity, private sector credit demand had clearly exceeded the agreed ceilings. In addition, the increase in the public sector deficit to the equivalent of 9 per cent of GDP was unfortunate, especially as it had been caused by unanticipated current account developments and by lending to public enterprises. The deficit was squeezing the resources needed for private and public investment and should certainly be reduced.

Monetary developments had been moving in the right direction, Mr. Cross said, and the staff could presumably analyze the recent data soon and make any necessary adjustments in the assumptions underlying future targets. Interest rates certainly had to be kept high; they still had not reached positive real levels. Furthermore, the exchange rate had to be kept competitive. It was, however, true that Portugal was suffering from restrictions on its exports. Finally, the authorities were to be commended for the measures they had adopted to liberalize the exchange and trade system, but he, like some previous speakers, was concerned about the remaining restrictions, and he hoped that the authorities would be able to continue making progress toward eliminating them.

Mr. Amuzegar stated that he too thought that the authorities were to be congratulated for the courageous steps they had taken to solve some of the problems facing the economy. He wished to deal with some of the broad issues raised by the case of Portugal.

As Mr. Dini had emphasized in his opening statement, Mr. Amuzegar recalled, the program for Portugal under the present stand-by arrangement had been quite stringent, but it was not the severity of a Fund-supported program that members objected to; rather, they were opposed to the idea that the Fund should be able to impose programs that were clearly not within a member's power to implement. Experience showed that whenever a member was able to meet the conditions in a program it welcomed the challenge and made every attempt to succeed. It was impracticable and unwise for the Fund to impose on members conditions that obviously could not be met.

A second lesson from the case of Portugal, Mr. Amuzegar considered, was that the Fund needed to be flexible in reviewing the agreed conditions under a given stand-by arrangement. Accordingly, if a member had not observed certain conditions for reasons other than a lack of will on the part of the authorities, the Fund should perhaps be prepared to provide additional help, to moderate the conditions under the established program, or to examine the possibility of providing medium-term assistance instead of short-term help.

He was pleased, Mr. Amuzegar said, that the Executive Board had actively participated in instituting the stand-by arrangement for Portugal. Each stand-by arrangement should be the result of consultation and discussion involving not only the staff and the authorities, but also the Executive Director for the country concerned and the Executive Board as a whole.

The staff representative from the European Department remarked that inflation in Portugal had apparently reaccelerated in the final quarter of 1978. The price rise in October 1978 of around 3.4 per cent had been due primarily to increases in administered prices for public services. Such increases had to be introduced periodically, and more were planned for the first quarter of 1979. The increases in administered prices introduced an element of bumpiness into the quarterly movements; for that reason, the staff preferred for the time being to say that the annual rate of inflation was 22 per cent and to take another look at it during the discussions in Lisbon in February 1979. Of course, an inflation rate of 22 per cent was still quite high.

A separate ceiling on credit to the public sector was necessary, the staff representative explained, since a substantial proportion of total credit was being absorbed by the public sector to finance both public enterprises whose pricing policies were unsatisfactory and government deficits that had not made any direct contribution to investment and long-term economic growth, or to the structural adjustments in the export sector on which the correction of the balance of payments deficit depended. The authorities and the staff felt that an effort should be made to keep the absorption of credit by the public sector to a minimum. In the past the authorities had maintained a floor, rather than a ceiling, on the credit available to public enterprises. The staff now wished to make certain that the reduction in the growth rate was not due to excessive absorption of credit by sectors that did not contribute directly to economic growth.

The consistency of a 3 per cent rate of growth with a $1 billion current account deficit also required close examination, the staff representative said. The staff's preliminary conclusion was that the slowdown in the growth of output of the economy in 1978 had occurred primarily because of capacity constraints. The staff and the authorities had discussed the problem at length. As reported on page 2 of SM/78/304, the slowdown of the economy had begun as early as the latter part of 1977, before the introduction of the stabilization program. The authorities had attributed that development in part to the increase in interest rates in August 1977, but also to the emergence of capacity constraints reflecting the relatively low rates of fixed investment during previous years. Of course, relaxing demand management now, in the face of capacity constraints, could quickly spill over to the balance of payments and could affect the price performance.

The low rates of fixed investment and widespread misallocation of investment showed the need for structural changes in the Portuguese economy, the staff representative commented. The authorities clearly recognized the need, and the staff had been urging them to review their public investment program, which represented a considerable proportion of total investment; such a review could be seen as one of the major preconditions for discussions on a possible extended arrangement. At the moment, however, the authorities did not appear to be in a position to discuss possible access to the extended Fund facility, in part because elections were to take place in about 12 months.

If the assumption that capacity constraints existed in the Portuguese economy was correct, the staff representative said, the effort to bring the public sector deficit under control was clearly of great importance. Improving the pricing policy of the public enterprises would play a crucial role in reducing the public sector deficit. In addition, there was some room for increasing the discipline in expenditure control, since the Ministry of Finance did not have full control over all public sector expenditure. Moreover, there might be some scope for adjustments in the existing tax policy. The staff mission in February 1979 would have to examine the issues in detail.

The Deputy Director of the Exchange and Trade Relations Department remarked that, in considering whether or not to enable a member to use Fund resources, the staff merely examined the facts in the case. As he understood it, Mr. Muns wished to know whether or not the performance clauses in a stand-by arrangement could be varied; in fact, any member could ask the Executive Board to approve changes in performance clauses.

The discussion with the Portuguese authorities, the Deputy Director said, had clearly shown that the public sector was a key variable in the adjustment effort. The Fund usually required a public sector commitment in a stand-by arrangement with any member. If the credit situation in a country changed unexpectedly, the authorities could inform the staff, which could propose to the Executive Board that adjustments be made in the credit ceilings. As to Mr. Amuzegar's general point on the feasibility of Fund-sponsored programs, the staff was obliged to present viable programs to the Executive Board; the expectation was that, in the medium term, the balance of payments position would recover, so that the government involved would be in a position to repay the Fund resources it had used. In devising viable programs, the staff had to be careful to make full allowance for the assistance that the member concerned planned to receive from other countries. While the staff fully recognized that it was useless to encourage a government to adopt an unrealistic program, it did not wish in any way to underestimate the problems facing a country.

Mr. Dini said that he wished to express his appreciation to Executive Directors for their substantive remarks, which would be most helpful to the Portuguese authorities. The stimulating discussion had been possible because the staff had clearly brought out in its reports the central problems and policy issues facing Portugal.

He wished to make three general comments to add to the answers that had been given by the staff representative from the European Department, Mr. Dini continued. The first concerned inflation. The Executive Directors had remarked that the rate of inflation, although reduced in 1978, was still rather high, and his authorities would certainly agree with that judgment. However, it should be kept in mind that the principal components of the inflation in 1978 had been the effects of the depreciation of the escudo and the sharp increase in administered prices--for foodstuffs and for utility and other services provided by public sector enterprises--both of which were central measures of the adjustment program requested by the Fund under the stand-by arrangement. The effects of the factors on prices should moderate in 1979. At the same time, however, an improvement in the position of public sector enterprises might require further increases in the prices of the services they provided, something that would contribute to price inflation in 1979.

His second general comment, Mr. Dini went on, concerned the policy mix and the degree of policy stringency that the financial program for 1979 should contain in order to reduce, among other things, the current account deficit. In that connection, it was useful to note that Portugal had already re-established full cost-competitiveness for its exports, real wages had been reduced substantially during successive years, and relative costs were at present seen by the staff as being reasonably appropriate. Few Executive Directors had emphasized that exports during 1978 had indeed responded well to the new conditions in the economy, rising by more than 10 per cent in volume. However, an important question was whether or not exports could be expected to increase as much in 1979. The authorities and the staff did not consider a further major increase unrealistic, but export expansion had been hampered by the fact that, on export markets, Portugal had offered lines of products for which the demand had not been growing rapidly. In addition, other countries had introduced restrictions on some of Portugal's traditional exports, such as textiles. In the circumstances, there was a need to restructure the export sector in the medium term. The import performance in 1978 had benefited not only from the tight monetary conditions, but also from the favorable effects of the unwinding of speculative inventories and of changes in leads and lags, which might play a smaller role in 1979 than in 1978 in moderating imports. If the Fund requested a further reduction in the balance of payments deficit, the authorities would be expected to cut back domestic demand at a time when economic activity was already flat and the momentum of present policies might lead to negative growth in 1979. He understood previous speakers to mean that they did not wish to see recessionary conditions develop in Portugal in 1979 and that, in devising the policy mix, the authorities would have to find a reasonable balance between supporting domestic activity and stimulating balance of payments adjustment.

His authorities agreed that a major effort was required to reduce the public sector deficit, Mr. Dini said; they also recognized that the current deficit of public enterprises was becoming an undesirable component of the balance of payments deficit. As one Executive Director had said, it would be more important in 1979 to improve the nature and composition of the current external deficit than to reduce its size. The Portuguese authorities agreed that in 1979 policies designed to remove structural obstacles to the growth of production and exports would have to go hand in hand with prudent demand management policies.

The Chairman made the following summing up in concluding the consultation:

The Executive Directors noted the determination with which the authorities have pursued the objectives of the stabilization program on the basis of which the Executive Board approved a stand-by arrangement with Portugal in June 1978, and they welcomed the improvement that has been achieved in both the external balance of payments and the domestic financial situation in 1978.

Credit and interest rate policy was supplemented by a courageous incomes policy, which resulted in a further decline in real wages, and also by an orderly and flexible exchange rate policy.

Some disappointment has been expressed about the serious deterioration in the public sector finances. The Executive Directors welcomed the intention of the new Government to continue its close cooperation with the Fund in seeking solutions to the important problems that remain.

The thrust of the staff appraisal in the report for the 1978 Article IV consultation with Portugal was generally approved. The Executive Directors observed that, despite the improvement in 1978, the rate of inflation remains uncomfortably high. They also felt that a further gradual reduction in the external current account deficit was required. They emphasized that additional progress in stabilizing the economy would require continuing credit restraint and major efforts to improve the financial situation of the public sector, including the public enterprises. The adequacy of the latter's pricing policies should be further reviewed. Moreover, deceleration in the rate of wage increases was necessary if inflation was to continue to moderate. Various Directors observed that, in the interim, in the light of the high rate of inflation in Portugal, the authorities should continue with their flexible exchange rate and interest rate policies.

Many Directors commented on the staff view that the required degree of stringency in economic policy in the near future may not be compatible with a 3 per cent real growth of GDP from 1978 to 1979, which the Portuguese authorities regard as the minimum required to prevent a further rise in unemployment. While there were somewhat differing views on this question, most Directors believed that further gradual progress toward the restoration of internal and external balance would continue to require caution on the part of the Portuguese authorities, and that any premature easing of the stabilization efforts in the near future could jeopardize the good results achieved thus far.

The Executive Directors stressed the importance of achieving the required restructuring of the Portuguese economy. They emphasized the necessity of reallocating resources and increasing exports and agricultural output in the framework of a medium-term program that would find the necessary support of international investment financing. This foreign capital inflow would assist greatly in facilitating the adjustment of the Portuguese economy in the coming years.

The Executive Directors saw the liberalization of Portugal's trade and payments system in 1978 as a welcome development and expressed the hope that further progress could be achieved in the near future in this field.

The Executive Directors then turned to the proposed decisions.

Mr. Dini suggested that the opening sentence in paragraph 2 of the decision pursuant to Article XIV should be amended to read: "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." In addition, the word "liberalize" in the second sentence should be replaced by "raise." The final sentence could be amended to read: "In the meantime, the Fund grants approval for retention by Portugal of this restriction... ."

The Deputy Director of the Exchange and Trade Relations Department explained that an Article XIV decision need deal only with matters that were within the Fund's jurisdiction. Hence, the words that Mr. Dini wished to add to the opening sentence of paragraph 2 were acceptable but, strictly speaking, unnecessary.

The staff representative from the European Department added that a restriction in addition to the one mentioned in the present text needed to be reapproved; therefore, it would be best to say in the final sentence of paragraph 2 "the restrictions on payments and transfers."

Mr. Amuzegar said that he was willing to accept the amendment proposed by Mr. Dini to the opening sentence of paragraph 2, but he hoped that it would not set a precedent for future decisions.

The Executive Board then approved the following decisions:

a. Decision Pursuant to Article XIV

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.

Decision No. 6028-(79/14), adopted
January 24, 1979

b. Review of Stand-By Arrangement

The cable dated November 20, 1978 from the Minister of Finance and Planning and the Governor of the Bank of Portugal shall be attached to the stand-by arrangement for Portugal (EBS/78/228, Sup. 2), and the letter of intent of May 8, 1978 shall be read as modified by the cable dated November 20, 1978.

Decision No. 6029-(79/14), adopted
January 24, 1979

3. EXECUTIVE BOARD DECISIONS

Mr. Dini made the following statement:

In the wake of our meeting on Portugal, and precisely on the Article IV consultation, I would like to turn briefly to the question of the format of our Article IV and related Article VIII and Article XIV decisions. The Executive Directors may remember that I have been one of those who consider inadequate the new decision, for it covers only matters coming within the jurisdiction of approval of the Fund. In this regard, I expressed support last week for the final paragraph of your buff statement, Mr. Chairman, on surveillance and ad hoc consultations in which you referred to the fact that some Executive Directors have pointed out that, in their present format, decisions fail to give due weight to members' adjustment policies and their efforts to reduce their reliance on exchange restrictions generally because we are limiting the decision to the area requiring approval by the Fund.

There are a few points I would like to make today, for they stem from the recent Board discussions on consultation reports and from today's discussion on Portugal. During a recent meeting, Mr. Amuzegar and other Executive Directors will remember, when it came to decisions, I had requested that, as a minimum, they should contain a descriptive paragraph on the system of trade and exchange restrictions maintained by a member with a reference to the appropriate staff documents where a full description of the system is provided. In recent cases we have approved decisions that do not even contain such a full reference. I submit that a reference to the system of trade and exchange restrictions maintained by a member should be included in all such decisions as a matter of policy for the reason of uniformity, or symmetry, of treatment of all members.

The present stand-by arrangement in Portugal contains two performance clauses with respect to import licensing criteria and the elimination of an import surcharge. If the Fund considered it desirable in accordance with the purposes of the Articles that these restrictions should be removed by countries that are confronted with balance of payments difficulties, why should the Fund be silent when similar restrictions are maintained by countries that do not have balance of payments problems? I submit that such an approach is characterized by a fundamental asymmetry,

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FOR AGENDA

EBS/78/707
Supplement 1

CONFIDENTIAL

January 22, 1979

To: Members of the Executive Board

From: The Secretary

Subject: Portugal - Review of Stand-By Arrangement

The attached supplement on the review of the stand-by arrangement with Portugal has been prepared on the basis of additional information received.

This subject has been scheduled for discussion on Wednesday, January 24, 1979.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

PORTUGAL

Review of Stand-by Arrangement
Supplementary Information

Prepared by the European Department and
the Exchange and Trade Relations Department

Approved by L.A. Whittome and Ernest Sturc

January 22, 1979

On the basis of preliminary data for end-December, it is now possible to update Table 1 in EBS/78/707, 12/26/78. At end-December, net domestic credit of the banking system reached Esc 796.3 billion or Esc 3.4 billion above the ceiling for end-December as agreed under the terms of the existing stand-by arrangement (Table 1). Banking system credit to the public sector reached Esc 171.8 billion at end-December or Esc 11.5 billion above the subceiling. Net foreign liabilities of the banking system reached US$1,216 million at end-December, US$946 million below the ceiling.

There is also more recent data related to progress in meeting the external current account and price objectives of the program. The Portuguese authorities now estimate that the current account deficit was reduced in 1978 to US$1,100 million compared with an estimate of US$1,200 million given to the staff team in November 1978. Consumer prices rose by 3.4 per cent in October and a further 1.2 per cent in November. In both months, the price level was slightly more than 25 per cent above that prevailing a year earlier. These figures are still consistent with an average rate of inflation of 22 per cent in 1978, compared with 27 per cent in 1977.

Table 1. Portugal: Evolution of Quantitative Performance Criteria Under Stand-by Arrangement

	1977	1978				1979
	December	March	June	September 1/	December 1/	March
			In billions of escudos			
Net domestic credit of the banking system 2/						
Ceiling	--	--	698.8	735.8	792.9	808.6
Actual						
Including bad debt	708.6	740.2	789.0	826.2	...	...
Excluding bad debt	651.2	672.1	711.1	744.2	796.3	...
Banking system credit to the public sector 2/						
Subceiling	--	--	137.3	142.3	160.3	177.3
Actual	123.3	132.7	142.0	156.6	171.8	...
			In millions of U.S. dollars			
Net foreign liabilities of the banking system 3/						
Ceiling	--	--	1,787	1,957	2,162	2,322
Actual	1,217	1,609	1,799	1,478	1,216	...

Source: Data provided by the Portuguese authorities.

1/ Actual data for September and December 1978 are provisional.
2/ Allowing for the downward revision of the end-1977 base data, by Esc 2.8 billion for overall net domestic credit and Esc 6.5 billion for net credit to the public sector, as described in the cable dated November 20, 1978 from the Portuguese authorities (EBS/78/707, 12/26/78).
3/ Allowing for the downward revision of the end-1977 base data by US$135 million, as described in the cable dated November 20, 1978 from the Portuguese authorities (EBS/78/707, 12/26/78).

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EBS/78/707

CONFIDENTIAL

December 26, 1978

To: Members of the Executive Board

From: The Acting Secretary

Subject: Portugal - Review of Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff review of the stand-by arrangement for Portugal. A draft decision appears on page 7.

This subject, together with the 1978 Article IV consultation with Portugal (SM/78/304, 12/26/78), will be brought to the agenda for discussion on a date to be announced.

Att: (1)

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INTERNATIONAL MONETARY FUND

PORTUGAL

Review of Stand-by Arrangement

Prepared by the European and the Exchange and Trade Relations Departments

(In consultation with the Legal and Treasurer's Departments)

Approved by L.A. Whittome and Ernest Sturc

December 22, 1978

I. Purpose of the Review

Effective June 5, 1978, the Executive Board granted Portugal a one-year stand-by arrangement in the second credit tranche, for an amount equivalent to SDR 57.35 million (EBS/78/228, Supplement 1, 5/23/78, and Supplement 2, 6/6/78). In paragraph 18 of the letter of intent the Portuguese authorities stated an intention to review the evolution of the policy program with the Fund in January 1979, and at that time to reach such understandings with the Fund as may be necessary. An intention is also stated in paragraph 16 to review, also in January, Portugal's quantitative import restrictions with a view to reaching understandings on steps to reduce or eliminate their restrictiveness in 1979. At the request of the Portuguese authorities the staff team that visited Lisbon in November 1978 to conduct Article IV consultation discussions also performed the two reviews required under the stand-by.

The Portuguese representatives informed the staff team that, in view of the impending change of government, they were not in a position to reach new understandings for the remaining period of the stand-by arrangement. Though the objectives of the stand-by program are in process of being attained, compliance with performance criteria has been incomplete as described below. Accordingly, Portugal is not at this time able to request any purchases under the stand-by arrangement which will raise the Fund's holdings of escudos beyond the first credit tranche, until new understandings are reached regarding the circumstances in which it may resume such purchases. Meanwhile the Portuguese authorities have requested revisions of certain ceilings in the stand-by arrangement to reflect statistical improvements, and a decision by which this would be achieved is proposed at the end of this paper.

Thus far no purchases have been made under the stand-by arrangement. Since Portugal paid part of its quota increase in the Fund in foreign exchange earlier this year, and is repurchasing in full the two gold tranche drawings of 1975, the Fund's holdings of escudos, excluding those arising from purchases under the oil facility and the compensatory financing facility, will decline to within the reserve tranche by the end of 1978. Thus, despite the 1977 purchase in the first credit tranche, Portugal will be able to purchase up to SDR 43.60 million before the Fund's holdings of escudos rise above 125 per cent of quota; this compares with a maximum that could be drawn until April 1, 1979 of SDR 44.35 million under the phasing specified in the stand-by arrangement.

In a communication from the Governor of the Bank of Portugal dated December 5, 1978, the new Portuguese government which took office on November 22, 1978 confirmed its intention to begin negotiations with the Fund in the latter half of January for a new stand-by arrangement, based on a program covering calendar 1979, to replace the existing arrangement. For future reference the present paper reviews the provisions of the existing stand-by arrangement in the light of developments since May 1978. Section II presents a summary of Portugal's record with respect to the performance clauses of the arrangement. Section III offers an evaluation of the way in which the policy program that forms the basis for the existing arrangement was formulated.

II. Performance Under the Stand-by Arrangement

1. Contents of the program

The program on which the present stand-by arrangement was based had for its objectives a strengthening of the balance of payments and reduction of domestic inflationary pressures while maintaining a positive rate of economic growth as a means of keeping unemployment in check. During the program period--the year to end-March 1979--the authorities aimed to limit the external current account deficit to US$1,000 million, and the overall balance of payments deficit to US$800 million; these targets compared favorably with US$1,500 million and US$1,300 million, respectively, during the preceding 12-month period. The core of the program was an attempt to hold the increase in the net foreign liabilities of the banking system within specified ceilings by a flexible use of exchange rate and interest rate policy. This was to be supported by wage restraint and by limits on domestic credit expansion and on bank credit to the public sector. External adjustment would then permit a progressive liberalization of the import regime.

In addition to the standard clause relating to trade and exchange restrictions and multiple currency practices, the performance criteria under the stand-by program consisted of (i) quarterly ceilings on the net foreign liabilities of the banking system, the overall net domestic credit of the banking system, and the banking system's net credit to the public sector; (ii) a requirement that all applications for import items not subject to quantitative restrictions be granted automatic authorization beginning not later than June 30, 1978, by which date the existing backlog of import applications was to be fully eliminated; and (iii) a reduction of 10 percentage points in the 30 per cent import surcharge, effective October 1, 1978, under an announced schedule to abolish the surcharge by October 1, 1979. Finally, the right of Portugal to make purchases under the stand-by arrangement after January 1, 1979 was made subject to the condition that such understandings as may be necessary would be reached with the Fund; in addition, the arrangement called for a review with the Fund before the end of January 1979 aimed at reaching understandings about steps to reduce or eliminate the restrictiveness of quantitative import restrictions in 1979.

The program was also designed to provide a more solid foundation for long-term economic reconstruction and development. For this purpose, main reliance was placed on (a) a flexible exchange rate policy designed to improve in combination with wage restraints the international competitiveness of the Portuguese economy; (b) increases in interest rates intended to reverse the prevailing trend of financial disintermediation; (c) increased fiscal discipline aimed at generating public sector current savings to help finance expanded investments; and (d) a phased dismantling of external restrictions to pave the way for Portugal's full participation in the international economy, including membership in the European Community.

2. Compliance with performance criteria

Slightly more than halfway through the program period, the Portuguese economy has registered notable progress toward the program objectives of improving the balance of payments, reducing domestic inflationary pressures, and maintaining a positive rate of economic growth. On present estimates the deficit on external current account will fall from US$1,500 million in 1977 to US$1,200 million in 1978, and gives promise of falling further to the program target of US$1,000 million in the year to March 1979. The annual rate of price inflation also appears to have slowed down, even more than expected, from 27 per cent in 1977 to approximately 22 per cent in 1978. These results are being achieved at a lower cost in terms of a slowdown in economic activity than was once feared; real output appears still to have grown by 4 per cent in 1978 compared with 6 per cent in each of the preceding two years.

With respect to the quantitative performance criteria, Portugal has since September 1978 kept the ceiling on the net foreign liabilities of the banking system by a substantial margin, despite the fact that the ceilings on the net domestic credit of the banking system as well as the subceilings on the banking system's net credit to the public sector have been exceeded (Table 1). Reflecting the increase in interest rates, the deceleration of inflation and the strengthening of confidence, the public has shown far greater willingness to hold domestic money balances than had been projected when the stand-by program was designed: the income velocity of money, which had been expected to increase by 7.5 per cent, showed little or no change during the period. Combined with a higher than expected level of foreign borrowing by the public sector, this unanticipated stability in the income velocity of money permitted a better than expected performance in the net foreign liabilities of the banking system, despite the greater than programmed expansion in domestic credit.

The limits on domestic credit under the stand-by arrangement would have allowed an expansion of Esc 84.6 billion, or 15 per cent of the December 31, 1977 money stock, by the September 30, 1978 test date. Present Bank of Portugal estimates result in a domestic credit expansion of Esc 117.6 billion, including uncollectible items, or about 21 per cent of the initial money stock, over the same period. Excluding the increase in uncollectible items--which were classified with other items net and inadvertently excluded from the credit ceiling in the letter of intent--this figure would be reduced to Esc 93.0 billion. The Portuguese representatives explained that most of the increase in uncollectible items had occurred in the last quarter of 1977 in response to a directive that banks classify as uncollectible all debt in arrears. Since the first quarter of 1978, their proportion of quarterly increases in domestic credit has steadily declined. From October 1978 they have also been subsumed under the ceilings the Bank of Portugal sets on the credit operations of individual commercial banks.

The subceilings on banking system credit to the public sector would have allowed an expansion of Esc 19.0 billion in the first nine months of 1978; the preliminary outturn showed a figure of Esc 33.3 billion instead. Though expenditure overruns also contributed, the main reason for this result was traced to substantial revenue shortfalls in this period. The Portuguese representatives thought that, with the help of US$450 million raised in the Euro-dollar market during the summer, the calls of the public sector on the domestic banking system could be brought substantially closer to program targets by the end of the year. They accepted, however, that the overall budget deficit, which had been forecast at Esc 54 billion for the year, was now likely to reach Esc 71 billion, or 9 per cent of GDP. It was particularly unfortunate that the entire discrepancy was found in the current account of the public sector; in place of showing a surplus of Esc 3 billion as had been projected earlier in the year, the outturn was forecast to show a deficit for the year of Esc 14 billion, or 2 per cent of GDP.

The staff team accepted that the welcome but unanticipated stability in the income velocity of money might have been grounds for a revision of the stand-by ceilings on domestic credit, had the Portuguese authorities been in a position to reach new understandings with the Fund. It was also noted that the continued exclusion of uncollectible items from the ceilings allows an additional margin to domestic credit until a new stand-by program covering the calendar year 1979 can be negotiated. Meanwhile, there have been further improvements of a purely technical nature in the financial statistics which deserve to be recognized. These revisions require a downward adjustment of the end-December 1977 figures for the levels of net domestic credit, public sector recourse to the banking system, and net foreign liabilities of the banking system, on which the program ceilings and sub-ceilings had been calculated. Accordingly, the Portuguese Minister of Finance and Planning and the Governor of the Bank of Portugal requested a statistical adjustment in the relevant ceilings under the present stand-by arrangement.

As regards exchange restrictions, the Portuguese representatives confirmed that remittances of profits and dividends had since August 1977 been subject to phasing for balance of payments reasons, though this had not been reported before. Before July 1978, individual applications for outward remittances in excess of approximately US$40,000 were subject to phasing for a period up to one year, but after July the minimum amount was increased to US$250,000 and the maximum phasing reduced to six months. The outward remittances of profits and dividends totaled the equivalent of US$9.9 million in 1976, US$13.9 million in 1977, and US$32.7 million in the 12 months to October 1978. The practice of phasing is a restriction on the availability of foreign exchange and is subject to Fund approval under Article VIII, section 2(a). A decision by which this would be granted is proposed in the staff report on the 1978 Article IV consultation discussions (SM/78/304).

The two performance criteria relating to the liberalization of import authorizations and the reduction of the import surcharge have been observed, but no understandings were reached about steps to reduce or eliminate the restrictiveness of quantitative restrictions.

3. Other policy instruments

As noted above, policies aimed at the program objectives of promoting financial stability and economic growth included those relating to interest and exchange rates as well as wage restraints. In this connection, the Portuguese authorities have adhered to the policy, adopted after a 6 per cent step depreciation in May 1978, of depreciating the escudo at a monthly rate of about 1.25 per cent in effective terms. They have also maintained domestic interest rates at the increased levels introduced on May 8, 1978--namely 18-23 per cent for the discount rate, 8-20 per cent for deposit rates, and 18.25-21.25 per cent for lending rates, depending on maturity. As for wages policy, a 20 per cent annual limit on contractual wage increases was decreed by the authorities in April 1978. Actual wage developments in 1978 have been consistent with this limit: the average rate of wage increase during the year is estimated at about 18 per cent, against a 22 per cent annual rate of price inflation; this followed a 9 per cent decline in real wages during 1977. In combination with other policies, these measures have helped to achieve a substantial improvement in external cost competitiveness. As noted in the previous section, the increase in domestic interest rates has also had the intended effect of increasing the demand for money while helping to moderate market demand for domestic credit. However, the intention of the Government to study alternative domestic tax measures with a view to phasing out the 60 per cent import surcharge has not yet been acted upon.

III. Staff Appraisal

While present projections for a deficit on external current account of US$1,200 million, declining to the stand-by target of US$1,000 million in the year ending March 1979, appear reasonable, the outlook on present policies is for a renewed deterioration to a deficit again of US$1,200 million in the 1979 calendar year. To avoid this outcome it will be necessary to obtain wage limits in 1979 low enough to help with a further reduction in prices, to continue credit restraint sufficient to ensure continued improvement in the overall balance of payments, and to reverse the deterioration in the public sector accounts. These issues are dealt with in more detail in the staff report on the 1978 Article IV consultation discussions (SM/78/304). The present appraisal considers the principles on which the existing stand-by arrangement was formulated.

The proximate target of the stand-by program was a ceiling on the growth in the net foreign liabilities of the banking system which was made a performance clause. By end-September these liabilities had grown to only US$1,478 million, well within the permissible US$1,957 million even after allowance for unanticipated foreign borrowing by the public sector. The main policy instruments designed to achieve this result were interest rates, primarily deposit rates, and the exchange rate. Interest rates were to rise sufficiently relative to prices to arrest the steady decline in money holdings relative to GDP that had characterized the preceding four years. The exchange rate was to depreciate sufficiently relative to wages to restore and maintain the competitiveness of the Portuguese economy. The exact effects of such measures is always difficult to predict, but the degree of success has considerably exceeded expectations.

Interest rate and exchange rate policy was to be supported by credit restraint, and a ceiling on domestic credit expansion was accordingly made a performance clause. However, reflecting the initial uncertainty regarding the effect of higher interest rates on the demand for money, and its timing, the likely growth of the money stock in the program period turned out to be seriously underestimated. In consequence, the expansion of domestic credit consistent with the given external objective was fixed at a level rather lower than would now appear to have been permissible. Mitigation was found in the exclusion from domestic credit of allowances for bad debt; though this omission will have to be rectified in future it has for the present provided an additional margin above the ceiling.

In an effort to ensure that the available credit should as much as possible go to productive investment, the stand-by arrangement also contained as a performance clause a subceiling on banking system credit to the public sector. For balance of payments reasons firm control of domestic credit expansion will continue to be necessary; hence the need for fiscal restraint also remains. The fact that the public sector registered another current account deficit in 1978 instead of the expected surplus, is particularly disappointing in this context. The poor financial condition of many public enterprises has resulted in an additional use of domestic saving for nonproductive purposes. To avoid a further misallocation of credit, the fiscal deterioration both of the public sector and of the public enterprises, clearly needs to be reversed.

The performance clauses did not include any limitation on the accumulation of external debt, except insofar as the domestic credit ceiling included not only bank lending, but also short-term borrowing abroad with a domestic bank guarantee. For the rest, the program was designed to make compliance with its performance clauses easier, to the extent that additional foreign credits could be obtained outside the banking system. However, as access to international capital markets eases with the improvement in the overall external position of the country, it will become more urgent for the authorities to ensure that borrowing abroad be related to productive uses, so as to conserve the country's borrowing capacity for the time when a more firmly managed development effort can be launched. At present a centralized reporting system for foreign borrowing is still in process of being organized; it should be made operational as soon as possible.

With the improvement in the external position the Portuguese authorities have taken steps to relax their restrictions on external trade and payments during the past year. This momentum should not be lost. The schedule of reductions in the 30 per cent surcharge calls for complete elimination by October 1, 1979. It is regrettable that new understandings could not be reached on this occasion about steps to reduce and eliminate the restrictiveness of quota restrictions, or about domestic tax measures to replace the 60 per cent surcharge. Also, while the steps taken to liberalize the previously unreported restrictions on the outward remittance of profits and dividends are welcome, their early elimination would seem to be desirable.

IV. Proposed Decision

The request by the Portuguese authorities mentioned above--for a statistical adjustment in the stand-by ceilings on domestic credit, banking system credit to the public sector, and the net foreign liabilities of the banking system--was made in the attached communication from the Minister of Finance and Planning and the Governor of the Bank of Portugal dated November 20, 1978. The proposed changes in no way affect the policy intentions of the existing stand-by arrangement or the economic significance of the ceilings. Accordingly, the following decision is proposed for adoption by the Executive Board:

> The cable dated November 20, 1978 from the Minister of Finance and Planning and the Governor of the Bank of Portugal shall be attached to the stand-by arrangement for Portugal (EBS/78/228, Supplement 2), and the letter of intent of May 8, 1978 shall be read as modified by the cable dated November 20, 1978.

Lisbon, Portugal

November 20, 1978

Dear Mr. de Larosiere,

Since the date of the letter of intent in which the Portuguese authorities requested a stand-by arrangment with the Fund, May 8, 1978, we have had to make a number of changes in the statistical data on domestic credit and net foreign liabilities which are being monitored under the terms of the stand-by arrangement granted by the Fund on June 5, 1978. The object of these changes was to improve the accuracy of the figures. The changes are strictly of a technical nature and take into account the definitive end-1977 figures for both the Banco de Portugal and the commercial banks and also comprise corrections for previously incorrect classification of data and errors in reporting. These changes in no way affect the policy intentions of the existing stand-by arrangement or the economic significance of the ceilings.

As a result of these changes, some of the figures in the letter of May 8, 1978 should be modified. The figure for December 1977 in paragraph 6 of the letter of intent, which defines net foreign liabilities of the banking system would be reduced by US$135 million to US$1,217 million. The ceilings on net foreign liabilities for the remainder of the program year would be adjusted downward by the same amount so that net foreign liabilities of the banking system will not be allowed to exceed US$1,787 million on June 30, 1978, US$1,957 million on September 30, 1978, US$2,162 million on December 31, 1978, and US$2,322 million on March 31, 1979.

Similarly, in paragraph 8, the figure for December 1977 which defines net domestic credit of the banking system should be reduced by Esc 2.8 billion to Esc 651.2 billion. The ceilings on net domestic credit for the remainder of the program year should be adjusted downward by a similar amount so that the net domestic credit of the banking system will not be permitted to exceed Esc 698.8 billion on or before June 30, 1978, Esc 735.8 billion on or before September 30, 1978, Esc 792.9 billion on or before December 31, 1978, and Esc 808.6 billion on or before March 30, 1979.

Finally, in paragraph 11 of the letter of intent, the figure for December 1977 which defines net claims of the banking system on the public sector, should be reduced by Esc 6.5 billion to Esc 123.3 billion. The ceilings for the remainder of the stand-by period would be reduced by the same amount so that the net claims of the banking system on the public sector would not be permitted to rise above Esc 137.3 billion on or before June 30, 1978, Esc 142.3 billion on or before September 30, 1978, Esc 160.3 billion on or before December 31, 1978, and Esc 177.3 billion on or before March 30, 1979.

Jose da Silva Lopes
Minister of Finance and Planning

Dr. Rui Vilar
Governor, Banco de Portugal

Table 1. Portugal: Evolution of Quantitative Performance Criteria Under Stand-by Arrangement

	1977	1978				1979
	December	March	June	September 1/	December	March
			In billions of escudos			
Net domestic credit of the banking system 2/						
Ceiling	--	--	698.8	735.8	792.9	808.6
Actual						
Including bad debt	708.6	740.2	789.0	826.2	...	...
Excluding bad debt	651.2	672.1	711.1	744.2	...	...
Banking system credit to the public sector 2/						
Subceiling	--	--	137.3	142.3	160.3	177.3
Actual	123.3	132.7	142.0	156.6	...	...
			In millions of U.S. dollars			
Net foreign liabilities of the banking system 3/						
Ceiling	--	--	1,787	1,957	2,162	2,322
Actual	1,217	1,609	1,799	1,478	...	...

Source: Data provided by the Portuguese authorities.

1/ Actual data for September 1978 are provisional.
2/ Allowing for the downward revision of the end-1977 base data, by Esc 2.8 billion for overall net domestic credit and Esc 6.5 billion for net credit to the public sector, as described in the attached cable.
3/ Allowing for the downward revision of the end-1977 base data by US$135 million, as described in the attached cable.

Portugal 1766

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

EBS/78/228
Supplement 2

CONFIDENTIAL

June 6, 1978

To: Members of the Executive Board

From: The Acting Secretary

Subject: Portugal - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Portugal agreed at Executive Board Meeting 78/81, June 5, 1978.

Att: (1)

<u>Stand-By Arrangement - Portugal</u>

1. Annexed hereto is a letter dated May 8, 1978 from the Minister of Finance and Planning and the Governor of the Bank of Portugal setting forth the objectives and policies which the Portuguese authorities will pursue.

2. The International Monetary Fund grants this stand-by arrangement to support these objectives and policies.

3. Portugal will remain in close consultation with the Fund during the period of the stand-by arrangement and, in particular, will consult with the Fund in accordance with paragraphs 18 and 20 of the letter. These consultations may include correspondence and visits of officials of the Fund to Portugal or of representatives of Portugal to the Fund. For the purposes of these consultations, Portugal will provide the Fund, through reports at intervals on dates requested by the Fund, with such information as the Fund requests in connection with Portugal's objectives and policies set forth in the annexed letter.

4. For a period of one year from June 5, 1978, Portugal will have the right, after making full use of any reserve tranche that it may have at the time of making a request for a purchase under the stand-by arrangement, to make purchases from the Fund in an amount equivalent to SDR 57.35 million, provided that

(i) purchases under the stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 14.35 million until July 1, 1978; the equivalent of SDR 24.35 million until October 1, 1978; the equivalent of SDR 34.35 million until January 1, 1979; and the equivalent of SDR 44.35 million until April 1, 1979; and

(ii) the right of Portugal to make purchases under this stand-by arrangement shall be subject to paragraph 19 of the letter of intent to the extent that such purchases would increase the Fund's holdings of escudos beyond the first credit tranche.

If at any time any limit in (i) above would prevent a purchase under the stand-by arrangement that would not increase the Fund's holdings of escudos beyond the first credit tranche, the limit will not apply to that purchase.

5. Purchases under the stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in special drawing rights if, on the request of Portugal, the Fund agrees to provide them at the time of the purchase. Purchases shall be made in exchange for escudos.

6. Portugal will pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

7. Subject to paragraph 4 above, Portugal will have the right to engage in the transactions covered by this stand-by arrangement without further review by the Fund. This right can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Portugal. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 7, purchases under this stand-by arrangement will be resumed only after consultation has taken place between the Fund and Portugal and understandings have been reached regarding the circumstances in which such purchases can be resumed.

8. (a) Repurchase of the outstanding amount of escudos that results from a purchase under this arrangement and is subject to charges under Article V, Section 8(b):

(i) may be made at any time;

(ii) will be expected normally as the balance of payments and reserve position of Portugal improves;

(iii) shall be made in accordance with the representation of the Fund if, after consultations with Portugal, the Fund represents that under its policies at the time of the repurchase Portugal should repurchase because of an improvement in its balance of payments and reserve position; and

(iv) shall be completed five years after the date of the purchase, provided that the repurchase shall be made in equal quarterly installments during the period beginning three years and ending five years after the date of the purchase unless the Fund approves a different schedule.

(b) Any reductions in escudos held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) Repurchase shall be made with special drawing rights, or with the currencies specified by the Fund at the time of the repurchase in accordance with the policies and procedures of the Fund at the time of the repurchase.

Annex to Stand-By Arrangement

Lisbon, Portugal
May 8, 1978

Dear Mr. Witteveen,

1. The pressures on Portugal's balance of payments have continued strong this past year, as internal and external disequilibria proved considerably more intractable than had earlier been expected, complicated as they are by serious structural maladjustments in the economy. In fact, it is mainly through a policy directed to overcome these structural problems of the economy that the external imbalance can be controlled on a more permanent basis. A medium-term strategy to restructure and increase productivity in industry and modernize agriculture will be implemented by the authorities to achieve that aim.

2. Meanwhile a substantial stabilization effort is clearly called for to provide a solid foundation for long-term economic reconstruction and development in Portugal. Accordingly, the Government of Portugal authorizes the Banco de Portugal to request a stand-by arrangement from the Fund, under which the Banco de Portugal will have for a period of one year the right, after making full use of any reserve tranche it may have, to purchase from the Fund the currencies of other members in exchange for escudos up to an amount equivalent to SDR 57.35 million. Before making purchases under this stand-by arrangement, the Banco de Portugal will consult with the Managing Director on the particular currencies to be purchased.

3. The purpose of this request is to support the stabilization program recently adopted by the Government of Portugal, to strengthen the balance of payments and reduce inflationary pressures while maintaining a positive rate of growth of the economy to keep unemployment in check. These objectives are to be achieved through fiscal, monetary, and wage restraint combined with an exchange rate policy as outlined below. By these means the external current account deficit is to be reduced from about US$1,500 million in the period April 1977-March 1978 to about US$1,000 million in the period April 1978-March 1979. Net non-monetary capital inflows are expected to increase from US$150 million to US$200 million. This improvement in the external balance is to provide the main source of economic growth in the program period.

4. After a decline in real gross domestic product of nearly 4 per cent in 1975, the Portuguese economy recovered sharply in 1976, with real growth estimated at close to 6 per cent. It is estimated that a comparable expansion was achieved in 1977, despite a major decline in agricultural production. A shift of resources from consumption to investment and exports accompanied that expansion. Nevertheless, unemployment remained at about 7 per cent of the labor force at end-1977. At the same time, the rate of wage increases which moderated substantially in 1976 declined further in 1977, in line with the ceiling of 15 per cent placed upon it by law. Real wages appear to have been reduced in the course of 1977 by at least 7 per cent, as the rate of domestic price increases accelerated in late 1976, peaking at a very high level in May 1977 before moderating somewhat later in the year.

5. Despite the depreciation of the escudo in February 1977 and the maintenance of some import restrictions, a continued high rate of increase in domestic demand, due to the recovery of production and investment and the speculative accumulation of stocks, contributed to a further increase in the trade deficit to US$2,530 million in 1977. This deterioration was offset to some extent by significant increases in tourist receipts and emigrants' remittances, but not by enough to keep the current account deficit from rising from US$1,244 million or some 8 per cent of GDP in 1976, to US$1,495 million or about 9 per cent of GDP in 1977. The overall deficit rose from US$1,268 million to US$1,462 million, largely financed by compensatory borrowing and the use of gold reserves. As commercial banks also increased their foreign liabilities, the net foreign assets of the banking system turned negative in early 1977, if the official reserves of gold are valued at the traditional price.

6. The Government considered it appropriate, after an initial effective depreciation of 4 per cent in late August 1977, to move to a crawling peg system for the escudo. Thus, the effective rate depreciated by a total of 14.3 per cent in the 12 months through April 1978. A further adjustment of 7.0 per cent in the effective exchange rate was made in early May 1978. The authorities intend to continue the policy of the crawling peg. Exchange rate policy will in future be guided by the Government's decision not to allow the net foreign liabilities of the banking system, which stood at US$1,352 million on December 31, 1977, to exceed US$1,922 million on June 30, 1978; US$2,092 million on September 30, 1978; US$2,297 million on December 31, 1978; and US$2,457 million on March 31, 1979.

7. The authorities are determined to reduce inflationary pressures despite the prospective shift of resources to the external sector. Accordingly, to limit unnecessary pressure on the external value of the escudo, interest rates were raised in both February and August 1977. The Government decided on further substantial increases in May 1978, when the discount rate of the Banco de Portugal was raised from a range of 13-18 per cent to a range of 18-23 per cent. Interest rates on time deposits were raised by 4 percentage points to levels of 19 per cent and up on deposits of six months or more. Basic lending rates were raised 3.5 percentage points, but those for housing by only 1-2 percentage points, and those for agriculture, exports and priority investments by 2-3 percentage points, so as to minimize the impact of credit restraint on these vital sectors. The authorities consider these rates necessary for the present to check increases in the velocity of money, speculation in stocks, or adverse capital movements. They intend to raise or lower them in response to changing circumstances.

8. Monetary policy is designed to contribute substantially to the prospective improvement in the external balance and to the containment of inflation. By the close of 1977, the rate of domestic credit expansion had reached 34.5 per cent of the initial money stock, substantially exceeding the rate of growth in the money stock itself, before moderating to 32 per cent in the year ending March 1978. On average, the money stock grew by 22 per cent in 1977 compared with a 33 per cent growth in nominal GDP, but is expected to be reduced to about 18 per cent against an anticipated growth in nominal GDP of

about 27 per cent in the year to March 1979. Taking this into account along with the target for the balance of payments, net domestic credit of the banking system, the total of which amounted to Esc 654.0 billion on December 31, 1977, will not be permitted to exceed Esc 701.6 billion on or before June 30, 1978; Esc 738.6 billion on or before September 30, 1978; Esc 795.7 billion on or before December 31, 1978; and Esc 811.4 billion on or before March 31, 1979. The resulting increase in net domestic credit in the program year is estimated at about 23 per cent of money stock at the beginning of the period.

9. To give effect to these limits, the authorities have introduced indicative credit ceilings on individual banks and are prepared to make them mandatory should the need arise. To tighten credit control, domestic bank lending in escudos but denominated in foreign currencies has been included under the ceilings. More fundamentally, however, the monetary authorities intend to keep the development of the monetary base under close and continuous scrutiny and have set the following indicative targets for the program year: Esc 143.6 billion by June 30, 1978; Esc 143.6 billion by September 30, 1978; Esc 151.0 billion by December 31, 1978; and Esc 149.2 billion by March 31, 1979. To ensure that these limits are kept, the monetary authorities have gradually reduced rediscount quotas and introduced an uniform reserve requirement of 7 per cent on all monetary deposits, with the result that the banks' liquidity position has already become very tight. Finally, interest rates are being managed flexibly. Recent increases will help contain the demand for domestic credit and thus minimize the need for credit rationing.

10. A further contribution to domestic stabilization will come from fiscal restraint. A significant reduction in the deficit of the public sector was achieved in 1977, taking it down from 11 per cent of GDP in 1976 to 8 per cent in 1977, mainly in consequence of tax increases and the containment of public consumption. This improvement is to be consolidated in 1978 on the basis of the budget recently passed by Parliament. New tax measures have been authorized to raise revenues by the equivalent of 2 per cent of GDP over what they would otherwise have been. In addition, the administered price increases referred to in paragraph 12 below, will serve to limit the need for subsidies to state trading agencies and public utilities and corporations. After allowance for normal underspending, a surplus in the current account of the public sector will be achieved for the first time since 1974. There is still to be a rise in real capital expenditures, resulting mainly from an increase in equity capital subscriptions to public enterprises. Although the overall deficit of the public sector will thus remain unchanged in nominal terms, it will decline further in relation to GDP to 6 per cent in the year to March 1979.

11. The authorities intend to take every precaution to ensure that these budget outturns are realized. The revenue effort will be supplemented as necessary to make up for any revenues lost as a result of the phasing out of the import surcharge referred to in paragraph 15 below. Furthermore, any revenues from existing taxes that may exceed budgeted amounts will be used to reduce the public sector deficit and not to finance additional expenditures. Finally, during the period of the stand-by arrangement, the use of government securities to discharge tax obligations will be limited to arrears in direct taxes prior to 1977, as presently permitted by law. Thus, after allowing for other sources

of finance, the net claims of the banking system on the public sector, the total of which amounted to Esc 129.8 billion on December 31, 1977, will not be permitted to rise above Esc 143.8 billion on or before June 30, 1978; Esc 148.8 billion on or before September 30, 1978; Esc 166.8 billion on or before December 31, 1978; and Esc 183.8 billion on or before March 31, 1979.

12. To take account of increasing costs and to moderate the need for government subsidies, certain administered prices were increased substantially in April of this year. Utility rates for water, electricity and gas as well as transportation prices were raised by 35-50 per cent, while the prices of essential food products, which had been frozen since February 1977, were raised by more than 20 per cent. To ease the adjustment, the minimum wage, which had remained unchanged since January 1977, was raised by approximately 30 per cent, unemployment benefits were increased by about 25 per cent, and pensions were raised by up to 22 per cent. To help contain cost increases in the future, however, wage policy will have to remain firm, and legislation was therefore passed in April of this year limiting increases in contractual wages to 20 per cent in 1978, and requiring a minimum contract period of 12 months. Legislation was also passed in August 1977 allowing firms in financial distress to suspend wage contracts if their work force concurs.

13. Portugal's external medium and long-term debt, excluding obligations of the banking system, increased from US$1,125 million at the end of 1975 to US$1,469 million at the end of 1976 and further to US$1,848 million at the end of 1977. Most of this is either guaranteed by the Government or an obligation of public enterprises, including enterprises brought within the framework of the public sector since 1974, but not officially guaranteed. The ratio of debt service payments to exports of goods and services is estimated at 15 per cent in 1977 and is expected to rise to 19 per cent in 1978. In addition, short-term private debt has risen from US$145 million at the end of 1976 to US$717 million at the end of 1977. The Government will seek to avoid any further increase in such short-term debt during the program year. It will strengthen its efforts to avoid excessive external indebtedness and to improve the maturity profile, by continuing its policy of monitoring overall external debt developments and of coordinating foreign borrowing by public sector agencies and enterprises. Particular attention will be paid to limiting external borrowing to the financing of productive investment projects.

14. All imports are effected on the basis of import bulletins, which for imports not subject to quantitative restrictions serve a statistical purpose and enable the importer to obtain the necessary foreign exchange. For imports subject to restrictions, the bulletin is equivalent to an import license. Import bulletins are normally issued without delay. However, in late 1977 the process of authorizing import bulletins was subject to some delays, partly in conjunction with the introduction of new administrative procedures. As a result, a backlog of applications has been built up and the Government is seeking, in cooperation with private sector importers, to devise means of eliminating this problem. Already, the Government decided on May 2, 1978, that thenceforth all applications for imports of raw materials and intermediate goods would be

authorized automatically. It is the intention of the Government that this automatic procedure will be extended, no later than June 30, 1978, to all other categories of imports not subject to quantitative restrictions, and that by the same date, the backlog of import applications will have been fully eliminated.

15. The Government of Portugal abolished its import deposit requirement at the end of 1977, but still imposes an import surcharge of 30 per cent on the value of items covering about 29 per cent of total imports in 1976, and one of 60 per cent covering 2 per cent of 1976 imports. The 30 per cent surcharge will be phased out gradually: effective October 1, 1978 the rate will be reduced to 20 per cent; further to 10 per cent effective April 1, 1979; and fully abolished effective October 1, 1979. The 60 per cent import surcharge, applicable mostly to luxury goods, will be maintained temporarily, but the Government intends to study alternative domestic tax measures with a view to phasing it out beginning in 1979.

16. The temporary value quotas for certain consumer goods, applicable to about 4 per cent of 1976 imports, have been raised with effect from April 1, 1978 to an annual rate of Esc 3.405 billion, which is equivalent in foreign exchange terms to the value of these quotas in the year to March 1978. The value quotas for knocked-down automobiles, applicable to about 2.8 per cent of 1976 imports, remain unchanged in 1978 at their escudo level of 1977. All import quotas are strictly temporary and the Portuguese Government intends to review them with the Fund before the end of January 1979 with a view to reaching understandings with the Fund about steps to reduce or eliminate the restrictiveness of these quantitative import restrictions in 1979.

17. The Government establishes an annual foreign exchange budget for its own operations as well as foreign exchange budgets for the various state agencies in charge of monopoly imports of certain basic commodities, primarily foodstuffs. These budgets are, however, only indicative and the Government intends to amend these budgets from time to time so as to avoid restricting imports through rationing of foreign exchange. The Government of Portugal does not intend to introduce any multiple currency practices, or any new restrictions, or intensify existing ones, on payments and transfers for current international transactions, or to conclude any new bilateral payments agreements with the Fund members, or to introduce restrictions, or intensify existing ones on imports for balance of payments reasons.

18. Given the many uncertainties of the international and domestic economic situation, it is the intention of the Government to review the evolution of the program in January 1979 and on that occasion to reach such understandings with the Fund as may be necessary.

19. During any period of the stand-by arrangement in which the ceilings on net foreign liabilities of the banking system in paragraph 6, or the credit ceilings in paragraph 8, or the ceilings on government borrowing in paragraph 11 are not observed, or the intentions in the last sentence of paragraph 14, in the penultimate sentence of paragraph 15, and in the ultimate sentence of paragraph 17, are not carried out, or during any period after

January 1, 1979 in which understandings have not been reached with the Fund as indicated in the ultimate sentence of paragraph 16 and in paragraph 18, the Banco de Portugal will not request any purchases under the stand-by arrangement which would raise the Fund's holdings of its currency beyond the first credit tranche, except after reaching understandings with the Fund regarding the circumstances in which such purchases may be made.

20. The Government of Portugal believes that the policies set forth in this letter are adequate to achieve the objectives of the program but will take any further measures that may become appropriate for this purpose. During the period of the stand-by arrangement, the Government will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 19 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the stand-by arrangement and while any Fund holdings of escudos above the first credit tranche include currency resulting from purchases under the stand-by arrangement, the Government will consult the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Portugal's balance of payments policies.

Sincerely yours,

Dr. Vitor Constancio
Minister of Finance
and Planning

Dr. Jose da Silva Lopes
Governor
Banco de Portugal

Portugal 760

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Orig: EUR
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INTERFUND WSH

12143 MINFIN P

20.11.1978

DEAR MR. DE LAROSIERE,

SINCE THE DATE OF THE LETTER OF INTENT IN WHICH THE PORTUGUESE AUTHORITIES REQUESTED A STAND-BY ARRANGEMENT WITH THE FUND, MAY 8, 1978, WE HAVE HAD TO MAKE A NUMBER OF CHANGES IN THE STATISTICAL DATA ON DOMESTIC CREDIT AND NET FOREIGN LIABILITIES WHICH ARE BEING MONITORED UNDER THE TERMS OF THE STAND-BY ARRANGEMENT GRANTED BY THE FUND ON JUNE 5,1978. THE OBJECT OF THESE CHANGES WAS TO IMPROVE THE ACCURACY OF THE FIGURES. THE CHANGES ARE STRICTLY OF A TECHNICAL NATURE AND TAKE INTO ACCOUNT THE DEFINITIVE END-1977 FIGURES FOR BOTH THE BANCO DE

MILLION ON SPTEMBER 30, 1978, USDOLLARS 2162 MILLION ON DECEMBER 31,1978, AND USDOLLARS2322 MILLION ON MARCH 31,1979.

SIMILARY, IN PARAGRAPH 8, THE FIGURE FOR DECEMBER 1977 WHICH DEFINES NET DOMESTIC CREDIT OF THE BANKING SYSTEM SHOULD BE REDUCED BY ESC2.8 BILLION TO ESC 651.2 BILLION . THE CEILINGSON NET DOMESTIC CREDIT FOR THE REMAINDER OF THE PROGRAM YAR SHOULD BE A ADJUSTED DOWNWARD BY A SIMILAR AMOUNT SO THAT THE NET DOMESTIC CREDIT OF THE BANKING SYSTEM WILL NOT BE PERMITTED TO EXCEED ESC 698.8 BILLION ON OR BEFORE JUNE 30, 1978, ESC735.8 BILLION ON OR BEFORE SEPTEMBER 30, 1978, ESC792.9 BILLION ON OR BEFORE DECEMBER31,1978 AND ESC 808.6 BILLION ON OR BEFORE MARCH 30, 1979.

FINNALLY, IN PARAGRAPH 11 OF THE LETER OF INTENT, THE FIGURE FOR DECEMBER 1977 WHICH DEFINES NET CLAIMS OF THE BANKING SYSTEM ON THE PUBLIC SECTOR, SHOULD BE REDUCED BY ESC6.5 BILLION TO ESC123.3 BILLION. THE CEDLINGS FOR THE REMAINDER OF THE STAND-BY PERIOD WOULD BE REDUCED BY THE SAME AMOUNT SO THAT THE NET CLAIMS OF THE BANKING SYSTEM ON THE PUBLIC SECTOR WOULD NOT BE PERMITTED TO RISE ABOVE ESC137.3 BILLION ON OR BEFORE JUNE 30,1978, ESC142.3 BILLION ON OR BEFORE SEPTEMBER 30, 1978 ESC160.3 BILLION ON OR BEFORE DECEMBER 31, 1978, AND

Portugal 1960

SEP 29 1978

September 28, 1978

Sir:

This letter responds to your request for information regarding Portuguese progress under the stand-by arrangement agreed for the period April 1978 to March 1979. At this early point it appears that the external objectives of the program may be in the process of being met. The increase in the net foreign liabilities of the banking system was below the ceiling set for end-June and all indications are that the increase to end-September will be well below the ceilings set for that month. The authorities have been depreciating the escudo at the agreed rate and are reducing restrictions on external trade and payments on schedule.

The ceilings on net domestic credit expansion and on public sector recourse to bank credit were unfortunately exceeded in June. However, steps were taken in July and again in August with the objective of bringing the growth in the credit aggregates below the ceilings agreed for end-September.

Finally, we have agreed with the Portuguese to schedule Article IV consultation discussions for November of this year, in combination with the program review provided for in the stand-by arrangement.

Very truly yours,

cc: MD
DMD
EUR

J. de Larosière
Managing Director

The Honorable
Sam Y. Cross
U.S. Executive Director
International Monetary Fund

c-files

SEP 29 1978

INTERNATIONAL MONETARY FUND
THE WORLD BANK

Boards of Governors · 1978 Annual Meetings · Washington, D.C.

September 28, 1978

To: The Managing Director

From: L.A. Whittome /LAW

Subject: Portugal - Letter to the U.S.

As you know the final disbursement of the U.S. contribution to the Paris credits for Portugal was intended to be contingent on confirmation by you to the U.S. Executive Director that the Portuguese have remained in good standing with us. We had intended to discuss this matter with the Portuguese during the proposed November consultation discussions in Lisbon.

However, the U.S. Treasury informed us this morning that they now need to make that final disbursement today or tomorrow in order to be able to charge it to their 1978 rather than the 1979 fiscal year. The terms of their agreement with the Portuguese permit them to do this without actual receipt of the proposed letter from you, but they much prefer to have it so as to avoid undermining our leverage with the Portuguese and doubtless they appreciate the cover which such a procedure provides.

It would be advantageous for us to maintain our role in this procedure, and we have therefore prepared the attached draft letter for your approval and signature. It should preferably be dated no later than September 29, 1978.

Att.

Address replies to:
JOINT SECRETARIAT — ANNUAL MEETINGS
IMF — WORLD BANK
WASHINGTON, D.C. 20431

Cable Address:
INTERMEET
WASHINGTONDC USA

Telex Address:
(RCA) 248331 IMF
(ITT) 440040 FUND UI
(WUI) 64111 INTERFUND

Portugal 1760

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INTERNATIONAL MONETARY FUND
Washington, D.C. 20431

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1978 AUG -3 PM 2:48

TIME RECEIVED

ADDRESS

~~Governor Silva Lopes~~
~~Bank of Portugal~~
~~Lisbon, Portugal~~

not in C.F.

Special Instructions

With reference to your cable No. 22 of July 31 please confirm that provisional May figure for net foreign liabilities (US dollar 1,688.2 million) is consistent with figure for December 1977 (US dollar 1,228.7 million) and previously reported provisional April figure (US dollar 1,694.6 million).

Also, please clarify that reported figure for disbursements under Paris credits in June (16.7) refer to disbursements to the Government of Portugal rather than to the Bank of Portugal.

Finally, we would appreciate the effective exchange rate index to be recalculated on the basis of March 31, 1978 equals 100 as in memorandum of understanding. Corresponding index for end of April and May would also be appreciated.

Best regards,

Whittome

INTERFUND

Distribution

cc: Mr. Dini

MESSAGE MUST END HERE

Drafted by: PEngstrom:rp
Department: European
Date: August 3, 1978

LAWhittome
NAME (TYPE) SIGNATURE

NAME (TYPE) SIGNATURE

FOR CABLE ROOM USE ONLY

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9-2-76

Portugal 1760

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cc: Mr. Dini
EUR
TRE

JUN - 7 1978

Gentlemen:

I am enclosing herewith the text of the stand-by arrangement for Portugal approved by the Executive Board on June 5, 1978.

Sincerely yours,

Anna Watkins
Chief, Operations Division

Banco de Portugal
Rua do Comercio 148
Lisbon 2, Portugal

Enclosure

/hr
June 6, 1978

Portugal 1766

INTERNATIONAL MONETARY FUND

Washington, D.C. 20431

Central Files

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#8

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FOR IMMEDIATE RELEASE
June 6, 1978

The International Monetary Fund has approved a stand-by arrangement in the second credit tranche for the Government of Portugal authorizing purchases up to the equivalent of SDR 57.35 million over the next 12 months, in support of the Government's program to stabilize the economy.

Since 1974, Portugal's balance of payments, which had traditionally been in surplus, has moved into a substantial deficit. Major shocks to the economy had been delivered by social changes at home, the loss of overseas markets, a sharp deterioration in the terms of trade, including the quadrupling of oil prices, and the onset of a major world recession. In relation to the country's gross domestic product, 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. In order to stop the deterioration of the external situation, the Government adopted a stabilization program early last year, in support of which the Fund approved a one-year stand-by arrangement in the first credit tranche equivalent to SDR 42.4 million. In August 1977, a supplementary policy package was introduced. Among other measures, interest rates were raised substantially, and the effective exchange rate of the escudo, after an initial adjustment of 4 per cent, was allowed to depreciate by 1 percentage point per month beginning September 15, 1977.

In view of the persistence of Portugal's payments problems, representatives of 14 countries agreed in June 1977 to contribute a total of about US$750 million in medium-term credits over the following 18 months, most of it to be in the form of direct balance of payments support. This assistance was in large part contingent on the successful negotiation of an upper credit tranche stand-by arrangement with the Fund. The present program, in support of which the present stand-by arrangement has been approved, aims at strengthening the balance of payments and reducing inflationary pressures while maintaining a positive rate of growth of the economy to keep unemployment in check. The external objective of the program is to reduce the deficit in the balance of payments on current account from about US$1,500 million in the year ending March 1978 to US$1,000 million in the year ending March 1979. In order to achieve this improvement in the balance of payments, the Portuguese authorities will continue their flexible exchange rate policy. However, to minimize pressure on the exchange rate and on prices, the emphasis of the program is to be on credit control supported by continued fiscal restraint. Higher interest rates are intended both to reduce the demand for credit, particularly for speculative inventory accumulation and to strengthen the external

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capital account. In combination, these measures are expected to allow a relaxation of restrictions on external trade and payments in the program period and beyond.

Portugal's quota in the Fund is equivalent to SDR 172 million. At present, the Fund's holdings of escudos representing purchases from the Fund which are subject to repurchase were equivalent to SDR 274.2 million, including SDR 114.8 million resulting from purchases under the oil facility, SDR 87.8 million resulting from purchases under the compensatory financing facility, and SDR 42.4 million resulting from purchases under last year's stand-by arrangement with the Fund.

Portugal 1760

June 6, 1978

MEMORANDUM

To: Treasurer
Internal Auditor
General Counsel
Director, European Department
Director, Exchange and Trade Relations Department

From: The Acting Secretary

Subject: Portugal - Request for Stand-By Arrangement

At EBM/78/81 (6/5/78), the Executive Board agreed to the request of Portugal for a stand-by arrangement, approved the stand-by arrangement as set forth in EBS/78/228, Supplement 2 (6/6/78), and granted any necessary waiver of the conditions of Article V, Section 3(b)(iii), of the Articles of Agreement.

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Portugal 1760

1. REPORT BY STAFF

The Deputy Director of the Research Department made the following statement:

> The Deputies of the Group of Ten held a short meeting in Paris on May 31. The principal purpose of the meeting was to elect a new chairman. Mr. Karl Otto Poehl of the Federal Republic of Germany was unanimously selected to replace Mr. de Larosière.
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> In the very brief discussion that followed it was agreed that the Deputies' main activity in the period ahead should be to carry out the mandate of the Ministers and to re-examine the role of the GAB, including the question of revising the amounts. Full support was given to Mr. Poehl's proposal to hold meetings to discuss this matter on September 8 in Paris and on September 23 in Washington, and for him to report the next day to the meeting of the G-10 Ministers.
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> As background for this discussion, Mr. Poehl requested the Fund staff to undertake the preparation of a paper which, of course, in the usual way, would be circulated to the Executive Board.
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> The Deputies noted with interest the wide range of work on SDRs that had been requested of the Executive Board by the Interim Committee in its recent meeting in Mexico City. It was agreed that the Deputies should not duplicate the work of the Fund but that they would follow the progress made on SDR and related questions.

The Executive Board took note of the report by the Deputy Director.

2. PORTUGAL - STAND-BY ARRANGEMENT

The Executive Board considered a request from Portugal for a stand-by arrangement for a period of one year in an amount equivalent to SDR 57.35 million, together with the staff's analysis and recommendation (EBS/78/228, 5/9/78; Cor. 1, 5/22/78; and Sup. 1, 5/23/78).

Mr. Dini made the following statement:

> My Portuguese authorities wish to record their appreciation for the spirit in which the staff has carried out the work that has led to the conclusion of the stand-by program which is before the Executive Board. I myself wish to pay tribute to the staff for a very substantive and well presented report, and my remarks are intended only to underline salient features of the Portuguese economic position and policies.

Portugal's current economic difficulties arise largely from the important changes that have taken place during the last few years in the country's internal political and social structure and in its external environment. Attempts have been made since 1975 to correct the imbalances that have emerged, and progress has been made in alleviating domestic obstacles to a more balanced performance of the economy, but the Portuguese authorities recognize that price and balance of payments developments have been less that satisfactory, and that a more decisive effort to improve performance in these areas is now required.

The financial program adopted in early 1977 and supported by use of Fund resources contained sizable adjustment measures but its implementation was not fully adequate to attain the external objectives that the authorities were aiming at. To be sure, a policy of wage and fiscal restraint was effectively applied: real wages were reduced considerably and, together with a substantial depreciation of the currency, allowed for the restoration of the economy's external competitive position close to that of 1973; private consumption remained approximately flat and public consumption grew only moderately. However, these efforts proved insufficient to meet the balance of payments target, as export growth was disappointing, and monetary policy was not sufficiently tight to prevent accumulation of stocks of both domestic and imported goods and a capital outflow. Interest rates were raised, but not to a level consistent with inflation. Indeed, Portugal has historically had low rates of interest, and the authorities considered unacceptable the very sharp increase required to bring them in line with the rise in domestic prices, for they feared severe adverse effects on business and consumers alike.

While imports expanded rapibly and made possible substantial growth in manufacturing output and national product, the increase in exports remained below expectations mainly because of low market growth for Portugal's traditional exports, restrictions applied abroad to key Portuguese products, and limited scope for substitution between production for domestic use and export. As a result, in 1977 the trade deficit increased rather than declined, and the size of the current account deficit in the balance of payments assumed unexpected dimensions.

The Portuguese authorities have now devised a new financial program for the year ending March 1979, which is the basis of the current request for the stand-by arrangement. The authorities recognize the present overriding importance of bringing the current account deficit of the balance of payments in line with available medium- and long-term financing. They have therefore accepted to pursue more stringent domestic policies to achieve this result in the period ahead.

Since the principal policy weakness in 1977 was in the monetary and credit field, under the new financial program the authorities will maintain much tighter monetary conditions, along with continued fiscal and wage restraint and a flexible exchange rate policy.

The credit expansion is to be contained within 20 per cent in the year ending March 1979, compared with a likely growth of nominal GNP of about 27 per cent, and interest rates have been raised by as much as 5 percentage points. Moreover, reforms have been introduced to establish a better control on the expansion of the monetary base, such as the creation of uniform reserve requirements on all types of deposits and the reduction in rediscount quotas. Such tight monetary and credit conditions should help to reduce stocks and have beneficial effects on the inflow of funds into Portugal. In order to reduce the current deficit in the external accounts to the targeted level, the authorities have also agreed, beyond the action already taken, to continue pursuing a policy of gradual exchange rate depreciation aimed at improving cost competitiveness beyond the 1973 position to compensate for the worsening in Portugal's terms of trade that has occurred since then. They have furthermore accepted to take additional exchange rate action should this be required to attain the overall balance of payments target under the stand-by arrangement, which calls for quarterly ceilings on the net foreign liabilities of the banking system.

The staff recognizes that the structural element in Portugal's deficit in its external current account is so large that more than a single year will be required for its correction. Indeed, the implementation of the financial program supported by the requested stand-by arrangement must be seen as a major effort. There is little doubt that it will allow for a substantial improvement in the balance of payments, but it will also have the effect of curtailing sharply the growth of the economy, involving as it does a further reduction in real wages and a fall in total domestic expenditure and in imports.

While accepting the policy mix chosen by the Portuguese authorities that places relatively heavy emphasis on domestic credit restraint, the staff has broadly hinted that it would have preferred more reliance on measures designed to produce a larger switch of resources from domestic expenditure to exports. The Portuguese authorities firmly believe, as reported by the staff, that a larger exchange rate depreciation than already planned could only lead to excessive inflationary pressures which in turn would make it more difficult to contain wages. Moreover, given the market constraints facing Portuguese products, higher profitability in the export sector, rather than stimulating exports, could under present conditions lead instead to unwanted capital outflows.

As I stated, the Portuguese authorities recognize that in present circumstances the attainment of an improvement in the current external account position, which is urgently needed, requires the curtailment of domestic expenditure, but they stress that the country's economic problems cannot be solved by restrictive demand management measures alone. Domestic policies are now very stringent, and the ensuing balance of payments deficit cannot be said to be caused by excessive consumption or investment, nor by the lack of competitiveness in the export sector. Rather, as I indicated at the outset, it is largely the consequence of structural changes within Portugal which have irreversibly altered previous equilibria, and of the modification of external elements outside Portugal's control, such as the sharp deterioration in the terms of trade, restricted access to export markets, and the interruption in the flow of migrant workers abroad.

In these circumstances, it would not be reasonable to expect Portugal to eliminate its substantial balance of payments deficit within a short period of time. A fundamental correction of the external imbalance will depend on a major expansion of agricultural productivity and output and the development of new lines of manufacturing products capable also of competing in growing export markets. Indeed, the authorities are in the process of finalyzing a development program which concentrates on investments designed to attain this objective. For this purpose and to support the balance of payments, Portugal will continue to require in the coming years sizable external financing in appropriate forms from international institutions and friendly countries alike.

As reported by the staff, the authorities have opted to tackle the fundamental causes of the external disequilibrium without the use of trade and exchange restrictions. It must be recognized that, considering the extreme balance of payments difficulties with which Portugal has been confronted during the last few years, its present trade and exchange systems contain today limited elements of restrictions, which the authorities have stated they intend to remove as rapidly as possible. Import procedures are being simplified and the import surcharges are being phased out. Consequently, the word "dismantling" used repeatedly in the staff report to characterize the action that is desired in this sector seems to overstate the degree of restrictiveness of Portugal's trade and payments arrangements as they stand today.

Mr. Samuel-Lajeunesse expressed his support for Portugal's request for a stand-by arrangement. He agreed with both Mr. Dini and the staff that it would not be reasonable to expect Portugal to eliminate rapidly its substantial balance of payments deficit; time was needed for the country to adjust to the many important changes that had affected its internal, political and social structure and its external relations.

Coming after the 1977 stabilization program, which had brought some progress, Mr. Samuel-Lajeunesse said, he hoped that the current economic program would bring about the needed increase in confidence. In the future, he would willingly support further arrangements to help Portugal tackle more directly the main structural weaknesses in its economy. In that context, he wondered why the present stand-by request was limited to the second credit tranche and whether the rationale for such a limitation was linked to the degree of conditionality involved. He would welcome some general clarification on the criteria used to decide on the size of stand-by arrangements in the different upper credit tranches.

During 1977, Mr. Samuel-Lajeunesse observed, GDP had grown, and the economic indicators for productivity, manufacturing output, and capital expenditures had all evolved quite satisfactorily. However, the rate of inflation and the balance of payments deficit had remained at disturbing levels, a situation that was difficult to understand. On the one hand, wages policy had been successful, as had fiscal policy up to a point; although it needed to be remembered that the financing of the deficit had been met too largely through the banking system. On the other hand, monetary developments had, overall, been unsatisfactory. The public had not recovered confidence in the financial system, and negative anticipation had led to a stockpiling of domestic and imported consumer goods.

While agreeing with the staff that adjustments of the exchange rate were needed to restore external competitiveness, Mr. Samuel-Lajeunesse remarked that the negative effects of those adjustments had been numerous. They included, for instance, the disappointing gap between increases in the volume of tourist activity and in the value of the receipts stemming from it, a gap that was only partially explained by the tightness of controls on hotel prices. Depreciations of the escudo could also be blamed in part for the high inflation rate and for the persistent anticipation of further adjustments, which had led to the stockpiling of imports and the outflow of short-term capital. Moreover, given the pattern of Portuguese exports, the benefits to be drawn from the currency depreciation were not very large.

He would be interested in the opinion of the staff and of Mr. Dini on the policy of the "crawling peg," Mr. Samuel-Lajeunesse said. His own view was that such a policy could perpetuate negative anticipations and that it might be better to adjust the exchange rate once and for all. Could the staff document more thoroughly its idea that further adjustments of the exchange rate were needed to improve competitiveness beyond 1973 levels? Would it not be better to regain competitiveness through productivity efforts rather than through risky exchange rate policies? Finally on exchange system matters, the Portuguese authorities' intention to dismantle gradually the external restrictions that had been introduced in recent years was extremely welcome.

The new program adopted by the Portuguese authorities was appropriate and courageous, Mr. Samuel-Lajeunesse stated. The major emphasis on credit restraint in the program was proper and adequate, since it was undoubtedly in that area that developments had proved unsatisfactory in 1977. He welcomed the measures taken by the authorities to increase their ability to control domestic credit developments such as the introduction of an interbank money market and of a uniform reserve requirement and the gradual reduction in the rediscount quotas. As to interest rates, he wondered whether the Portuguese authorities had considered the possibility of introducing variable rates; such a technique might be useful in a context where there was resistence to a necessary raising of interest rates. He noted the willingness of the the authorities to make the credit ceilings for banks mandatory should the need arise. The wages policy was particularly courageous since it could well bring about a further decline by 4-5 per cent of real wages in a country that was already relatively poor. Incidentally, he asked the staff how the 30 per cent rise in the minimum wage and the planned legal limitation of 20 per cent for wage increases were related. Had there been a tapering of wage increases from 30 per cent to 20 per cent, or were the two measures independent and cumulative?

In conclusion, Mr. Samuel-Lajeunesse remarked that, although 1977 had not brought the hoped for restoration of financial equilibrium, definite progress had been made in improving the fiscal situation and in controlling the evolution of wages.

Mr. Pieske commented that the present discussion crowned a long and difficult negotiating effort. He congratulated the Portuguese authorities for their courageous and ambitious adjustment efforts and the staff for its patience and perseverance in often trying and difficult conditions. Portugal provided a remarkable case study of some aspects of conditionality currently under discussion in the Executive Board. The German Government had taken a strong interest in developments in Portugal and had provided assistance to the country in order to help it maintain political and economic stability. The German authorities had been aware of the political risks that the Portuguese Government ran in working toward stabilization and austerity, but had been equally convinced that a return to economic stability was a necessary precondition to the ultimate, political success of the new regime. He therefore supported the staff in its efforts to obtain the necessary commitments for the adoption of appropriate national policies.

In spite of external difficulties, 1977 had not been an unsuccessful year for Portugal, Mr. Pieske observed. In fact, some of the country's achievements had been remarkable. For example, GDP had grown by 6 per cent for the second consecutive year; manufacturing output had expanded strongly; productivity had increased (with the consequence that unit labor costs had risen more slowly in Portugal than in competitor countries); external receipts from workers' remittances and tourism had increased; and a commendable start had been made in dismantling external restrictions. He was puzzled, however, by the fact that in spite of the considerable GDP growth rate, and of the fact that the public and external sectors taken together had released resources to the other sectors in the amount of some 3 per cent of GDP, real wages in manufacturing had declined by 7 per cent. Logically there must have been a considerable increase in the share of nonwage earners in the national income. More specifically, GDP was 9 per cent higher in 1977 than it had been in

1973; real wages, however, were 13 per cent higher. If real wages were to decline a further 4 to 5 per cent in 1978, the share of wages in GDP would return to about 1973 levels. It might well have been necessary to redress the share of wages, which had run ahead of what was economically justifiable in 1974 and 1975, but the continuing reduction of real wages did not give grounds for satisfaction. It was essential that nominal wage and price increases should be kept in check, but it was also essential to improve the functioning of the economy so that both output and real wages could grow.

The economic policies adopted in 1977 and the new program embodied in the present Letter of Intent, Mr. Pieske commented, were welcome as short-term stabilization measures. He was encouraged by the staff's assessment that the planned measures would improve the viability of the balance of payments and would begin to deal with some structural problems. Clearly a more fundamental approach was needed, and he was gratified at the Government's intention to start implementing, during 1978, a medium-term strategy for industry and agriculture, even though it would probably require external assistance. Any such strategy should aim in particular at a sustained improvement in Portugal's balance of trade. There was need and scope for more import substitution in the food sector, where imports were three times as high as exports. For example, whereas fish had traditionally been one of Portugal's exports, the country was at present a net importer of fish. Export diversification was also essential. It could not be denied that Portugal's textile exports were being harmed by protective barriers, but even without such barriers, the textile market would remain a difficult one in which developing countries would increasingly compete. It would be prudent for Portugal to reduce the high share of textiles and shoes in its exports.

It would be desirable for the level of interest rates in Portugal to stay ahead of inflation, Mr. Pieske remarked, not only to encourage a rational distribution of resources and an increase in savings but also to increase capital inflows and reduce capital outflows. In conclusion, he commended the Portuguese authorities for their stabilization efforts, in particular for their most recent program, which had been formulated and implemented against considerable domestic opposition. He agreed with the staff that the program was beset with a number of risks, and he welcomed, therefore, the agreement to review developments in January 1979. He urged the Portuguese authorities to persevere with their efforts, not only because greater domestic and external stability was a prime need, but also because success in external borrowing would require visible progress in the reduction of the current account deficit. He fully supported the proposed decision.

Mr. Kafka expressed support for the Portuguese request for a stand-by arrangement. Portugal was obviously facing a tremendously difficult situation with great courage. Fortunately, the country was able to count on relatively generous assistance from a variety of countries, notably including Venezuela.

The staff had mentioned repeatedly the difficulties created for Portugal by protectionism in its partner countries, Mr. Kafka recalled. Many of those countries appeared to prefer to lend rather than to import, or to impose indebtedness upon a country rather than to let it earn its own way. The situation was particularly serious in the case of a small country like Portugal, where the failure of traditional industries to find export markets was bound to lead to unemployment. Indeed, the policy imposed upon Portugal by some of its partners constituted a net loss for the country. It would have been interesting to have a table giving quantitative estimates of the impact of protectionism on Portugal.

The statistical information in the staff papers contained a number of lacunae. For instance, there were no tables on the structure of trade, and no details on items in the balance of payments such as gross capital flows. As to matters of policy, there were a number of points to be stressed. First, the reduction by one third in the current deficit in the program period ending March 1979 was the same as that envisaged in an earlier stand-by, but starting from a higher base. The reduction seemed appropriate, but it would probably not have been any larger if Portugal had been given a three-year extended Fund facility. In some other cases, as a condition for a one-year stand-by, the staff had insisted on a much larger first-year reduction in the current account deficit, even where the financing of the deficit for the future was no less uncertain than in the case of Portugal. It was precisely to avoid such a lack of coordination that systematic monitoring of Fund policies could be useful. It would be interesting in that connection if the staff could furnish estimates of a viable current account deficit for Portugal over the coming three or four years.

The staff believed that in Portugal expenditure needed to be shifted rather more than reduced, Mr. Kafka noted. The question of the option between expenditure switching and expenditure reduction was not mainly a technical one; it was really a matter of choice between more unemployment on the one hand and more inflation or perhaps only more income redistribution, on the other. If it was a question of the social welfare function rather than a technical question, he wondered whether the staff should comment upon it at all. Comment could prove destabilizing if it became known to the market, as it could suggest the possibility of an eventually larger devaluation in line with the staff's preference. He was concerned that the paper spoke with such frankness of the proposed rate of devaluation, and he wondered whether such information could not have been outlined orally. Finally, was it necessary for Portugal to have accepted so many performance clauses? For example, the authorities had done remarkably well with the budget, and the establishment of separate ceilings for the budget and for government borrowing seemed unnecessary.

Mr. Drabble said that he had been struck by the combination of adverse factors that had affected Portugal. In addition to the universal problems of rising energy costs and world recession, Portugal had had to face dramatic political changes, a sharp shift in social objectives, and the disruptive effects of a sudden break with the former colonies. Those factors had made adjustment more difficult and more prolonged than could otherwise have been expected. In such difficult circumstances, accepting a one-year stand-by was probably the best course of action; too much could not be expected of the country too rapidly.

Portugal had been forced to make many difficult short-term decisions to meet short-term crises, Mr. Drabble said. The Government would, however, have to develop, as soon as possible, a coherent program to deal with the serious structural problems, such as the need to improve both the agricultural and industrial sectors. Like Mr. Samuel-Lajeunesse, he would be happy to consider a request for a longer stand-by as soon as the authorities were able to present a medium-term strategy.

The present program seemed to have taken into account the areas of weakness that had become apparent in 1977, Mr. Drabble observed. In the 1977 program, problems had followed the combination of weak monetary and credit policies with the reluctance of the authorities to adjust the exchange rate quickly enough. The balance was difficult to strike; the authorities had shown prudence of late in accepting the need for further and more appreciable adjustments, both in the recent one-step depreciation and in the prospective rate of depreciation for the months ahead. Caution would, however, be needed in devaluing the currency, given Portugal's present political and social problems. For example, care should be taken to avoid intensifying the difficulties of developing a satisfactory incomes policy. On the monetary side the authorities needed to take some further action on credit policies and interest rates. Without higher interest rates it would be difficult to deal with problems such as speculative stockbuilding--which had contributed to the pressure on imports--and the continued capital outflows. It was gratifying to note that the Portuguese authorities had raised interest rates and intended to keep the matter under review.

In a rather dramatic way, Portugal illustrated a problem that had faced the policymakers of many countries, Mr. Drabble commented. For many years Portugal had experienced a low rate of price increase; in consequence, the people were accustomed to low rates of interest. The question that arose in such situations was how general public acceptance of higher interest rates could be gained. In the Portuguese case there was perhaps a cultural lag rather than any real fear that rates of interest close to the rate of inflation would do serious damage. The authorities appeared to be concerned that higher interest rates would place constraints on the private sector. However, some constraints would be advantageous; they would, for example, remove the temptation to speculate in commodities.

It was not always realized by governments, Mr. Drabble continued, that extension of public control over wider areas of the economy meant that more of the savings needed to generate investment had to come from the public sector. The Portuguese authorities had been wise in making moves to set more realistic prices for the products of a number of public sector industries. Could the staff give any further details of the savings made in public enterprises? In conclusion, he approved the request for a stand-by arrangement and wished the authorities success in the development of a medium-term strategy that would bring Portugal's economy back to a path of sound expansion.

Mr. Schneider welcomed the successful conclusion of the negotiations with the Portuguese authorities and stated his support for the one-year stand-by arrangement. After many years on the sidelines of the international financial community, Portugal, since 1974, had been exposed to a number of major shocks in the political and economic fields. While the Portuguese people were struggling for a new political identity, the economy had had to cope with a number of difficulties going beyond those experienced by other countries. After the revolution, the newly emerging democratic Government had been overwhelmed with popular expectations that could not be satisfied in the prevailing world economic situation. In recent months the Portuguese authorities had apparently succeeded in convincing the people that tough measures were needed to restore external and internal equilibria. Taking into account the precarious political situation, what had already been achieved should not be underestimated. However, much more needed to be done to re-establish equilibrium; the intention of the Portuguese authorities to set up a medium-term program to deal with structural difficulties was therefore welcome. The program outlined in the paper was courageous and ambitious, but only a step in the right direction. Further measures would have to follow, and it would take some time before major changes could be brought about.

Mr. Kent said he had followed with concern as well as sympathy the long and difficult discussions both within Portugal itself and between the country and the Fund. He commended the staff for its patience and expressed his support for the proposed stand-by arrangement. A one-year stand-by arrangement seemed appropriate, given the difficulties of predicting the changes that would take place during the period. Once the results of the arrangement were clear, a program for a second and third year could be elaborated. The most difficult work of changing trends and directions would have to take place in the first year, and it was the timing, and the way in which various factors would interact, that made predictions so difficult.

He agreed with the previous speakers that, ultimately, a medium-term strategy would be necessary, Mr. Kent remarked. More immediately, efforts should be made to strengthen monetary policy, which had proved to be a major weakness in economic management in 1977. It was essential that Portugal's credit standing should improve so that it could borrow more, since it was unlikely that the balance of payments gap could be closed very rapidly. The Portuguese situation proved that the Fund could not adopt a universal prescription for economic problems in every country. Portugal had found it extremely difficult to accept the Fund's conditionality because to do so would require imposing further sacrifices on a population that had already sacrificed much. It was to be hoped--rather optimistically, perhaps, in view of the pattern of exports and invisible earnings--that the progress made under the present program would build up a certain momentum toward greater economic strength.

Obviously, protectionist barriers were a problem, Mr. Kent commented; but, even if they were removed, the competition in the export markets in which Portugal was involved was intense and growing. Incidentally, the most effective way of reducing the effects of protectionism could well be through concerted action to increase world trade, rather than through extended campaigns to remove restrictions.

Mr. Cross indicated his support for the requested stand-by arrangement and welcomed the stabilization program being implemented by the Portuguese authorities. The adjustments required to return the economy to internal and external equilibrium were substantial and could not be easily or rapidly achieved. Obviously, much needed to be done, and the proposed program only represented the next move in the adjustment process. The year ahead would, nevertheless, be crucially important, with a clear need to reverse the deterioration in the current account and bring credit expansion under greater control. The costs in terms of a marked slowdown in real growth and continued high unemployment in 1978 would be significant.

He understood the political factors which precluded an increase in interest rates to a positive level, Mr. Cross said, but, as conditions permitted, he hoped that the Portuguese authorities would raise interest rates to a level that would permit credit and savings to be allotted on a more effective basis. He welcomed the reforms that would give the authorities greater influence over monetary developments. Finally, he hoped that Portugal would adhere closely to the program outlined in the Letter of Intent. In doing so progress would be made toward economic recovery, and toward the establishment of external confidence that would bring greater access to foreign credits. He was confident that the implementation of the program would permit continued Fund assistance, perhaps under the extended Fund facility, or the supplementary financing facility.

Mr. Hollensen supported Portugal's request for a stand-by arrangement. The Portuguese authorities deserved commendation for the courageous steps they had taken toward a fundamental adjustment of their economy. Clearly, they wanted to lay the foundations for long-term structural economic reconstruction and development.

Portugal had been affected adversely not only by world economic problems, Mr. Hollensen remarked, but also by the need to absorb large numbers of people returning from former colonies. In view of the grave problems facing the economy, the proposed stand-by arrangement appeared rather modest; however, the Portuguese authorities were not yet in a position to lay down a detailed long-term program. Large amounts of money were expected to be made available to Portugal through bilateral agreements with other countries, shortly after the approval of the present stand-by. More financial support from the Fund would certainly be required later. It was to be hoped that at that time Portugal would be able to achieve the necessary domestic and external equilibrium.

The adjustment measures in the present program, Mr. Hollensen said, would not be easy to carry out. The authorities had chosen to place emphasis on domestic credit restraint. He was rather concerned that perhaps they had placed too great a burden on credit policy. Admittedly, Portugal had traditionally enjoyed low interest levels and perhaps, as Mr. Drabble had said, there was a cultural lag. However, monetary policy was sometimes overburdened for the reason that it was an area little comprehended by the general public and the authorities could, for a certain time, hide its effects. There were dangers inherent in such tactics. Placing more emphasis on interest rates and exchange rate policy might have given more room for real domestic expansion and less credit restraint, but such a course of action had apparently been politically unacceptable. In conclusion, he hoped that the program decided on by the authorities could be implemented without too much strain on the domestic situation.

Mr. Ruding commended both the Portuguese authorities and the Fund staff for the outcome of the long and difficult negotiations that had resulted in the present request for a stand-by arrangment, which he fully supported. Portugal provided a unique case study of the Fund's conditionality policies.

The one-year program proposed by the authorities was ambitious and courageous, but it was inevitably insufficient to overcome the enormous problems facing the country, Mr. Ruding said. The program certainly provided an appropriate basis for a drawing under the Fund's second credit tranche and for the unlocking of bilateral credits. Those credits would be used to support the balance of payments, and their long maturity would improve the country's debt profile. None of the loans would, in the next year, contribute toward reducing the ever worsening debt service ratio.

Like previous speakers, Mr. Ruding said, he felt that a medium-term program was necessary and he was gratified to see that the Portuguese authorities had taken steps in that direction. When an appropriate program was presented to the Executive Board he would, in principle, be ready to support the granting of an extended Fund facility. Because of the structural factors involved, the extended Fund facility would seem to be better tailored to the country's needs than would a longer stand-by arrangement. Noting that the present stand-by arrangement was limited to the second credit tranche, he asked the staff, in connection with the general discussion on conditionality, whether drawings under the third and fourth tranches would have been accompanied by any stricter conditionality.

The staff had correctly mentioned that the program put heavy emphasis on domestic credit restraint, Mr. Ruding observed. Obviously, there were political restraints to be borne in mind, but he wondered whether the proposal to raise nominal interest rates by 5 per cent would be enough to reverse the outflow of funds. Did the staff consider the interest rate question to be a weak point in the country's program? The argument advanced by Mr. Kafka that Portuguese exports had been harmed by the barriers raised in a number of countries that were currently providing balance of payments assistance was certainly thought provoking. He would ensure that the point was made known to his own authorities.

With regard to exports, Mr. Ruding continued, Portugal was not only affected by cyclical problems but also by structural problems in the sense that lost export markets in former colonies would not be recovered. It was to be hoped that the Portuguese export performance would improve, but the difficulties in the way of success were enormous. The restrictions that the Portuguese authorities had placed on access to their economy were to some extent understandable. The staff had emphasized the need to dismantle those restrictions, but perhaps Mr. Dini was right in saying that too much pressure should not be applied in that direction. The Portuguese authorities were rightly committed to establishing a more open economy, and the matter should certainly be stressed in the medium if not in the short term.

Mr. Mayobre expressed his support for the proposed stand-by arrangement. Portugal's economic program, which obviously drew on the experience of past years, was courageous and ambitious, without being overambitious. Tax and incomes policies were well balanced; allowance had been made for a small but reasonable growth rate; and adequate emphasis had been given to monetary policies. As Mr. Drabble had remarked, the country's difficulties had arisen from a unique combination of events. However, in his view, two of those events--democratization and decolonization--were to be welcomed, in spite of the economic problems they might have caused.

As to the problems connected with protectionism, Mr. Mayobre said that he shared the views expressed by Mr. Kafka. It was encouraging to note the support given to Portugal by the international community. Venezuela, for example, had made an unconditional contribution as a token of its appreciation of the efforts and policies of the Portuguese authorities. Finally, he asked the staff whether the impact of the trade liberalization on the balance of payments had been quantified or assessed, and to what extent those measures would offset some of the other policies that were to be undertaken.

Mr. Masunaga congratulated the Portuguese authorities and the staff for the successful completion of their long and difficult negotiations; he supported the resulting request for a stand-by arrangement. The Portuguese authorities were facing many problems, of both a structural and a short-term nature. The measures contained in the Portuguese program as well as those that the authorities had already taken would be essential as the first step in the stabilization effort required for the re-establishment of confidence in the management of the economy.

It might be true, as Mr. Hollensen had remarked, that the program put great emphasis on monetary policy, but that was inevitable in view of the program's rather short-term objectives. In conjunction with several other countries Japan had extended balance of payments assistance to Portugal in 1977, and he would be interested to see how well the Portuguese authorities could adhere to the program set out in the stand-by arrangement. The arrangement was, of course, only a first step, since even after its completion a substantial balance of payments deficit would still remain. Portugal's situation was extremely difficult. A great effort was needed to re-establish and especially to restructure the economy; achieving those objectives would be as important as achieving the shortterm objectives contained in the program. Finally, he wondered how valuable Fund assistance could be, particularly in the form of the extended Fund facility and drawings in the higher credit tranches.

Mr. Caranicas mentioned that the Portuguese experience could well be used as a case study for the Executive Board's current discussions on conditionality. He warmly supported the request for a stand-by arrangement; both the staff and the Portuguese authorities should be commended for their patience and flexibility that had led to its successful conclusion.

It was clear, Mr. Caranicas said, that many countries sought a stand-by agreement with the Fund because they considered it as a green light for further accommodations with the commercial banks and the international market in general. The Portuguese authorities had certainly been motivated by such a consideration, as the staff had pointed out on page 10 of EBS/78/228, Supplement 1 and as Mr. Constancio, the Portuguese Minister of Finance, had acknowledged on Portuguese television on May 22. A major purpose of the stand-by arrangement was, therefore, to reassure commercial banks and other potential lenders, whose assistance was contingent on an upper credit tranche stand-by, that Portugal was following the right policies.

On the external side, Mr. Caranicas said, he agreed with Mr. Dini that the staff had overstated the degree of restrictiveness of Portugal's trade and payments arrangements. Certainly, it seemed impossible to "dismantle" completely those restrictions in the foreseeable future. Mr. Kafka had made an interesting observation on protectionism when he had said that what some countries had given to Portugal with one hand they had taken away with the other. It was unquestionable that most developing countries would prefer trade to aid.

Portugal's economic problems could not be solved by restrictive demand management measures alone, Mr. Caranicas argued. The nature of the country's structural difficulties demonstrated that there were many elements outside the Portuguese authorities' control; at least for the time being, Portugal would be compelled to rely extensively on external financing in the form of international credits.

Finally, referring to the preliminary negotiations between Portugal and the European Communities, Mr. Caranicas wondered whether the political benefits of joining the Communities might not be offset by an aggravation of Portugal's economic difficulties; EEC regulations could have harmful effects on the present state of the Portuguese economy. That fear had been expressed in a recent article in The Economist which had been aptly titled "Come In, Portugal, and Welcome to Trouble."

Mr. Kharmawan maintained that the conditionality accepted by Portugal was no harsher than that already accepted by a number of other countries. Indeed, the conditionality agreed with some developing countries had gone well beyond that outlined in the Portuguese arrangement. It was, therefore, difficult to understand why the arrangement had generated so much outside comment. Obviously the conditions seemed hard to a country still recovering from major social and political changes; perhaps the Portuguese authorities could console themselves by the example of the Netherlands, which had not suffered lasting economic damage as a result of granting sovereignty to Indonesia. In fact, losing colonies often meant liberation from an economic burden.

The authorities had been wise to limit their arrangement to one year, Mr. Kharmawan observed. Many countries, including notably Indonesia, had come to the Fund for three or four consecutive years to ask for assistance, and had gradually been able to turn their economies around. The Portuguese authorities should not feel inhibited in taking such an approach; it should be clearly acknowledged that serious imbalances could not be reversed in one year.

Why was the staff so concerned that the shift from demand to time deposits could lead to greater liquidity, Mr. Kharmawan inquired. Even if the shift was accompanied by an increase in liquidity in the banks, such an increase could well be controlled by the credit restrictions and the lending rate measures that figured in the authorities' overall program. In his view, shifts from demand to time deposits should be welcome. He also wondered why the staff had specified the dismantling of certain trade and payments restrictions as a performance criterion. Would it not have been more appropriate in the Portuguese case to have considered "dismantling" as a general objective rather than as a specific performance criterion? He would appreciate staff comments on the nature of the bilateral credits that would be paid to Portugal. Would they be used for project aid or uniquely as balance of payments aid? What had happened to the counterpart funds?

Mr. Nana-Sinkam stated his support for the proposed stand-by arrangement. He wondered whether the Portuguese situation could not have been accommodated better by an extended Fund facility than by a one-year stand-by program. The country's problems were mainly structural, and attempts to solve them by short-term solutions might prove more damaging to the country than attempts to solve them by a medium-term or long-term approach. Unfortunately, any drastic measures taken to solve Portugal's problems might well have a detrimental impact on the economies of its former colonies. Those countries had provided markets for Portuguese exports, a fact that went far to explain Portugal's present difficulties in establishing a wider export market. It should also be remembered, however, that the production system in the former colonies had been tailored in reciprocal fashion to serve the market of the mother country. Any deterioration in the economic situation of Portugal, therefore, would be strongly felt in those countries, which themselves had yet to establish new markets for their exports. The staff should perhaps have tried to assess in financial terms the outcome of trade liberalization for Portugal. In conclusion, he welcomed the fact that, because of the political situation in Portugal and the need to avoid jeopardizing social measures and changes that were under way, the Fund had been realistic enough not to recommend any conditionality extending beyond that associated with the second credit tranche.

The staff representative from the European Department explained, in reply to Mr. Samuel-Lajeunesse, that the 20 per cent objective referred to contractual wages and not to wages in general, which might conceivably rise by more or less than that figure. The 30 per cent minimum wage applied to relatively few workers, and even though the objective for the increase in contractual wages was 20 per cent, there was legislation on the books that would permit individual firms in financial distress to suspend labor contracts. In short, the two figures referred to different areas of the labor market, and the end result was difficult to estimate with any degree of confidence. The share of wages in total income was about the same as in 1973, as Mr. Pieske had calculated. At present the distribution of income per se was less of a problem than the disposition of what could be called the economic surplus. More attention was required in that area because it would be undesirable for the surplus to be taken up in speculation or capital flight.

On the fiscal side, the staff representative indicated, there had been considerable achievements during 1977 in reducing both the public sector current account deficit and the overall deficit. It was a major objective of the authorities that such reductions should continue. There were problems with the generation of surpluses in public sector enterprises not included under the public sector budget. The authorities were conscious of the problems and had, among other actions, recently increased the prices charged by public sector enterprises, with a view to reducing the need for government subsidies. More generally, the authorities were planning to reduce subsidies to the point where some modification in wages policy might become necessary in one or more of the public sector enterprises.

Many Executive Directors had correctly observed that the main emphasis of the program concerned monetary policy, the staff representative stated. Many problems remained. For example, it was difficult to know precisely the final figures for domestic credit expansion at the end of March 1978. The authorities were addressing the problem and were determined to solve it at an early stage in the course of the stand-by period. The introduction of variable interest rates would seem to require more of an upset to the existing arrangements than would be worthwhile in present circumstances. The issue was, however, under continuing study by the authorities. The shift toward time deposits and the resulting creation of excess liquidity in the banking system had proved a problem in 1977 when, in fact, credit restraint had been ineffective. The increase in the liquidity of the banking system had contributed to the expansion of domestic credit beyond the ceiling. That particular side effect had been eliminated by the introduction of an across-the-board 7 per cent reserve requirement.

Replying to speakers who had inquired whether interest rates were high enough in relation to the rate of inflation, the staff representative explained that the GDP deflator was expected to rise by 25 per cent, slightly less than in 1977; that the rediscount rate was 23 per cent; and that the time deposit rate was 19 per cent. Certainly, interest rates were rather low, but they could well be adequate, particularly if prices slowed down more than had been indicated, as was possible. Positive interest rates could be attained not only by raising nominal interest rates but also by having prices slow down somewhat over the program period.

The staff's candor on exchange rate questions, the staff representative said, was no greater than that of the Portuguese authorities themselves. On a number of occasions, their candor had, in fact, taken the staff by surprise. They seemed to feel that, on such a sensitive subject, "candor was the better part of valor" and that the market should not be left with a degree of uncertainty, which could be harmful if the exchange rate continued sliding without any clear objective being stated. The Portuguese authorities were quite clear in their own minds that any one-time devaluation would do more damage to the economy than a sliding or crawling peg devaluation. The staff had no objection to their approach as long as, for example, interest rate policy was adapted accordingly.

Some Executive Directors, the staff representative recalled, would have preferred it if the staff had not expressed its preference between relatively more expenditure switching and relatively more expenditure reduction. In fact, the staff accepted the Portuguese authorities' judgment on that matter, which was one that went beyond technical judgments or social policy judgments. There were several ways of attaining specific objectives, and the staff had felt that, whatever its own predilections, as long as the program was adequate for the task, the exact policy mix had to be decided by the Portuguese authorities.

Perhaps the staff had overstated the issue of restrictions in Portugal by speaking of "dismantling," the staff representative acknowledged. In its paper the staff had intended to convey the degree to which the Portuguese authorities, despite their difficulties, were determined to reduce what might be regarded as a relatively moderate degree of restrictiveness. They were determined to reduce restrictions not so much for ideological as for functional reasons; quite simply, the system of restrictions in force had done very little to reduce imports and had, apparently, become a source of income to those who administered it. Moreover, the increased costs of imports that the restrictions had caused had increased costs for a variety of other productive activities, including exports. In the conditions of 1977, it was less easy for exporters to pass on the increased costs than for those selling in the domestic market. The restrictions, therefore, posed an additional difficulty for exports, and the Portuguese authorities were anxious to reduce them as soon as possible.

The Portuguese authorities had requested a one-year stand-by for reasons mentioned during the discussion, the staff representative indicated. Above all, the authorities were not at present in a position to formulate a longer term program. The stand-by had been restricted to one credit tranche, because the Fund wanted to husband its resources. It should not be forgotten that the stand-by acted as a trigger to release a large portion of the so-called "Paris credits," adding up to a total of US$750 million. As Mr. Mayobre had quite correctly pointed out, not all those credits were contingent on the Fund stand-by; but, a very large proportion was. By saving its own resources, the Fund would be in a position to contribute to financing future deficits of the Portuguese balance of payments. Certainly, Fund help would be required beyond the present stand-by arrangement; it was gratifying to hear some Executive Directors say that they would be prepared to give favorable consideration to further stand-by requests.

The Director of the Exchange and Trade Relations Department, referring to the seemingly paradoxical position in which some countries gave aid to Portugal, while at the same time placing restrictions on the country's exports, explained that Portuguese exports were structurally difficult for many countries to absorb without adequate adjustment assistance to their own industries. It was true that nearly all those countries that restricted imports of Portuguese textiles had higher per capita income figures than Portugal. However, they also had considerable unemployment, especially in the textile industry, which was difficult to eradicate. In certain economies thoughtful and careful consideration would have to be given to the whole problem of adjustment in those industries, which would gradually have to be phased out. The subject was at present under intense negotiation in the GATT.

Mr. Dini stated that Portugal was well aware that a major adjustment effort was required in the short run to reduce the balance of payments deficit to more manageable proportions. The financial program supported by the requested stand-by arrangement was a long step along the path of adjustment. The Portuguese authorities valued the assistance of the Fund; they were in the process of developing a medium-term strategy to correct the more fundamental causes of the imbalances existing in the economy, and they were likely to return to the Fund for a more extended use of Fund resources in the near future. In his view, the present policy mix was well balanced and adequate for the circumstances; it did not place undue weight on a single policy instrument. The authorities were pursuing not only stringent wage, fiscal, and credit policies, but also a flexible exchange rate policy designed to keep the exchange rate in line with domestic cost-price developments in order to maintain competitiveness, which had been restored to a comfortable level.

While interest rates had lagged behind inflation in the past, the Portuguese authorities had increased them by as much as 10 percentage points since August 1977, Mr. Dini recalled, although interest rate policy continued to be a sensitive issue. Interest rates well above 20 per cent were regarded as even more disturbing in Portugal than similar rates of inflation; it was feared, for example, that they might bring about the collapse of the construction sector, which had supported economic activity in the recent period.

It was correct, Mr. Dini said, that the loss of nonmetropolitan territories in Africa had had adverse effects on the economy, but that was mainly because decolonization had come at a time when major changes were taking place within Portugal itself. The domestic changes had been far more important for the economy than the loss of assured export outlets to the former territories. Regarding the trade and payments system, he was satisfied that it had been recognized that its degree of restrictiveness was rather modest, and that the language used in the staff report had tended to overstate the present situation.

Mr. Samuel-Lajeunesse expressed a feeling of uneasiness that Fund assistance should be linked to outside assistance. The two issues were clearly separate.

The staff representative from the European Department, in reply to questions from Mr. Kharmawan, explained that the performance criteria, in specifying the dismantling of trade and payments restrictions, reflected a desire to reinforce the commitment of the Portuguese authorities to correct the balance of payments through methods that would promote export performance, rather than through restrictive methods, which, at best, would provide only temporary solutions. The Portuguese authorities had raised no objections to it. With regard to the "Paris credits," none of the resources would be used for project aid; they were all earmarked for medium-term balance of payments assistance. Most of the funds would be disbursed to the Bank of Portugal and would not give rise to any counterpart funds. The immediate effect would be an increase in the Bank of Portugal's foreign assets and, of course, in its foreign liabilities.

Finally, the staff representative proposed a number of textual amendments to the stand-by arrangement annexed to EBS/78/228, Supplement 1 (5/23/78). First, the words "of letter" should be deleted from the third line of paragraph 3. Second, the date June 5 should be added to the first line of paragraph 4. Third, in paragraph 8(c) the final four words of the second line--"at the time of"--should be deleted; in the third line the first two words--"the repurchase"--should be deleted.

The Executive Board accepted the proposed amendments, and approved the following decision:

1. The Portuguese authorities have requested a stand-by arrangement for one year from June 5, 1978 and for the equivalent of SDR 57.35 million. The Fund approves the stand-by arrangement annexed to EBS/78/228, Supplement 2 (6/6/78), and grants any necessary waiver of the conditions of Article V, Section 3(b)(iii), of the Articles of Agreement.

2. The Fund approves the retention by Portugal of the remaining restrictions on payments and transfers for current international transactions as described in EBS/77/100 and EBS/78/228, Supplement 1, until January 31, 1979.

Decision No. 5795-(78/81), adopted
June 5, 1978

3. CONDITIONALITY IN UPPER CREDIT TRANCHES

The Executive Directors continued from the previous meeting (EBM/78/80, 6/2/78), their review of a staff paper on conditionality in the use of the Fund's resources in the upper credit tranches (SM/78/103, 4/19/78; Cor. 1, 4/21/78; and Sup. 1, 6/1/78).

Mr. Matsunaga stated that conditionality was undoubtedly the most important feature of the Fund's assistance to member countries. Without conditionality there would be no need for the Fund's financial assistance, which could be taken over by the private banking system. What could be debated was the extent and nature of the conditionality that the Fund should seek to attach to its assistance.

Conditionality should be tailored to the economic and financial problems of the country requesting assistance, Mr. Matsunaga continued; the more serious the problems, inevitably the more severe the conditionality should be. In the past few years, there had been numerous complaints from persons outside the Fund that the Fund's conditionality was too harsh. It should be remembered, however, that in recent years many countries had suffered particularly severe imbalances in their economies, and that major steps had been required to enable them to effect necessary adjustment; conditionality had been correspondingly strict.

One reason for the increasingly strict conditionality, Mr. Matsunaga maintained, was that countries had been too late in adopting corrective measures. Conditionality could have been less strict if recourse to the Fund had been made earlier. Coming to the Fund early could lessen any friction or conflict. Weakening conditionality at a later stage would only worsen or prolong a country's problems. One occasion on which a member country could be encouraged to make early use of the Fund's resources would be at the time of the discussion between the member and

Portugal 1760

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NO. 10

PRIMO. EXECUTIVE BOARD TOOK FOLLOWING DECISION ON JUNE 5, 1978:

QUOTE

1. THE PORTUGUESE AUTHORITIES HAVE REQUESTED A STAND-BY ARRANGEMENT FOR ONE YEAR FROM JUNE 5, 1978 AND FOR THE EQUIVALENT OF SDR 57.35 MILLION. THE FUND APPROVES THE STAND-BY ARRANGEMENT SET FORTH IN EBS/78/228, SUPPLEMENT 1, AND GRANTS ANY NECESSARY WAIVER OF THE CONDITIONS OF ARTICLE V, SECTION 3(B)(III), OF THE ARTICLES OF AGREEMENT.

2. THE FUND APPROVES THE RETENTION BY PORTUGAL OF THE REMAINING RESTRICTIONS ON PAYMENTS AND TRANSFERS FOR CURRENT INTERNATIONAL TRANSACTIONS AS DESCRIBED IN EBS/77/100 AND EBS/78/228, SUPPLEMENT 1, UNTIL JANUARY 31, 1978.

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FOR
AGENDA

EBS/78/228
Supplement 1

CONFIDENTIAL

May 23, 1978

To: Members of the Executive Board

From: The Secretary

Subject: Portugal - Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is a staff report on Portugal's request for a stand-by arrangement equivalent to SDR 57.35 million. The draft decision appears on page 20.

This subject has been tentatively scheduled for discussion on Monday, June 5, 1978.

Att: (1)

INTERNATIONAL MONETARY FUND

Portugal--Request for Stand-By Arrangement

Prepared by the European and Exchange
and Trade Relations Departments

(In consultation with the Legal, Research,
and Treasurer's Departments)

Approved by A. Pfeifer and Donald K. Palmer

May 19, 1978

In a letter dated May 8, 1978 to the Managing Director from the Minister of Finance and Planning and the Governor of the Bank of Portugal (EBS/78/228, 5/9/78 and Correction 1, 5/22/78), the Portuguese authorities have requested a stand-by arrangement for a period of one year in an amount equivalent to SDR 57.35 million. If fully purchased, this would bring the Fund's holdings of escudos to 267.8 per cent of the new quota of SDR 172 million, or 150 per cent of quota after excluding purchases under the oil and compensatory financing facilities. The stabilization program that forms the basis for this request was discussed with the Portuguese authorities in Lisbon in the period from March 29 to April 29, 1978 by a staff mission comprising Hans Schmitt (EUR), Peter Engstrom (ETR), Brian Stuart (EUR), Claire Craik (EUR), and as secretary, Kathleen Delauder (ETR).

I. Fund Relations

Portugal became a participant in the Special Drawing Rights Department on July 22, 1975. Its SDR holdings, which were acquired from the General Resources Account to pay charges in connection with the use of Fund resources, amounted to SDR 0.2 million at the end of April 1978.

Portugal's old quota was SDR 117 million. The gold tranche of SDR 29.25 million was purchased in July and December 1975 and two purchases totaling SDR 114.8 million under the 1975 oil facility were made in January and April 1976. A purchase of SDR 58.5 million, equivalent to 50 per cent of quota, was made under the compensatory financing facility in July 1976, and another of SDR 29.25 million, representing a further 25 per cent of quota, in July 1977. The Executive Board approved a stand-by arrangement in the enlarged first credit tranche (SDR 42.4 million or 36.25 per cent of Portugal's old quota of SDR 117 million) in April 1977, and the full amount was drawn in May 1977. Portugal's new quota is SDR 172 million. Of the additional subscription, 25 per cent is being paid in the currencies of other members. After the payment of the quota increase, the Fund's holdings of Portuguese escudos will amount to 116.66 per cent of the present quota excluding amounts outstanding under the oil facility and compensatory financing facility, and 234.42 per cent including these amounts.

From March 1973 to February 1977, the escudo was allowed to float, although the exchange rate was in practice set by the Bank of Portugal. During that period the effective exchange rate depreciated by 19.5 per cent. On February 25, 1977 the escudo was depreciated by 15 per cent, and pegged to a basket of currencies. Between that date and end-August 1977, the effective exchange rate was maintained at a level some 30.75 per cent below that of May 1, 1970. On August 25, 1977, the Portuguese announced that a crawling peg system was to be introduced for the escudo, to compensate for differential price developments in Portugal and its main trading partners. After an initial drop of about 4 per cent, the authorities began on September 15 to quote forward rates for the currencies of major trading partners for one, three, and six months ahead, reflecting a prospective depreciation of 1 percentage point a month. This policy remained in effect until March 1978, when the depreciation of the escudo was accelerated. Following a further step adjustment in the effective rate of 6.1 per cent in early May 1978, the authorities announced that the escudo would be allowed to depreciate at a monthly rate of about 1.25 per cent but they discontinued the practice of quoting forward rates. On May 12, 1978 the effective exchange rate was at a level some 43.3 per cent below that of May 1, 1970.

The Fund approved the multiple currency practices and restrictions on current payments and transfers that were in effect on April 25, 1977 until the time of the next Article XIV consultation. From October 1976 a 50 per cent advance import deposit for six months was required on approximately 7.5 per cent of imports; this requirement was withdrawn at the end of December 1977. An import surcharge that was introduced in May 1975 remains in effect; some 29 per cent of 1976 imports are currently subject to a 30 per cent surcharge, and 2 per cent of 1976 imports are subject to a 60 per cent surcharge. The Portuguese authorities have announced a schedule for gradually phasing out the 30 per cent import surcharge between October 1, 1978 and October 1, 1979; they have also stated their intention to phase out the 60 per cent surcharge beginning in 1979. Quantitative import quotas in value terms announced in February 1977 on items accounting for about 4 per cent of 1976 imports were raised in April 1978 to an annual rate which in foreign exchange terms is equivalent to the value of these quotas in the year to March 1978. Similar quotas on automobile parts, accounting for about 3 per cent of 1976 imports, remain fixed in escudo terms. Both are to be reviewed before the end of January 1979.

In late 1977 the process of authorizing imports was subject to some delays, partly in conjunction with the introduction of new administrative procedures. As a result, a backlog of applications has built up. However, from May 2, 1978 all applications for imports of raw materials and intermediate goods are once more authorized automatically. This automatic procedure will be extended to all other categories of imports not subject to quantitative restrictions no later than June 30, 1978.

Economic developments and policies in Portugal were reviewed in the staff paper supporting the request for a stand-by arrangement in the enlarged first credit tranche (EBS/77/100, 4/12/77) which was considered by the Executive Directors at EBM/77/61 (4/25/77). More recent developments were discussed in the staff paper supporting Portugal's request for a second purchase under the compensatory financing facility (EBS/77/264, 7/19/77 and Sup. 1), which was considered by the Executive Directors at EBM/77/112 (7/27/77), and in the staff paper on Portugal's exchange system (EBS/77/332, 9/2/77). The most recent Article XIV consultation discussions with Portugal took place in June 1976; the Staff Report (SM/76/186, 8/20/76 and Sup. 1) was discussed by the Executive Board at EBM/76/141 (9/19/76). Recent economic developments were reviewed in SM/76/188 (8/31/76).

II. Recent Economic Developments

Beginning in 1974, Portugal's balance of payments, which had traditionally been in surplus, moved into substantial deficit. Major shocks to the economy had been delivered by the quadrupling of oil prices abroad, by the revolution at home, the loss of colonial markets, and the onset of a major world recession. 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$1,014 million and US$1,480 million over the same years. As a result, a net foreign asset position of the banking system of US$2,900 million at the end of 1973 changed to a net foreign liability position of US$1,100 million at the end of 1977; in both these figures gold is valued at the equivalent of SDR 35 per ounce.

1. Structural shifts

The adjustment problem in Portugal is complicated by the major structural shifts that have taken place both in the domestic economy and in its relations with the outside world. In the five years before 1974, GDP had grown at an average rate of 7 per cent per annum. Substantial surpluses in the balance of payments were then achieved mainly through rapidly rising receipts from tourism and from workers' remittances. In 1973, commodity export earnings covered 49 per cent of imports of goods and services, gross tourist earnings a further 15 per cent, and workers' remittances 30 per cent. Portuguese workers abroad numbered some 800,000 or about a quarter of the labor force remaining in Portugal.

This somewhat precarious structure was shaken, even before the revolution of April 25, 1974, by the sharp rise in world petroleum prices at the turn of the year. As a result, net imports of petroleum and petroleum products rose from US$150 million in 1973 to US$540 million in 1975, equivalent to two thirds of the deficit on current account, and then to approximately US$770 million in 1977. There was little opportunity to compensate by expanding exports in conditions of world recession; relative to 1973 Portuguese export markets actually shrank through 1975, and expanded by only 11 per cent in the four years to 1977. In addition, gross tourist receipts in 1977 covered only 8 per cent of imports of goods and services, and workers' remittances only 23 per cent.

The primary external objective of the 1974 revolution had been to end the colonial wars and recognize the independence of the former overseas territories. Achievement of this objective meant the loss of substantial markets for Portuguese exports there; the share of total exports going to Angola and Mozambique declined steadily from 12 per cent in 1973 to 3 per cent in 1976, before recovering slightly to 5 per cent in 1977. It also meant a major reflux of Portuguese settlers from the former colonies--an estimated 500,000 returnees added 6 per cent to Portugal's population in the two years following the revolution. This loss of markets and of employment opportunities abroad was superimposed on that induced by the world recession that had followed the energy crisis.

From an economic viewpoint, adjustment to an increase in the resident labor force in conditions of shrinking markets would have required an initial cut in real wages. However, in the short run at least, such an adjustment would have run counter to the major domestic objective of the 1974 revolution, that of achieving a substantial increase in the standard of living of the working population. Accordingly, in comparison with 1973 real wages rose 21 per cent by 1975, and despite their decline in subsequent years, they still stood 13 per cent higher in 1977 than in 1973. To be sure, real GDP recovered again after falling in 1975, and in 1977 stood 9 per cent above its 1973 level. However, the volume of exports in 1977 still remained 6 per cent below that recorded in 1973, there having been a loss of 15 per cent in market shares.

The social goals of the 1974 revolution and the inflow of returnees required a considerable expansion of public sector activities. Tax rates and social security contributions were successively raised, giving the tax system considerable buoyancy. Nevertheless, the financial position of the public sector deteriorated markedly. Its overall balance swung from a surplus equivalent to 2 per cent of GDP in 1973 to a deficit equivalent to 11 per cent of GDP in 1975, and despite determined efforts at control remained at about 8 per cent in 1977. The initial deterioration could be traced largely to current transfers and subsidies, including extra-budgetary Treasury operations. More recently, however, capital expenditures have increased while the current deficit was reduced from a high of almost 5 per cent of GDP in 1976 to about 1 per cent in 1977.

The impact of the events of 1974 also led to a marked loss of confidence in the monetary system. Compared with 1973, the public's holdings of broad money declined in real terms to 83 per cent in 1975, and further to 80 per cent in 1977. The public's holdings of broad money in relation to GDP had increased from 75 per cent to 95 per cent in the five years prior to the revolution; by 1977 this ratio declined once more to 80 per cent as inflation accelerated, while interest rates were kept low. As the capacity of the monetary system to mobilize domestic resources shrank, a substantial portion of domestic credit had to be financed from abroad, particularly as production and its financing requirements recovered after 1975. Thus, the proportion of domestic credit expansion financed from reserves and net foreign borrowing by the banking system rose to 45 per cent in 1975, and despite corrective measures remained at 35 per cent in 1977.

2. The 1977 stabilization program

The need for external adjustment--through the containment of demand or a reduction in incomes--did not seem pressing as long as international reserves remained ample. By the end of 1976, however, the deterioration had assumed proportions that induced the authorities to prepare the stabilization program that was implemented in the opening months of 1977. A major objective was to reduce the deficit on external current account from about US$1,250 million in 1976 to US$800 million. A modest inflow of autonomous capital was expected to restrict the overall deficit to about US$650 million. In the event, the external situation far from improving deteriorated further, with both the current account and overall deficits expanding to almost US$1,500 million in 1977, or 9 per cent of GDP.

a. The policy package

To help achieve the targets set at the beginning of the year, the escudo was depreciated by 15 per cent on February 25, 1977 (Chart 1). Legislation limiting wage increases to 15 per cent was passed to restrain private consumption, the system of price controls was liberalized, and prices of a basket of basic commodities were raised before being frozen for a year. The public sector budget for 1977 had already provided for a reduced current deficit, with little change projected in the overall deficit despite the considerable intervening price inflation that had occurred. Sales taxes were raised and the prices of petroleum products, a direct source of government revenue, were also increased. Targets for public sector borrowing and overall credit expansion were set, on the basis of a projected expansion of the money stock several percentage points less than the expected growth in nominal income. Interest rates were increased by 1.5 percentage points. In addition, import quotas in escudo terms were imposed on items accounting for some 7 per cent of total imports, mainly automobile parts, household appliances, coffee, and bananas, and the 60 per cent surcharge was extended to an additional 1 per cent of imports.

b. The domestic economy

The measures taken early in the year did not prevent gross domestic product from growing some 6 per cent in 1977, the same rate as the year before. In contrast to the original hopes and expectations, such growth was not achieved through an improvement in the external current account, but rather by an unexpected buoyancy in domestic expenditure (Table 1). This buoyancy was related primarily to a resurgence of stockbuilding, much of it apparently of a speculative character. There was some revival in domestic fixed capital formation, too. Public consumption, following a major increase in 1976, was held to an expansion of 2 per cent. Despite the reduction in real wages, private consumption still rose slightly, perhaps reflecting some speculative buying also.

The production response to high demand differed among sectors. Agricultural production declined by an estimated 10 per cent in 1977, mainly because of the weather. Manufacturing output, on the other hand, grew by more than 9 per cent during 1977, to well above its previous peak in early 1974 (Chart 2), but most of this expansion was directed to the domestic market; at least two important export industries, textiles and wood and cork, experienced declines since 1974. Construction, meanwhile, expanded by 11 per cent in 1977.

The continued high rate of economic growth did not lead to any significant improvement in employment opportunities as the increase in output was achieved largely through higher productivity. Many firms continue to have an excess of labor due to legal barriers against dismissals. As a result, new entrants to the labor force are encountering severe employment problems. Thus, the rate of unemployment rose somewhat further in the course of the year, to an estimated 7 per cent of the end-1977 labor force. At the same time, limits on usable plant capacity in expanding sectors contributed to a worsening of inflationary pressures (Table 2). Price increases accelerated from about 15 per cent in mid-1976 to a peak of 40 per cent in May 1977, before stabilizing somewhat. For 1977 as a whole, consumer prices still rose on average by 27 per cent.

Despite this sharp increase in prices, the policy of limiting wage increases to 15 per cent was remarkably effective: the annual average wage bill in manufacturing increased by 18 per cent. Real wages in manufacturing declined by about 7 per cent. However, looked at from the point of view of international competitiveness, the combined effect of devaluation, wage restraint and improved productivity still left Portugal's unit labor costs in 1977 above those prevailing in 1973 relative to those of major trading partners. In addition, the increase in profitability does not appear to have been restricted to goods entering international trade, as the buoyancy of home demand seems to have raised the price of home goods as well.

c. Monetary policy and developments

Until recently, the authorities pursued an accomodating monetary policy which permitted a rapid expansion of domestic credit. By end-1976, the growth in domestic credit, measured in terms of the stock of broad money (M2) at the beginning of the year, reached 26 per cent compared with a postrevolutionary low of 16 per cent in early 1975 (Table 3). The initial target for domestic credit expansion of Esc 130 billion in 1977 would have brought a further acceleration in the growth of credit to 28 per cent similarly measured. It was nevertheless thought consistent with a significant improvement in the balance of payments on the assumption that the demand for money balances would also recover.

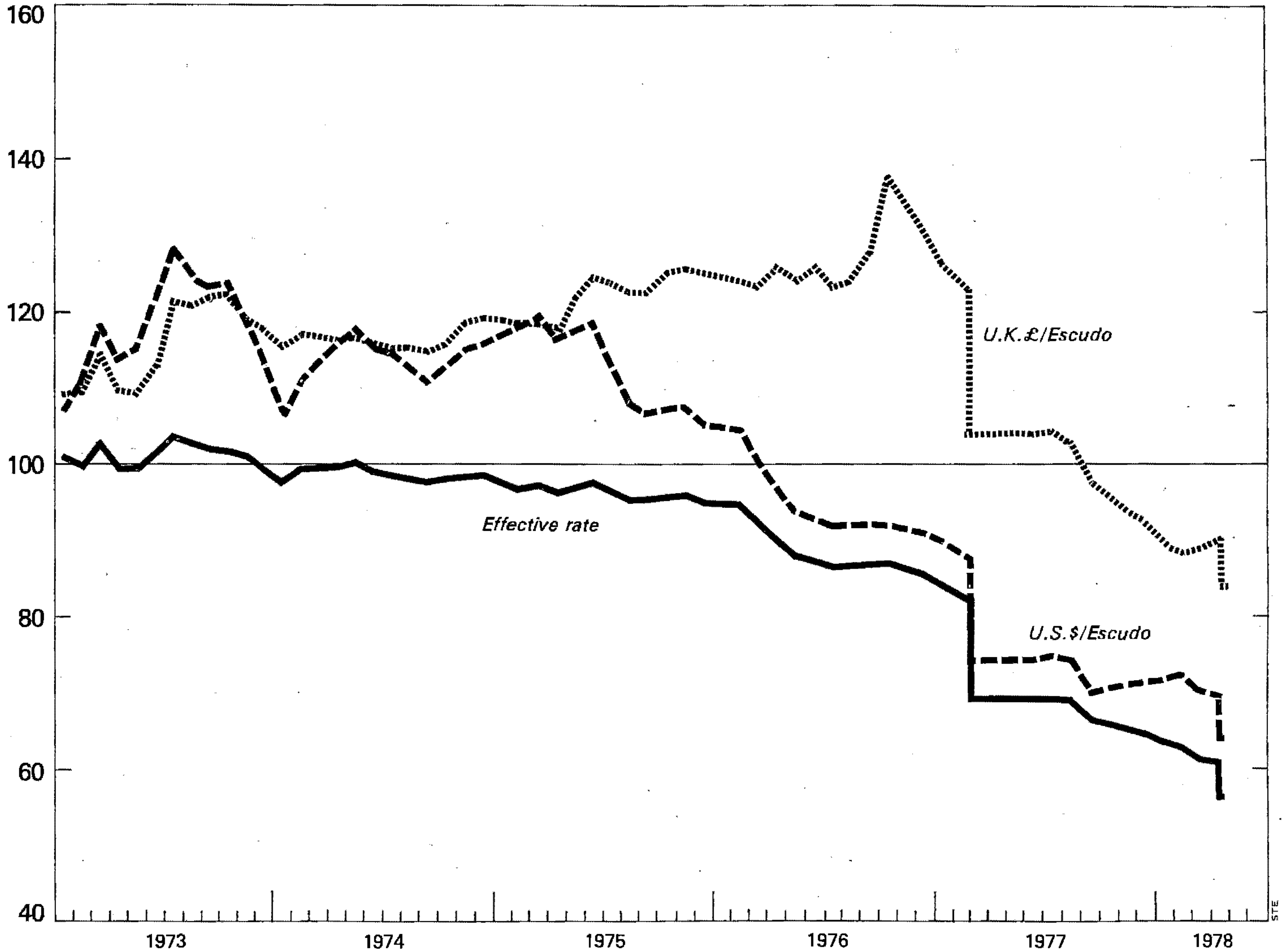
Though the income velocity of money had increased by 10 per cent in response to accelerated inflation in 1976, the stabilization effort in February 1977 was expected to act as a partial offset, and velocity was thus projected to rise by somewhat less in 1977. In the event, a renewed sharp increase in prices nullified this effect, contributing also to a further rise in the demand for credit, in part to finance speculative inventories and capital flight. At least initially, there was little restraint on credit expansion from the supply side. Thus, domestic credit in 1977 expanded by much more than the target, namely by Esc 159 billion or 35 per cent of the initial money stock,

CHART 1

PORTUGAL

EXCHANGE RATE INDICES

(May 1, 1970 = 100)



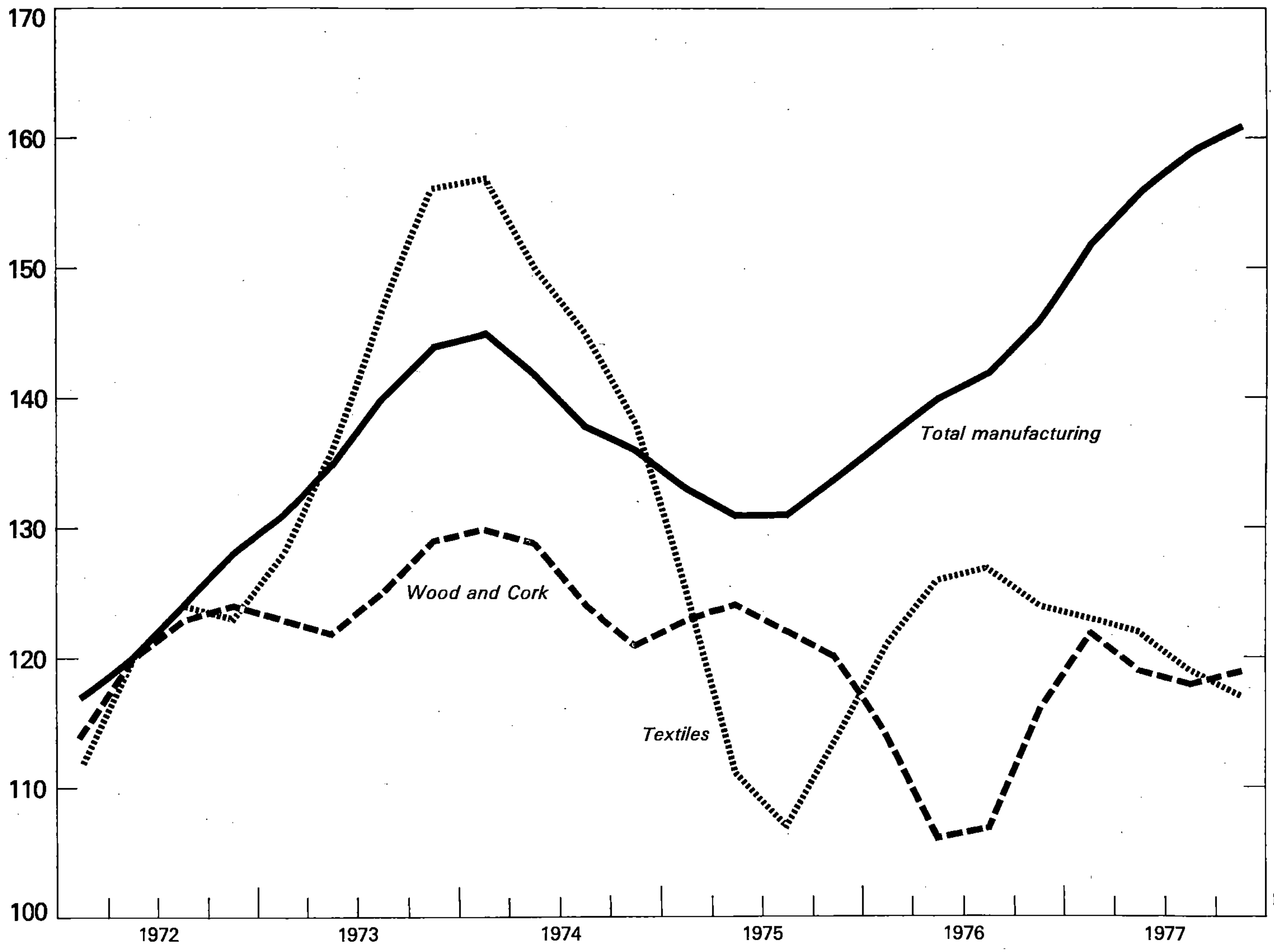
Source: IMF, European Dept.

CHART 2

PORTUGAL

INDUSTRIAL PRODUCTION 1972-77

(1970 = 100)



and although the money stock itself still grew by 23 per cent, the loss of net foreign assets of the banking system reached nearly Esc 58 billion, compared with the intended Esc 25 billion.

Credit restraint would in any case have been difficult to implement. The link between the monetary base and the money supply was considerably weakened after the 1974 revolution by wide variations in the composition of the money held by the public (Chart 3). The redistribution of income to people less accustomed to dealing with banks, as well as reduced confidence in the banking system, resulted in a marked shift from deposits to currency; this shift has only partly been reversed to date. In addition, reserve requirements for banks varied among types of deposits, while the major savings bank was exempt from reserve requirements altogether, so that the demand for reserve money changed with each shift between types of deposits or between banks. Finally, in the absence of an interbank money market the excess reserve position varied a great deal among individual banks.

However, measures were taken throughout 1977 and in early 1978 to improve the efficiency of monetary control. The principal ones include the introduction of an interbank money market, the reduction of rediscount quotas, and finally the establishment of a uniform reserve requirement. As a result, excess liquidity was initially redistributed within the banking system, and then gradually eliminated.

d. Fiscal policy and developments

The overall public sector deficit was held virtually constant in 1977 despite inflation; at Esc 54 billion it was even lower than the Esc 57 billion originally budgeted. 1/ However, unexpected difficulties were encountered with its financing, resulting in a larger recourse to the banking system than had been planned.

The original 1977 budget was designed to reduce the public sector deficit on current account, and by keeping the overall deficit virtually constant in nominal terms, to reduce it from 11 per cent to 9 per cent of nominal GDP. A basket of essential goods was defined whose prices were initially increased by more than 20 per cent; they were then kept constant through subsidies partially financed by a 20 per cent increase in gasoline prices in January, and a further 25 per cent increase in August 1977. An unexpected deficit in the social security system was in part offset by higher rates for the sales tax. Finally, spending authorizations were increased in mid-year when tax receipts began to exceed forecasts due to inflation-induced increases in the tax base, but actual spending was held back by customary administrative delays.

With a smaller carryover of 1977 budget expenditure to 1978 than had originally been anticipated, the total financing requirement remained about the same as originally foreseen. However, only Esc 4 billion, rather than an

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1/ The "public sector" concept includes Central and local governments, the social security system, and other administrative agencies, but excludes nationalized enterprises.

expected Esc 16 billion, could be financed by borrowing from the nonbank public. This development reflected the general unattractiveness of financial assets with a negative real rate of return, the competing appeal of more liquid time deposits, and the heavy investment in inventories. After taking account of foreign borrowing and other Treasury operations, this left Esc 52 billion to be drawn from the banking system, in place of the Esc 39 billion originally envisaged.

e. The external balance

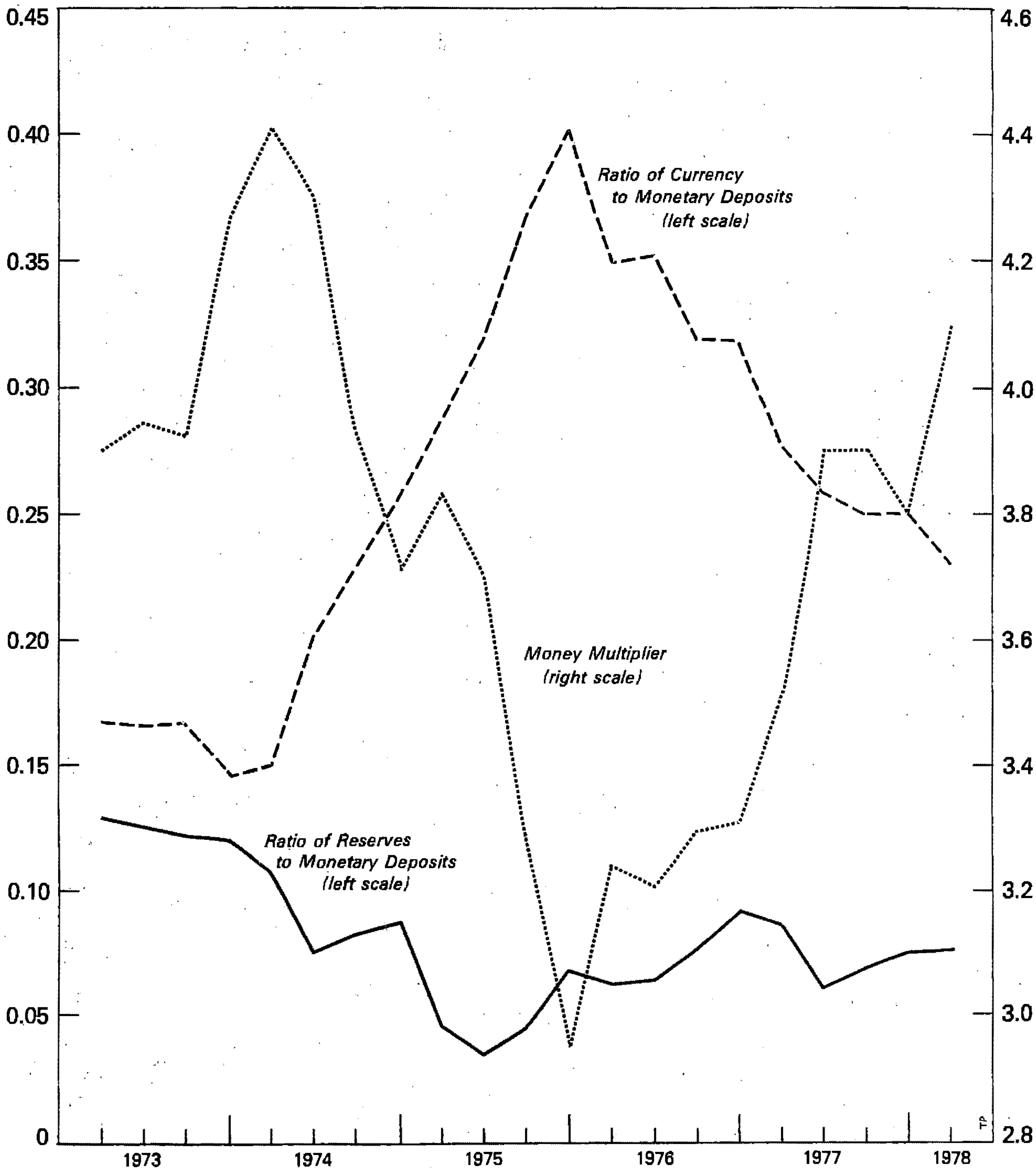
The deterioration in the external current balance to a US$1,495 million deficit was entirely due to a major worsening in the trade account (Table 5). The terms of trade improved modestly, but export volumes grew only slightly faster than the disappointing growth in markets, and there was a sharp increase in imports. As tourists took advantage of low Portuguese prices, tourist activity rose by 55 per cent but tourist receipts rose by only 22 per cent. Private remittances from workers abroad recovered to prerevolutionary levels (Chart 4).

A number of factors help to explain the deterioration in the trade balance. A significant part of Portugal's traditional export sector involves products whose growth prospects are poor; for example, textiles, still Portugal's most important export, are increasingly subject to restrictions abroad. Expanding domestic markets for exportables also contributed to limit the growth of export volumes. Meanwhile, the sharp increase in domestic expenditure and the speculative stockpiling of imported goods as an inflationary hedge, increased the volume of merchandise imports far beyond expectations. Finally, excess demand raised the prices of domestic goods in parallel with those of internationally traded goods sufficiently to nullify much of the effect of the exchange rate depreciation. The wage restraint that produced the decline in real incomes in 1977 undoubtedly served to hold down private consumption but had little effect on relative prices.

Despite a substantial inflow of medium-term and long-term capital, the net capital account was in virtual balance in 1977, reflecting a net outflow for short-term capital and errors and omissions of US$400 million, compared with about US$600 million in 1976 (Table 6). Given a considerable increase in short-term indebtedness, the gross unrecorded capital outflow may have been of the order of US$500-750 million. While it is not possible to identify the sources of these unrecorded outward movements, a large part probably reflected leads and lags in the trade account. Such activity, as well as the fact that a significant proportion of tourist receipts did not enter the banking system, may have been prompted by low domestic interest rates relative to those abroad, given expectations about exchange rate changes, and the relatively accommodating stance of monetary policy.

The overall balance of payments deficit in 1977 was financed by US$532 million in compensatory borrowing by the monetary authorities, use of gold reserves yielding US$535 million, and short-term borrowing by other banks amounting to US$811 million. In addition, commercial banks refinanced maturing short-term external obligations of over US$400 million. As a result, gross

CHART 3
PORTUGAL
MONEY MULTIPLIER, 1973-1978



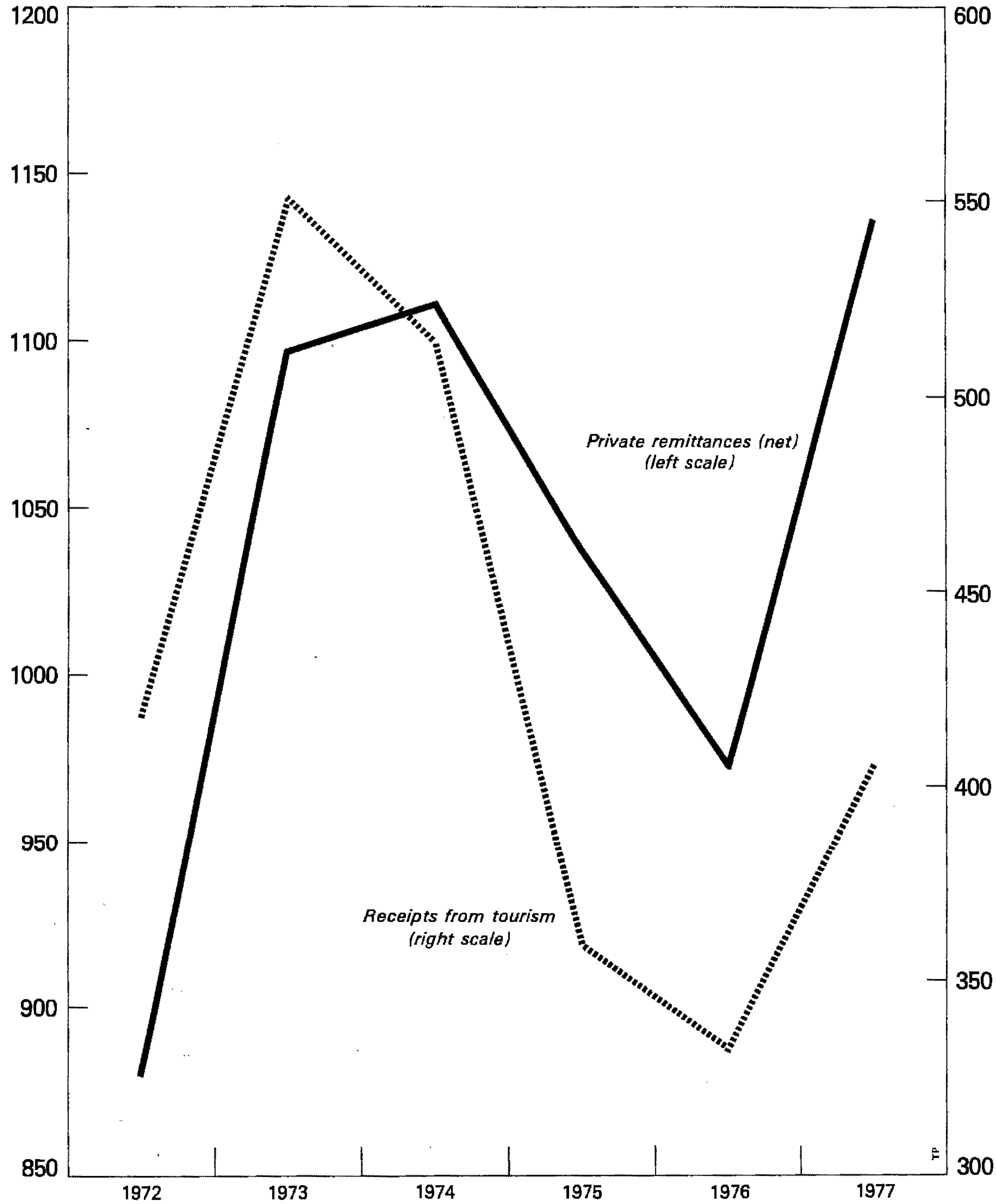
Source: Data provided by the Portuguese authorities.

CHART 4

PORTUGAL

INVISIBLE RECEIPTS 1972-77

(Millions of U.S. dollars)



assets of both the monetary authorities and other banks improved during the year. By the end of 1977, gross international reserves of the monetary authorities amounted to US$1,356 million, including US$1,025 million of gold valued at the dollar equivalent of SDR 35 per ounce. At the end of March 1978, total gold holdings amounted to US$999 million, similarly valued, of which 44 per cent was pledged as collateral for compensatory borrowing.

f. External debt

At the end of 1977, medium-term and long-term external debt was estimated at about US$1,968 million (Table 7). Most of this represents public sector debt, including nationalized industries whose external obligations are often classified under "other private sector." In addition, there is now a high level of short-term debt, estimated at a total of about US$700 million. Also, foreign liabilities of the banking system amount to about US$2,935 million. The ratio of debt service payments on medium-term and long-term external debt to exports of goods and services is estimated at about 15 per cent in 1977.

3. The August measures

The prospect that the external targets for 1977 might not be met became evident at mid-year. Until then, external pressures had been absorbed by commercial bank borrowing abroad cushioning the reserves of the central bank (Table 8). When this no longer proved adequate, the need for further measures became apparent, and a supplementary policy package was introduced on August 25, 1977.

To slow the growth of domestic credit expansion and to bring the cost of credit more in line with that abroad, interest rates were increased by an average of 4-5 percentage points. Also, after an initial adjustment of 4 per cent, the effective exchange rate was allowed to depreciate by 1 percentage point per month beginning September 15, 1977, mainly to compensate for differential rates of inflation at home and abroad. To support this policy, the monetary authorities provided forward rate guarantees for one, three, and six months. The increased cost of subsidizing imported foodstuffs was met by raising the price of gasoline by a further 25 per cent. A wide range of public sector appropriations for the remainder of the fiscal year was reduced in October, and the possibility of carrying 1977 budget appropriations over to calendar 1978 was restricted. Finally, following the introduction of an interbank money market, limits on central bank rediscounts were lowered in October and again in November.

There were signs of some moderation in the growth of credit to the private sector in the fourth quarter of 1977, although credit taken up by the public sector rose sharply from year-earlier levels. And while the external position of the banking system continued to deteriorate, it did so at a slower rate than earlier in the year. Exports continued their moderate but steady improvement through 1977. The growth of imports remained high, but there was a decline from the growth rates experienced in the first half of the year. It remains unclear to what extent this slowdown resulted from delays in issuing import licenses, which had become significant then. The improvement from year-earlier levels in the invisibles account was much less marked in the second half of 1977 than it had been in the first. The capital account moved into surplus, however, and the overall deficit was some US$200 million less in the second half of the year than in the first.

Despite the August measures, interest rates remained substantially negative in real terms, and given relative inflation rates, low in comparison with other countries. Also, the increase in deposit rates caused a shift out of demand deposits into time deposits with lower reserve requirements, thus enhancing bank liquidity. In the short run, the establishment of an interbank money market also permitted the reallocation of excess reserves to banks in the best position to expand credit. To compensate, a uniform 7 per cent reserve requirement against all bank deposits was introduced in January 1978, and indicative ceilings were set on the credit expansion of individual banks.

In response, the growth in domestic credit in the year ending March 1978 slowed to 32 per cent of the initial money stock, the loss of external reserves moderated further, and the capital balance, which was in surplus by only US$15 million for 1977 as a whole, recorded a net inflow of US$153 million for the year ending March 1978. Nevertheless, reflecting the continued substantial structural imbalance in the trade account and a relatively disappointing performance of invisibles, the current account deficit for the year through March 1978 remained at about US$1,500 million.

III. The Stabilization Program

The structural element in Portugal's deficit on external current account is so large that more than a single year will be required for its correction. In recognition of this circumstance, representatives of 14 countries 1/ agreed in Paris in June 1977 to contribute a total of about US$750 million in medium-term credits over the following 18 months, most of it to be in the form of direct balance of payments support. This assistance was in large part contingent on the successful negotiation of an upper credit tranche stand-by arrangement with the Fund. The present program, on the basis of which such a stand-by arrangement is proposed, has as its objective to strengthen the balance of payments and reduce inflationary pressures, while maintaining a positive rate of growth of the economy to keep unemployment in check.

1. Program targets

The external objective of the program is to reduce the deficit in the balance of payments on current account from about US$1,500 million in the year ending March 1978 (the base year) to US$1,000 million in the year ending March 1979 (the program period). Allowing for a modest increase in net nonmonetary capital inflows from US$150 million to US$200 million, that target implies a reduction in the overall external deficit from about US$1,350 million to US$800 million between the same periods (Table 9). An overall deficit of that

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1/ Austria, Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Norway, Sweden, Switzerland, United Kingdom, United States, and Venezuela.

size should be financeable from the Paris credits--net of amounts already drawn, borrowed against, or tied to donor-country exports--drawings under the Fund stand-by arrangement and perhaps some additional use of official reserves.

The growth in the volume of commodity exports is projected to accelerate only slightly from 7 per cent to 8 per cent. Even then, this may necessitate a further 2 per cent gain in market shares. Portugal's exports continue to be heavily concentrated in products such as textiles for which world demand remains low and competition stiff. The services account is forecast to be more buoyant with major improvements anticipated in receipts from tourism. Not only is hotel capacity expected to expand but price controls on hotels which kept prices well below international levels were lifted in the autumn of 1977. Furthermore, with the return of confidence a larger proportion of tourist receipts should find its way into the banking system. Nevertheless, to reach the current account target, a reduction in the volume of imports of 5 per cent will still be necessary. This will require a decline in domestic expenditure of at least 2 per cent even if domestic demand is redirected from stock accumulation and into such activities as construction whose import content is low.

Progress in the achievement of the external objective is to be monitored through quarterly ceilings on the net foreign liabilities of the banking system, which for this purpose are to include bank-guaranteed short-term debt as well as direct obligations of the banks themselves. In addition, the program contains the following performance clauses: quarterly ceilings on the net domestic credit of the banking system; quarterly ceilings on the net claims of the banking system on the public sector; the extension to all categories of imports not subject to quantitative restrictions, by June 30, 1978, of automatic approval of applications for import licenses, and the elimination by the same date of the backlog of applications; and reductions in the 30 per cent import surcharge of 10 percentage points each by October 1, 1978 and by April 1, 1979.

The evolution of the program as a whole, and the restrictiveness of value quotas on certain imports, are to be reviewed with the Fund in January 1979. Meanwhile, the Portuguese authorities have undertaken not to "introduce any multiple currency practices, or any new restrictions, or intensify existing ones, on payments and transfers for current international transactions, or to conclude any new bilateral payments agreements with Fund members, or to introduce restrictions, or intensify existing ones on imports for balance of payments reasons." These are also performance clauses.

2. Policy measures

In order to achieve the desired improvement in the balance of payments within the specified constraints, the Portuguese authorities will continue their flexible exchange rate policy. However, to minimize pressure on the exchange rate and on prices, the major emphasis of the program is to be on credit control supported by continued fiscal restraint. Higher interest rates are intended both to reduce the demand for credit, particularly for speculative inventory accumulation and to strengthen the external capital account. In combination, these measures are expected to allow a relaxation of restrictions on external trade and payments in the program period and beyond.

a. Exchange rate policy

Exchange rate policy is to be guided by the decision of the authorities to contain the increase in net foreign liabilities of the banking system within quarterly limits consistent with an overall deficit of US$800 million in the program year. In the context of the rest of the program, the authorities expect that an average effective depreciation of 19 per cent over the program period, compared with an average effective depreciation of 22 per cent in the base year, will be sufficient to achieve this aim. Taking into account wage policies described below, this should further improve the cost competitiveness of Portugal relative to its major trading partners to a level beyond the 1973 position (Chart 5).

When the crawling peg was first applied to the escudo starting in August 1977, the authorities held the monthly effective depreciation to about 1 per cent, and committed themselves in advance to buy and sell forward exchange at rates consistent with this policy. To attain the new target they have announced that the monthly effective rate of depreciation will have to rise to about 1.25 per cent, after a temporary acceleration beginning in March including a step depreciation of 6.1 per cent in early May. 1/ They also consider it no longer necessary for the Bank of Portugal to guarantee the forward rate, preferring instead to support the exchange market by increasing the rediscount rate of the Bank of Portugal by a further 5 points to a range of 18-23 per cent, and time deposit rates by 4 points to 19 per cent and over on deposits for six months or more (Table 10).

b. Monetary policy

The major emphasis in the program will be on credit restraint. The expansion of net domestic credit of the banking system is to be limited in line with the target for the overall balance of payments and the projected development of the demand for money, broadly defined. Domestic credit expansion will thus be limited to Esc 134.3 billion, or 23 per cent of the initial money stock, in the year through March 1979, compared with Esc 150.7 billion or 32 per cent in the year through March 1978 (Chart 6 and Table 11). This credit ceiling, which includes the domestic currency counterpart of foreign credits obtained with Portuguese bank guarantees, has been phased quarterly to take into account both seasonal variations in the demand for money balances and in the overall balance of payments, as well as the gradual improvement in the external accounts that is foreseen during the program period (Table 12).

The demand for money is projected to continue to rise by less than the rate of income growth. Thus, an increase in the average money stock of about 18 per cent is assumed, compared with an expected rate of growth in nominal GDP of about 27 per cent. Income velocity of money is consequently projected to rise by 7.5 per cent. This is a somewhat lower rate of increase than the 9-10 per cent observed in the preceding years. The containment of inflationary pressures at just below last year's rates, combined with the cumulative effect

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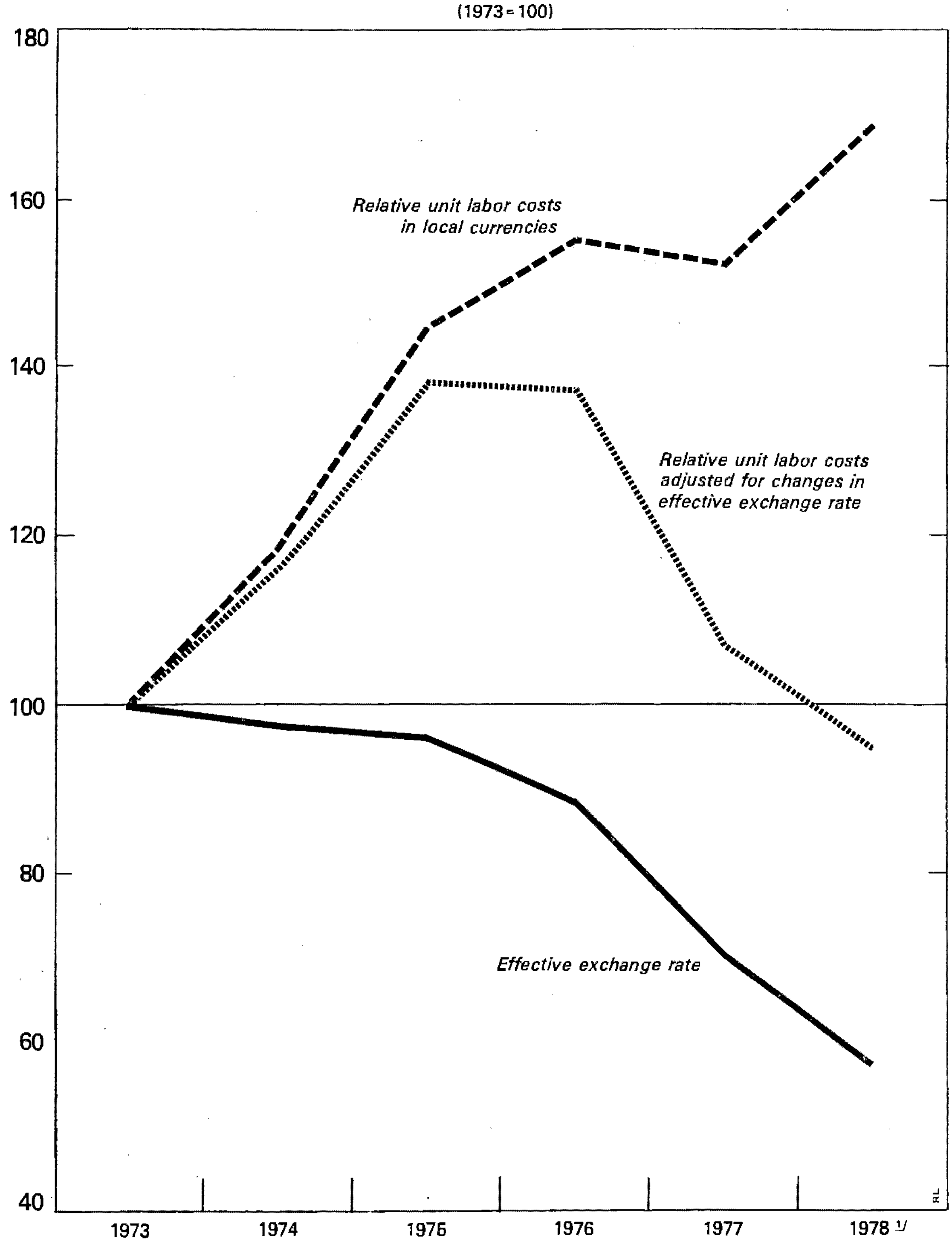
1/ Calculated in terms of the local currency cost of foreign exchange the total effective depreciation in the first half of May came to 7 per cent.

CHART 5

PORTUGAL

RELATIVE UNIT LABOR COSTS 1973-77

(1973 = 100)

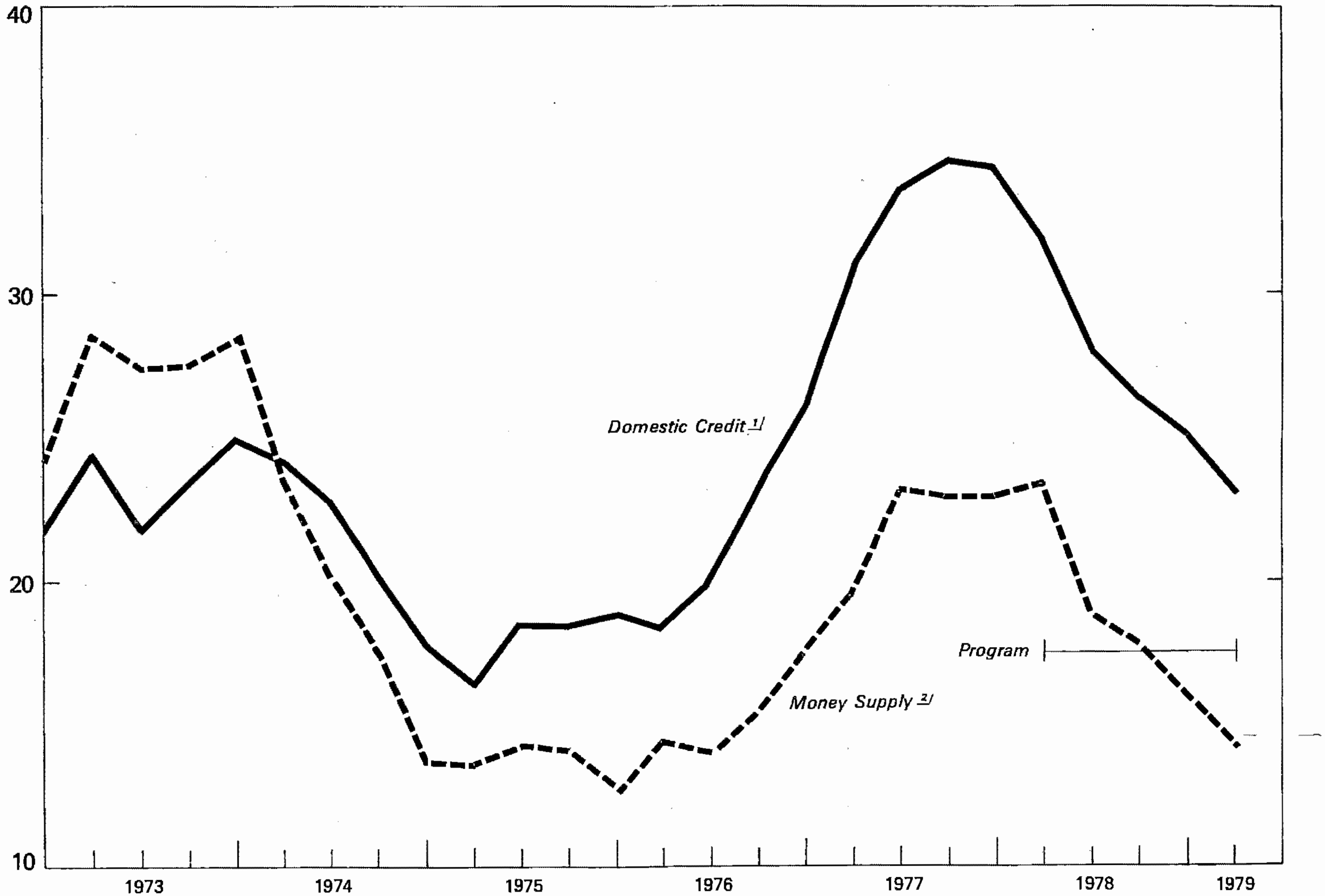


1/ Forecast.

CHART 6

PORTUGAL

DOMESTIC CREDIT AND MONETARY EXPANSION



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.

of increases in interest rates on deposits over the past year, is thought sufficient to produce this effect. The targeted overall balance of payments deficit of US$800 million translates into a decline in the net foreign assets of the banking system of Esc 37.4 billion, compared with a decline of Esc 55.8 billion in the preceding 12 months.

The authorities have taken a number of measures to make their policy of credit restraint effective. In order to limit demand for credit, basic lending rates were raised by 3.5 percentage points in May 1978, following earlier increases in February and August 1977. However, interest subsidies financed out of Bank of Portugal earnings from rediscounts and the surcharge on consumer loans are to limit the increase in lending rates for housing, agriculture, exports, and priority investments. The monetary authorities have also introduced indicative credit ceilings for the banks, and they are prepared to make these ceilings mandatory, if necessary. They intend, however, to seek to avoid that by a flexible management of interest rates.

The monetary authorities' ability to control domestic credit developments has also been substantially improved in recent months through the combined effects of the introduction of an interbank market, of a uniform reserve requirement, and of the gradual reduction in rediscount quotas. As a result of these measures, excess liquidity in the banking system has been eliminated and further credit developments can be more directly influenced by the developments of the monetary base. The monetary authorities have thus set indicative quarterly targets for the development of the monetary base thought consistent with the aims of the overall credit policy. Taking into account projected reductions in the currency to deposit ratio, they intend to limit the growth of the monetary base to 4 per cent in the program period.

c. Fiscal policy

Fiscal policy for the program year is designed to consolidate the gains achieved in 1977, when the deficit for the public sector was reduced to 8 per cent of GDP from 11 per cent the year before. The budget of the public sector, as approved by Parliament in April of this year, provides for additional taxes to raise revenues during the program year by the equivalent of 2 per cent of GDP. Chief among these are the introduction of a 10 per cent surcharge on the tax on earned income, a 15 per cent surcharge on most other direct taxes, a 10 per cent surcharge on the transactions tax, and the extension of the transactions tax with rates of 10-15 per cent to previously exempt services. Allowing for a normal level of underspending, it is estimated that public sector consumption will remain constant in real terms. Sharp increases in the prices of subsidized food products and utility and transportation charges will help contain net subsidies.

The current account of the public sector is thus projected to be in surplus in the program year for the first time since 1974 (Table 13). Capital expenditures are, however, estimated to rise somewhat in real terms, a major contributing factor being an increase in equity capital subscriptions to nationalized enterprises of Esc 7 billion in 1978 compared with Esc 3 billion in 1977. As a result, the overall public sector deficit in nominal terms will remain unchanged at about Esc 53 billion, though as a per cent of GDP it will decline from 8 per cent to 6 per cent. The amount financed by the banking system will also be reduced, to Esc 44 billion from Esc 52 billion in calendar 1977, due to the expected greater availability of financing from the nonbank public and from abroad.

The authorities will take additional revenue measures in the course of the program year to compensate for any revenue shortfall that will result from the phasing out of the import surcharge. In addition, they have decided not to increase public sector expenditures in the event that revenues exceed budgeted levels, but rather to use any excess revenues to reduce further the overall deficit. The use of government bonds issued in compensation for past expropriations for discharging tax obligations will be limited to arrears in direct taxes prior to 1977 as presently permitted by law. The amounts involved are expected to fall short of Esc 1 billion. Finally, the Government is considering legislation to restrict the access of autonomous agencies to cash balances built up in previous years. In the past, the ready access to such balances tended to reduce the effectiveness of control over public expenditures.

d. Wages and prices

To limit the need for public sector subsidies and to contain demand, the administered prices on the basket of essential food products last fixed in February 1977 were raised by an average of more than 20 per cent in April of this year. At the same time, utility rates for water, electricity and gas, as well as transportation prices, were raised by 35-50 per cent. The impact of the consequent increase in the cost of living has been eased for lower-income groups by raising the minimum wage about 30 per cent; it had remained fixed since January 1977. Unemployment benefits were also increased by about 25 per cent and pensions by up to 22 per cent. However, in order to limit cost increases, wage policy will remain firm. Real wages declined by at least 7 per cent in 1977. Legislation was passed in April of this year limiting increases in contractual wages to 20 per cent in 1978, and requiring a minimum contract period of 12 months. Legislation also exists according to which firms in financial distress may suspend wage contracts if their work force concurs. With consumer prices likely to rise by 26 per cent, real wages may decline by a further 4-5 per cent.

e. The restrictive system

As the present program is implemented, the authorities will gradually dismantle the external restrictions that have been introduced in recent years. The import deposit requirement was already abolished as of December 31, 1977. The 30 per cent import surcharge, currently levied on items covering about 29 per cent of total imports in 1976, will be phased out gradually. The authorities have announced a schedule according to which the rate will be reduced to 20 per cent on October 1, 1978 and to 10 per cent on April 1, 1979, before being fully abolished on October 1, 1979. A 60 per cent import surcharge is still imposed on certain luxury goods covering about 2 per cent of 1976 imports, but the Government will study alternative domestic tax measures with a view to reducing or eliminating it in 1979.

In addition, value quotas expressed in escudo terms apply to certain consumer goods, including consumer durables, accounting for about 4 per cent of total imports in 1976, and other such quotas apply to knocked-down automobiles, accounting for about 2.8 per cent of 1976 imports. The quota on knocked-down automobiles will remain unchanged in 1978 at its escudo level of 1977, but the value quotas for consumer goods have been raised with effect from April 1, 1978 to Esc 3.4 billion, which is equivalent in foreign exchange terms to the value of the quotas in the year to March 1978.

For imports not subject to quantitative restrictions, import authorizations are normally issued without delay. However, in late 1977 the process of authorization slowed down, partly as a result of the introduction of new administrative procedures. A backlog of applications has been built up which the Government, in cooperation with importers, is now trying to eliminate. From May 2, 1978, all applications for imports of raw materials and intermediate goods are being authorized automatically and the Government intends to extend this system to all categories of imports not subject to quantitative restrictions no later than June 30, 1978. By that time, the backlog of import applications is also to be fully eliminated.

The Government traditionally establishes annual foreign exchange budgets for its own operations as well as for the various state agencies in charge of monopoly imports of certain commodities, primarily foodstuffs. The authorities have stated that these budgets are only indicative and will be amended as the need arises so as to avoid restricting imports through rationing of foreign exchange.

3. Economic prospects

The Portuguese authorities expect that, with the stabilization program they have adopted, the external current account deficit can be contained to no more than US$1,000 million in the year to March 31, 1979. Gross domestic product in real terms may expand by about 1-2 per cent with the deflator rising by 25 per cent, slightly less than the year before. Domestic expenditure is expected to decline by 2 per cent, exclusively as a result of a decline in the rate of stockbuilding with fixed capital formation continuing to rise by some 4 per cent, and both public and private consumption remaining constant. The authorities expect that this pattern will suffice to reduce the volume of imports of goods and services by 6 per cent, while exports of goods and services may rise by 10 per cent (Table 14).

To help finance the current account deficit, substantial medium-term and long-term borrowing is thought already to be in prospect. With the proposed monetary and exchange rate policies, it is expected that these capital inflows will be offset to a much lesser extent than before by short-term capital outflows and negative errors and omissions. Given the large proportion of external debt of over one year that carries relatively short maturities, the debt service ratio is expected to rise to about 19 per cent in 1978. The Government is aware of the need for better control of external borrowing. As an initial measure, all short-term foreign credits with a Portuguese commercial bank guarantee have been included under the ceilings for net domestic credit and net foreign liabilities of the banking system. The authorities will also seek to improve the maturity structure of the external debt as a whole and to limit new foreign borrowing to productive investment projects.

The Portuguese authorities are confident that the proposed stabilization program will set in train the required process of external adjustment. However, they recognize that both internal and external disequilibria are complicated by structural maladjustments in the economy; thus, it is mainly through policies to overcome these that the external imbalance will be fully and permanently corrected. Accordingly, the authorities have begun to formulate a medium-term strategy to increase productivity in industry and to modernize agriculture, which will start to be implemented toward the end of this year. In its initial phases at least, such a program will require further balance of payments support, some portion of which they hope may come from the Fund.

IV. Staff Appraisal

Portugal is a low-income country without significant natural resources or a modern agricultural sector and with a weak and little advanced industrial sector. In recent years, its basic economic problems were compounded by major external and internal shocks. Externally, these include the higher cost for imported energy, the loss of traditional export markets and the simultaneous inflow of refugees in the wake of decolonization, and the international recession and increasing tendencies to protectionism in Portugal's key export markets. Domestically, rising social expectations and the efforts at income redistribution that resulted from the revolution in 1974 touched off a process of inflation, low business confidence, and substantial speculative pressures.

Deficits in the external accounts have in the last two years reached unsustainable levels, leaving Portugal with a substantial drain on its once ample reserves and with a rapidly increasing external debt burden. The continued financing of deficits of this magnitude would have reduced reserves and increased debt service payments to an untenable extent. Thus the authorities were faced with the necessity of bringing the deficits in line with available medium-term and long-term financing. In this situation, the policy choice was between reducing the external deficit through the use of trade and exchange restrictions, which would have further aggravated structural distortions in the economy, or through a set of policies designed to tackle the economic causes of disequilibrium and lay the groundwork for economic recovery in the medium term. The Portugese authorities have ruled out the former course of action and have opted for progress in an open economic system.

The required austerity is somewhat eased by the decision of 14 industrial countries to extend a total of about US$750 million in balance of payments support to Portugal. This has provided the Portuguese authorities with some additional time in which to stabilize the economy. Nevertheless, the adjustment effort now decided upon is substantial and will not be easy to carry out. It is, however, of crucial importance that the Portuguese authorities should achieve a significant turnaround in the trends of recent years in order to lay the foundation for subsequent longer-term efforts at modernizing the economy, and achieving sustainable levels of economic growth.

The policy mix chosen by the Portuguese authorities consists of flexibility in exchange and interest rates, continued wage restraint, and a firm domestic credit policy supported by fiscal restraint. Over the past year, there has already been a substantial cumulative movement in the effective exchange rate with the depreciation in February 1977, a further adjustment in September, and a policy of gradual depreciation since then. This has now been followed by the further discrete adjustment in early May, and a decision to continue a flexible exchange rate policy with a gradual depreciation of the escudo that is consistent with the other components of the program. The authorities have committed themselves to let exchange rate policy be determined by their target for the overall balance of payments deficit, and further adjustments should therefore be assured if and when they are needed.

The recent interest rate adjustments also come on top of adjustments made in both February and August of last year. Their combined effect has been to provide a much higher level of interest rates than before, which should help to reduce and possibly reverse the speculative pressures that have proved so troublesome in the recent past. The present wage policy follows upon a similar policy in the past year, which was successful in reducing real wages, and is indispensable to a further reduction of external and internal disequilibria. Taken together, economic policies have been strengthened in a process of continuous adaptation and their cumulative impact should now be substantial.

The staff accepts that domestic political constraints regarding the other principal policy components oblige the Portuguese authorities to place relatively heavy emphasis on domestic credit restraint. Their reluctance to devise a policy mix that would rely relatively more on expenditure switching than on expenditure reduction is largely based on the fear that further action on the exchange rate could lead to excessive inflationary pressures which in turn would make it more difficult to contain wages. Similarly, they are concerned that additional increases in interest rates could have adverse inflationary repercussions, and create financial difficulties for a large number of firms attempting to recuperate from losses suffered in the immediate aftermath of the 1974 revolution.

While the present stabilization program is primarily short-term in character, aimed at an immediate improvement in the balance of payments, it also begins to deal with some of the more intractable structural problems of the economy. The first of these is the imperative need for Portugal's trade balance to improve well beyond its 1973 position. The rise in energy costs has led to a secular increase in the import bill. However, the growth of remittances from migrant workers is likely to be smaller given the saturation of foreign labor markets; and the reflux of Portuguese from the former colonies requires the expansion of employment opportunities at home. Exchange rate policy must, therefore, be aimed at improving cost competitiveness beyond 1973 levels, and wage policy must be so framed as to permit this adjustment. The staff welcomes the progress that has already been achieved and is implicit in the program on both these points.

Another structural adjustment that is being advanced by the program concerns public sector savings. The social choices that were made in the 1974 revolution require an expansion of the role of the public sector in the Portuguese economy. Initially the reform of the tax system could not keep pace with rapidly rising social expenditures, and as the current account of the public sector moved sharply into deficit, the capacity of the economy to ensure future growth was correspondingly reduced. Since then the position has improved, and if current projections are realized, a surplus in the public sector's current balance should once more be achieved as part of the present stabilization program. The staff strongly supports continued efforts to consolidate and expand this achievement. It remains to develop a public investment program that will use to best advantage the resources thus set free.

A third structural improvement that is set in train by the current stabilization measures is to arrest and eventually reverse the trend toward financial disintermediation in recent years. Unless this trend is reversed, meeting the domestic credit requirements of both the public and the private sectors will become increasingly difficult, as the capacity to mobilize domestic resources through the banking system diminishes, and dependence on foreign sources of funds expands. The progressive increase in nominal interest rates relative to domestic inflation should slow down this process; the increase in the income velocity of money is accordingly postulated to decline in the program period from 10 per cent to perhaps 7-8 per cent. The staff very much hopes that the process of disintermediation will be reversed as inflationary expectations diminish and confidence in the banking system returns.

A final structural change that is built into the present stabilization program concerns external restrictions. In the recent past formal and informal restrictions on trade and payments have been resorted to in order to postpone needed exchange rate adjustments. This has contributed significantly to the present speculative climate. More fundamentally the restrictions have also tended to raise costs, and as cost increases could more easily be passed forward in domestic than in foreign markets, they placed a disproportionate burden on exports. The staff therefore welcomes the authorities' intentions to begin dismantling the system of restrictions that was built up in recent years, and hopes that, as part of a more outward looking development strategy, they will see their way clear to an acceleration of the process.

Given the many uncertainties of the international and domestic situation, the Portuguese authorities intend to review the evolution of the program in January 1979, and on that occasion to reach such understandings with the Fund as may be necessary. In the view of the staff, the cumulative effect of the fiscal, credit, interest rate, exchange rate, and wage policies in 1977 and 1978 should suffice to bring about the required reversal of speculative behavior, the return of confidence, and the desired turnaround in the external accounts. There are, nevertheless, some risks to which the authorities need to be particularly alert.

The first of these concerns the public sector budget. The problem here lies in "other Treasury operations" which made up 18 per cent of the overall deficit in the year ending March 1978, and which are accounted for largely by the spending of autonomous institutions not wholly under Treasury control. It is essential that the authorities tighten their control over the operations of these institutions. For if the projected decline in this residual were to fail to materialize, the overall credit ceiling could not be maintained without a commensurate reduction in credit to the private sector that would make the latter very tight.

A second risk concerns the projected decline in the value of imports. Over the last six months, imports have been artificially held down through delays in granting import licenses, a state of affairs which will be corrected by June 30, 1978. Some allowance has been made in the forecasts for the release of pent-up demand for imports, but this is obviously subject to a certain margin of error. Much will depend, for instance, on the effectiveness of credit restraint. It is in this area that the flexibility in interest rate policy to which the authorities are pledged assumes a particular importance.

A third risk concerns the foreign debt. With the sharp increase in both short-term and medium-term borrowing in recent years, the level of indebtedness and the debt service ratio have begun to be worrisome. It is important, not least for confidence reasons, that the maturity structure of debt be improved and that there be no further increase in short-term indebtedness. The authorities are aware of the problem and of the need to avoid borrowing abroad for purposes other than productive investment.

A final risk concerns Portuguese access to markets abroad. The staff notes that Portuguese exports have been harmed by protective barriers in a number of foreign markets, including those of countries that are currently providing balance of payments assistance. The staff also notes the intention of the authorities to restore automatic authorization of imports not subject to quantitative restrictions, to start phasing out the 30 per cent import surcharge, and not to increase the overall restrictiveness of the import quota system. It commends the Portuguese authorities for their commitment to a liberal trade system in the face of increasingly serious barriers to some of Portugal's exports elsewhere.

V. Conclusion and Proposed Decision

In conclusion, the staff considers that the stabilization program of the Portuguese authorities represents an ambitious and courageous but also a necessary adjustment effort. It should go a long way toward reducing the balance of payments deficit on current account to sustainable levels. Prospective further measures to restructure the economy should create the neccessary conditions for a resumption of sound economic growth.

Accordingly, the following decision is submitted for consideration by the Executive Directors:

1. The Portuguese authorities have requested a stand-by arrangement for one year from ___________ 1978 and for the equivalent of SDR 57.35 million. The Fund approves the stand-by arrangement annexed to EBS/78/228, Supplement 1 (5/23/78), and grants any necessary waiver of the conditions of Article V, Section 3(b)(iii), of the Articles of Agreement.

2. The Fund approves the retention by Portugal of the remaining restrictions on payments and transfers for current international transactions as described in EBS/77/100 and EBS/78/228, Supplement 1, until January 31, 1979.

Table 1. National Accounts, 1973-77

	1973 (In billions of escudos)	1974	1975	1976	1977 Program	1977 Outturn 1/
		Percentage change at constant prices				
Private consumption	191.0	8.0	1.0	1.0	-3.0	1.0
Public consumption	37.0	17.0	6.0	14.0	--	2.0
Total investment	74.0	-6.0	-46.0	30.0	30.0	33.0
Fixed capital formation	57.0	-4.0	-14.0	1.0	...	16.0
Stockbuilding 2/	17.0	(0.1)	(-8.0)	(5.0)	...	(4.0)
Domestic expenditure	302.0	6.0	-8.0	7.0	2.0	6.0
Exports of goods and nonfactor services	73.0	-16.0	-16.0	-1.0	15.0	10.0
Imports of goods and nonfactor services	93.0	5.0	-25.0	6.0	-2.0	14.0
Gross domestic product at market prices	281.0	1.0	-4.0	6.0	5.0	6.0
Memorandum items:						
Partner industrial countries real GNP (trade weighted)	5.5	1.0	-1.4	3.9	...	1.7
Percentage change in gross domestic product deflator	10.0	19.0	16.0	20.0	22.0	26.0

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

1/ Preliminary estimates.
2/ Change in the amount of stockbuilding, in constant prices, as per cent of previous years' GDP.

Table 2. Prices and Wages

(In per cent)

	Consumer Prices[1/]	Annual Earnings in Manufacturing	Real Wages (1973 = 100)
1974	28.0	41.0	110.2
1975	20.4	32.0	120.8
1976	18.0	19.0	121.8
1977	27.0	18.0	113.2

	Consumer Prices[1/]	
	Percentage change from preceding period (monthly average)	Percentage change from year earlier level
1976		
I	2.8	20.0
II	0.4	14.4
III	0.9	12.6
IV	2.8	21.6
1977		
January	1.0	16.5
February	3.0	21.8
March	10.0	30.9
April	2.8	34.8
May	4.4	40.6
June	-4.9	35.2
July	-3.2	30.7
August	0.3	26.6
September	0.8	23.5
October	2.6	24.0
November	1.8	22.9
December	1.7	21.5
1978		
January	4.2	25.9
February	-1.1	20.2

Source: Data provided by the Portuguese authorities.

1/ Average of consumer prices (excluding rents) for Lisbon and Oporto.

Table 3. Monetary Survey 1975-77

(In billions of escudos)

	1975	1976	1977						1978 1/
	Stock at year-end		Program	Outturn	I	II	III	IV	I
		Change during the period							
Net foreign assets	38.9	-34.4	-25.0	-57.6	-15.2	-16.8	-17.3	-8.3	-13.4
Net domestic credit	392.4	102.6	130.0	159.0	31.4	35.2	39.1	53.3	23.1
Public sector	52.6	25.6	39.0	51.6	16.4	8.1	7.4	19.7	10.0
Private sector	339.8	77.0	91.0	107.4	15.0	27.1	31.7	33.6	13.1
Money stock	391.9	68.8	105.0	105.5	13.6	26.9	24.7	40.3	18.8
Other items, net	39.4	-0.6	--	-4.1	2.6	-8.5	-2.9	4.7	-9.1
Memorandum items:									
Domestic credit expansion during previous 12-month period in per cent of initial money stock	18.8	26.2	28.2	34.5	31.1	33.8	34.6	34.5	31.8
Annual percentage change in money stock	12.6	17.6	22.8	22.9	19.6	23.2	22.9	22.9	23.3
Percentage change in income velocity 2/	-1.8	10.4	6.0	9.2	...	...	...	...	...

Source: Data provided by the Portuguese authorities.

1/ Estimate.
2/ Percentage change in nominal GDP divided by change in average money stock.

Table 4. Public Sector Finances, 1973-77

(In billions of escudos)1/

	1973	1974	1975	1976	1977 Program	1977 Outturn
Current receipts	63.5	77.8	93.2	127.1	163.1	173.6
Direct taxes and contributions to the social security system	28.6	35.8	47.1	57.5	80.9	80.5
Indirect taxes	30.4	37.3	41.8	62.2	73.1	82.1
Other	4.6	4.7	4.3	7.4	9.1	11.0
Current expenditures	54.8	76.5	102.6	149.3	181.7	182.1
Goods and services	37.1	49.1	58.0	78.5	104.2	95.0
Subsidies	2.9	7.6	7.5	19.3	12.5	21.7
Transfers	13.6	18.3	34.3	46.3	53.0	53.9
Interest on public debt	1.2	1.5	2.8	5.2	12.0	11.5
Current balance	8.7	1.3	-9.4	-22.2	-18.6	-8.5
	(3.1)	(0.4)	(-2.5)	(-4.6)	(-2.8)	(-1.3)
Capital receipts	4.0	4.5	4.0	4.4	10.0	5.3
Capital expenditures	12.2	13.5	15.9	33.1	48.2	41.5
Investment	6.4	7.8	10.3	14.9	34.4	31.9
Transfers	5.3	3.8	6.1	8.8	10.9	7.9
Net lending	0.5	1.9	-0.5	9.4	2.9	1.7
Capital balance	-8.2	-9.0	-11.9	-28.7	-38.2	-36.2
Other treasury operations, net	5.4	-1.6	-20.2	-2.0	--	-9.2
Overall balance	5.9	-9.3	-41.5	-52.9	-56.8	-53.9
	(2.1)	(-2.8)	(-11.0)	(-11.1)	(-9.0)	(-8.5)

Source: Data provided by the Portuguese authorities.

1/ Numbers in parentheses are per cent of GDP at market prices.

Table 5. Balance of Payments

(In millions of U.S. dollars)[1/]

	1973	1974	1975	1976	1977 Program	1977 Estimate[2/]
Exports	1,843	2,289	1,935	1,823	2,227	2,031
Unit values (per cent change)	23	28	-2	-10	7	5
Volumes (per cent change)	15	-3	-13	5	15	6
Imports	2,753	4,279	3,606	3,932	4,054	4,562
Unit values (per cent change)	17	47	8	-5	7	2
Volumes (per cent change)	15	6	-26	15	-2	13
Trade balance	-910	-1,990	-1,671	-2,109	-1,827	-2,531
	(-8)	(-15)	(-11)	(-13)	(-12)	(-15)
Nonfactor services, net	68	-66	-169	26	75	77
Of which:						
Tourist receipts	550	514	359	332	400	405
Capital income, net	86	120	-14	-133	-162	-177
Private transfers, net	1,097	1,112	1,037	972	1,102	1,136
Current account balance	341	-824	-817	-1,244	-812	-1,495
	(3)	(-6)	(-6)	(-8)	(-5)	(-9)
Capital account balance	-13	190	-197	-42	174	15
Overall balance	328	-634	-1,014	-1,286	-638	-1,480

Source: Data provided by the Portuguese authorities.

1/ Numbers in parenthesis are per cent of GDP.
2/ Preliminary estimate.

Table 6. Financing the Current Account Deficit

(In millions of U.S. dollars)

	1976	1977	1978 Year ending March
Current account balance	-1,244	-1,495	-1,485
Medium-term and long-term capital, net	541	414	535
Government	31	72	82
Government guarantee	89	107	152
Other private	370	165	251
Bank borrowing	41	74	54
Bank assets	--	-4	-4
Basic balance	-703	-1,081	-950
Residual, errors and omissions	-583	-399	-382
Short-term financing	...	472 1/	...
Other	...	-871	...
Overall balance	-1,286	-1,480	-1,332
Monetary movements	1,286	1,480	1,332
Bank of Portugal	1,065	836	760
Other banks	221	644	572

Source: Data provided by the Portuguese authorities.

1/ May include some short-term borrowing with commercial bank guarantee that is also shown as borrowing under "Monetary movements--Other banks."

Table 7. Medium-Term and Long-Term External Debt Outstanding 1/

(In millions of U.S. dollars)

	1975	1976	1977
	End-period		
Government	223.5	257.4	336.8
Bonds	38.0	30.4	26.5
Multilateral loans	--	22.9	53.6
Bilateral loans	185.5	204.1	256.7
Government guarantee 2/	370.8	505.6	705.4
Private banks	205.5	317.6	446.3
Bonds	26.8	23.1	67.6
Multilateral loans	60.4	94.9	123.4
Bilateral loans	63.6	54.7	48.2
Supplier's credits	14.5	15.3	19.9
Other private	533.0	761.0	926.0
Total	1,127.3	1,524.0	1,968.2

Source: Data provided by the Portuguese authorities.

1/ Disbursed debt with initial maturity of one year or more.
2/ Includes debt of the Banco de Fomento Nacional of: US$3.0 million in 1975; US$55.0 million in 1976; and US$120.0 million in 1977.

Table 8. Changes in Net Foreign Assets of the Banking System

(In millions of U.S. dollars)

	Bank of Portugal	Other Banks	Total
1977			
January	-102	-42	-144
February	-105	-70	-175
March	-67	-66	-133
1st quarter	-274	-178	-452
April	-54	-83	-137
May	-44	-143	-187
June	-149	86	-63
2nd quarter	-247	-140	-387
July	-130	-12	-142
August	-51	-64	-115
September	-47	-97	-144
3rd quarter	-228	-173	-401
October	-64	-75	-139
November	-22	-1	-23
December	-1	-77	-78
4th quarter	-87	-153	-240
Annual total	-836	-644	-1,480
1978			
January	-89	-41	-130
February	-60	7	-53
March	-49	-72	-121
1st quarter	-198	-106	-304
Year ending March 1978	-760	-572	-1,332

Source: Data provided by the Portuguese authorities.

Table 9. Balance of Payments Forecast

(In millions of U.S. dollars) 1/

	1976	1977	1978 2/	1979 3/
			Year ending March	
Exports	1,823	2,031	2,097	2,430
Unit values (per cent change)	-10	5	6	7
Volumes (per cent change)	5	6	7	8
Imports	3,932	4,562	4,652	4,730
Unit values (per cent change)	-5	2	4	7
Volumes (per cent change)	15	13	13	-5
Trade balance	-2,109	-2,531	-2,555	-2,300
	(13)	(15)	(15)	(13)
Nonfactor services, net	26	77	119	325
Of which:				
Tourist receipts	332	405	403	530
Investment income	-133	-177	-217	-325
Private transfers, net	972	1,136	1,168	1,300
Current account balance	-1,244	-1,495	-1,485	-1,000
	(8)	(9)	(9)	(6)
Medium-term and long-term capital, net	541	414	535	498
Residual, errors and omissions	-583	-399	-382	-298
Capital account balance	-42	15	153	200
Overall balance	-1,286	-1,480	-1,332	-800

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

1/ Numbers in parenthesis are per cent of GDP.
2/ Preliminary estimate.
3/ Forecast.

Table 10. Interest Rates

	1973	1974	1975	1976	1977		1978
	Year-end				As of February 28	As of August 26	As of May 8
Rediscount rate	5.00	7.50	6.50	6.50	8.00-12.00	13.00-18.00	18.00-23.00
Deposit rates							
30-90 days	3.50	4.50	4.50	4.50	5.00	6.00	8.00
180 days-1 year	6.00	9.00	9.50	9.50	11.00	15.00	19.00
1-2 years	6.50	9.50	10.50	10.50	12.00	16.00	20.00
Standard lending rates 1/							
Up to 90 days	5.75	7.75	7.75	8.75	10.25	14.75	18.25
180 days-1 year	6.75	9.25	9.50	10.50	12.00	16.50	20.00
2-5 years	8.50	11.50	11.75	12.25	13.75	17.75	21.25

Source: Data provided by the Portuguese authorities.

1/ Lower rates prevail for preferred types of credit such as for agriculture, exports, housing, and labor-intensive and export-oriented investments. The types of projects which receive subsidies have changed through time. An interest rate surcharge is applied on loans for the purchase of consumer durables.

Table 11. Monetary Program

(In billions of escudos)

	1975	1976	1977	1978 1/	1979 2/
	Stock at year end	December		March	
		Change during year ending in:			
Net foreign assets	38.9	-34.4	-57.6	-55.8	-37.4
Net domestic credit	392.4	102.6	159.0	150.7	134.3
Public sector	52.6	25.6	51.6	45.2	44.0
Private sector	339.8	77.0	107.4	105.5	90.3
Monetary liabilities	391.9	68.8	105.5	110.7	83.9
Other items, net	39.4	-0.6	-4.1	-15.8	13.0
Memorandum items:					
Domestic credit expansion in per cent of initial money stock	18.8	26.2	34.5	31.8	23.0
Annual percentage change in money stock	12.6	17.6	22.9	23.3	14.3
Percentage change in income velocity 3/	-1.8	10.4	9.2	...	7.5

Source: Data provided by the Portuguese authorities.

1/ Estimate.
2/ Program.
3/ Percentage change in nominal GDP divided by change in average money stock.

Table 12. Phasing of Monetary Program

(In billions of escudos)

	1977	1978				1979
	December 1/	March 2/	June 3/	September 3/	December 2/	March 3/
Net foreign assets	-53.1	-66.5	-78.1	-86.0	-95.9	-103.9
Net domestic credit 4/	654.0	677.1	701.6	738.6	795.7	811.4
Government, net 4/	129.8	139.8	143.8	148.8	166.8	183.8
Private sector	524.2	537.3	557.8	589.8	628.9	627.6
Monetary liabilities	566.2	585.0	595.3	618.8	656.7	668.9
Other items, net	34.7	25.6	28.2	33.8	43.1	38.6
Memorandum items:						
Net foreign liabilities 4/ (In millions of U.S. dollars)	1,352	1,656	1,922	2,092	2,297	2,457

Sources: Data provided by the Bank of Portugal; and staff estimates.

1/ Actual.
2/ Estimate.
3/ Projection.
4/ Performance test.

Table 13. Projection of Public Sector Finances

(In billions of escudos)[1/]

	1978	1979
	Year ending in March	
Current receipts	176.2	233.6
Direct taxes and contribution to the social security system	80.3	109.4
Indirect taxes	84.9	111.6
Other	11.0	12.6
Current expenditures	185.2	228.4
Goods and services	96.3	113.5
Subsidies	22.4	28.2
Transfers	55.2	59.2
Interest on public debt	11.3	27.5
Current balance	-9.0	5.2
	(-1.3)	(0.6)
Capital receipts	5.4	3.8
Capital expenditures	40.5	56.0
Investment	31.9	38.7
Transfers	7.9	6.3
Net lending	0.7	11.0
Capital balance	-35.1	-52.2
Other treasury operations, net	-9.6	-6.0
Overall balance	-53.7	-53.0
	(-8.0)	(-6.3)

Source: Data provided by the Portuguese authorities.

1/ Numbers in parentheses are per cent of GDP at market prices.

Table 14. National Accounts Forecast

	1978	1979	1979	
	In billions of escudos		Volume	Deflator
			Percentage change	
	Year ending in March			
Private consumption	502	634	--	26
Public consumption	96	114	--	19
Investment	167	192	-9	26
Fixed capital information	135	176	4	26
Stocks	32	15	-3 1/	26
Domestic expenditure	765	940	-2	25
Exports of goods and services	109	153	10	27
Imports of goods and services	206	246	-6	27
Gross domestic product at market prices	668	847	1	25

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

1/ Change in the amount of stockbuilding, in constant prices, as per cent of previous years' GDP.

Stand-By Arrangement - Portugal

1. Attached to EBS/78/228 (5/9/78) and Correction 1 (5/22/78), is a letter dated May 8, 1978 from the Minister of Finance and Planning and the Governor of the Bank of Portugal setting forth the objectives and policies which the Portuguese authorities will pursue.

2. The International Monetary Fund grants this stand-by arrangement to support these objectives and policies.

3. Portugal will remain in close consultation with the Fund during the period of the stand-by arrangement and, in particular, will consult with the Fund in accordance with paragraphs 18 and 20 of the letter of letter. These consultations may include correspondence and visits of officials of the Fund to Portugal or of representatives of Portugal to the Fund. For the purposes of these consultations, Portugal will provide the Fund, through reports at intervals on dates requested by the Fund, with such information as the Fund requests in connection with Portugal's objectives and policies set forth in the annexed letter.

4. For a period of one year from _______ 1978, Portugal will have the right, after making full use of any reserve tranche that it may have at the time of making a request for a purchase under the stand-by arrangement, to make purchases from the Fund in an amount equivalent to SDR 57.35 million, provided that

(i) purchases under the stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 14.35 million until July 1, 1978; the equivalent of SDR 24.35 million until October 1, 1978; the equivalent of SDR 34.35 million until January 1, 1979; and the equivalent of SDR 44.35 million until April 1, 1979; and

(ii) the right of Portugal to make purchases under this stand-by arrangement shall be subject to paragraph 19 of the letter of intent to the extent that such purchases would increase the Fund's holdings of escudos beyond the first credit tranche.

If at any time any limit in (i) above would prevent a purchase under the stand-by arrangement that would not increase the Fund's holdings of escudos beyond the first credit tranche, the limit will not apply to that purchase.

5. Purchases under the stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in special drawing rights if, on the request of Portugal, the Fund agrees to provide them at the time of the purchase. Purchases shall be made in exchange for escudos.

6. Portugal will pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

7. Subject to paragraph 4 above, Portugal will have the right to engage in the transactions covered by this stand-by arrangement without further review by the Fund. This right can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Portugal. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 7, purchases under this stand-by arrangement will be resumed only after consultation has taken place between the Fund and Portugal and understandings have been reached regarding the circumstances in which such purchases can be resumed.

8. (a) Repurchase of the outstanding amount of escudos that results from a purchase under this arrangement and is subject to charges under Article V, Section 8(b):

(i) may be made at any time;

(ii) will be expected normally as the balance of payments and reserve position of Portugal improves;

(iii) shall be made in accordance with the representation of the Fund if, after consultations with Portugal, the Fund represents that under its policies at the time of the repurchase Portugal should repurchase because of an improvement in its balance of payments and reserve position; and

(iv) shall be completed five years after the date of the purchase, provided that the repurchase shall be made in equal quarterly installments during the period beginning three years and ending five years after the date of the purchase unless the Fund approves a different schedule.

(b) Any reductions in escudos held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) Repurchase shall be made with special drawing rights, or with the currencies specified by the Fund at the time of the repurchase at the time of the repurchase in accordance with the policies and procedures of the Fund at the time of the repurchase.

Mr. Ware

Office Memorandum

TO : The Managing Director

DATE: May 23, 1978

FROM : Hans Schmitt HS

SUBJECT : Portugal--Wages and Employment

The following summaries of wage policy and the unemployment situation in Portugal are intended to clarify two questions you raised in connection with your reading of the draft staff paper supporting Portugal's request for a stand-by arrangement.

1. Wage legislation

Postrevolutionary governments in Portugal have introduced a number of measures that operate directly on the labor market to effect a redistribution of income. In May 1974, a legal minimum wage was introduced. As 50 per cent of the nonagricultural labor force was earning less than the minimum wage, this measure had a major impact on wage costs. The minimum wage was raised by 21 per cent in June 1975, 12 per cent in January 1977, and 27 per cent in April 1978, each time affecting a smaller proportion of the work force as the number of workers earning only the minimum wage steadily declined. In addition to this direct control of the minimum wage of workers whether or not they are unionized, the Government has undertaken to limit the wage increases that result from the process of collective bargaining. Thus, in 1977 a law was passed that limited wage increases to 15 per cent, except in the cases where increases had not been granted over an extended period of time. Despite an increase in consumer prices of 27 per cent, the increase in average annual earnings in manufacturing was held to 18 per cent. For 1978, a law has been introduced which requires that wage agreements resulting from collective bargaining cover a minimum period of 12 months and include wage increases of no more than 20 per cent. As workers earning the minimum wage will receive somewhat larger increases, wage differentials will be reduced.

2. Unemployment

Data related to employment in Portugal are limited. For a number of years after the revolution, it was thought that close to one million settlers had returned from the African territories to Portugal, a large proportion of them remaining unemployed to bring the unemployment rate to above 15 per cent. More recent estimates place the number of refugees at only some 500,000, and a recent sample survey endorsed by the I.L.O. and other outside experts, places unemployment at about 7-8 per cent. One of the most striking inferences from this survey is the ease with which the refugees were apparently absorbed in the productive sector, the result in no small part of the availability of cheap credit to set up small businesses. The Government now accepts an unemployment figure in this range, despite strong reservations in the Ministry of Labor where the rate is still estimated to be much higher.

The lack of solid information on how the postrevolutionary downturn and subsequent recovery in economic activity affected employment makes any estimates of the effect of the current stabilization effort somewhat impressionistic. Laws that were introduced shortly after the revolution limiting the dismissal of workers remain in effect. The existence of these laws has weakened the relationship between the level of activity and employment. During the recent recovery, employers were generally reluctant to undertake new hirings, and they may similarly be expected to limit dismissals during any downturn. It is also hoped that the impact of the credit squeeze will primarily be on the stockpiling of imported goods, with a much smaller impact on domestic incomes and productive investment. Even so. in the short run at least, domestic employment will probably be affected particularly in small-sized and medium-sized firms whose access to credit is likely to be restricted the most. Public expenditure on wages and salaries is to remain unchanged in real terms, meaning that public sector employment will be maintained. In the merchant marine where salaries are grossly out of line even by international standards, some layoffs are expected as subsidies are reduced. However, other nationalized industries with substantial disguised unemployment will not be greatly affected.

cc: Deputy Managing Director (o/r)
Mr. Whittome (o/r)
Mr. Pfeifer
Mr. Palmer
Mr. Ware

Portugal 1760

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

EBS/78/228
Corr. I

CONFIDENTIAL

May 9, 1978

To: Members of the Executive Board

From: The Secretary

Subject: Portugal - Request for Stand-By Arrangement

Attached for the information of the Executive Directors is the text of a letter dated May 9, 1978, from the Government of Portugal requesting a stand-by arrangement with the Fund.

The staff paper describing and analyzing the stabilization measures of the Portuguese authorities will be circulated later.

This subject has been tentatively scheduled for discussion on Monday, June 5, 1978.

Att: (1)

EBS/78/228
Corrected: 5/22/78

Lisbon, Portugal
May 8, 1978

Dear Mr. Witteveen,

1. The pressures on Portugal's balance of payments have continued strong this past year, as internal and external disequilibria proved considerably more intractable than had earlier been expected, complicated as they are by serious structural maladjustments in the economy. In fact, it is mainly through a policy directed to overcome these structural problems of the economy that the external imbalance can be controlled on a more permanent basis. A medium-term strategy to restructure and increase productivity in industry and modernize agriculture will be implemented by the authorities to achieve that aim.

2. Meanwhile a substantial stabilization effort is clearly called for to provide a solid foundation for long-term economic reconstruction and development in Portugal. Accordingly, the Government of Portugal authorizes the Banco de Portugal to request a stand-by arrangement from the Fund, under which the Banco de Portugal will have for a period of one year the right, after making full use of any reserve tranche it may have, to purchase from the Fund the currencies of other members in exchange for escudos up to an amount equivalent to SDR 57.35 million. Before making purchases under this stand-by arrangement, the Banco de Portugal will consult with the Managing Director on the particular currencies to be purchased.

3. The purpose of this request is to support the stabilization program recently adopted by the Government of Portugal, to strengthen the balance of payments and reduce inflationary pressures while maintaining a positive rate of growth of the economy to keep unemployment in check. These objectives are to be achieved through fiscal, monetary, and wage restraint combined with an exchange rate policy as outlined below. By these means the external current account deficit is to be reduced from about US$1,500 million in the period April 1977-March 1978 to about US$1,000 million in the period April 1978-March 1979. Net non-monetary capital inflows are expected to increase from US$150 million to US$200 million. This improvement in the external balance is to provide the main source of economic growth in the program period.

4. After a decline in real gross domestic product of nearly 4 per cent in 1975, the Portuguese economy recovered sharply in 1976, with real growth estimated at close to 6 per cent. It is estimated that a comparable expansion was achieved in 1977, despite a major decline in agricultural production. A shift of resources from consumption to investment and exports accompanied that expansion. Nevertheless, unemployment remained at about 7 per cent of the labor force at end-1977. At the same time, the rate of wage increases which moderated substantially in 1976 declined further in 1977, in line with the ceiling of 15 per cent placed upon it by law. Real wages appear to have been reduced in the course of 1977 by at least 7 per cent, as the rate of domestic price increases accelerated in late 1976, peaking at a very high level in May 1977 before moderating somewhat later in the year.

5. Despite the depreciation of the escudo in February 1977 and the maintenance of some import restrictions, a continued high rate of increase in domestic demand, due to the recovery of production and investment and the speculative accumulation of stocks, contributed to a further increase in the trade deficit to US$2,530 million in 1977. This deterioration was offset to some extent by significant increases in tourist receipts and emigrants' remittances, but not by enough to keep the current account deficit from rising from US$1,244 million or some 8 per cent of GDP in 1976, to US$1,495 million or about 9 per cent of GDP in 1977. The overall deficit rose from US$1,268 million to US$1,462 million, largely financed by compensatory borrowing and the use of gold reserves. As commercial banks also increased their foreign liabilities, the net foreign assets of the banking system turned negative in early 1977, if the official reserves of gold are valued at the traditional price.

6. The Government considered it appropriate, after an initial effective depreciation of 4 per cent in late August 1977, to move to a crawling peg system for the escudo. Thus, the effective rate depreciated by a total of 14.3 per cent in the 12 months through April 1978. A further adjustment of 7.0 per cent in the effective exchange rate was made in early May 1978. The authorities intend to continue the policy of the crawling peg. Exchange rate policy will in future be guided by the Government's decision not to allow the net foreign liabilities of the banking system, which stood at US$1,352 million on December 31, 1977, to exceed US$1,922 million on June 30, 1978; US$2,092 million on September 30, 1978; US$2,297 million on December 31, 1978; and US$2,457 million on March 31, 1979.

7. The authorities are determined to reduce inflationary pressures despite the prospective shift of resources to the external sector. Accordingly, to limit unnecessary pressure on the external value of the escudo, interest rates were raised in both February and August 1977. The Government decided on further substantial increases in May 1978, when the discount rate of the Banco de Portugal was raised from a range of 13-18 per cent to a range of 18-23 per cent. Interest rates on time deposits were raised by 4 percentage points to levels of 19 per cent and up on deposits of six months or more. Basic lending rates were raised 3.5 percentage points, but those for housing by only 1-2 percentage points, and those for agriculture, exports and priority investments by 2-3 percentage points, so as to minimize the impact of credit restraint on these vital sectors. The authorities consider these rates necessary for the present to check increases in the velocity of money, speculation in stocks, or adverse capital movements. They intend to raise or lower them in response to changing circumstances.

8. Monetary policy is designed to contribute substantially to the prospective improvement in the external balance and to the containment of inflation. By the close of 1977, the rate of domestic credit expansion had reached 34.5 per cent of the initial money stock, substantially exceeding the rate of growth in the money stock itself, before moderating to 32 per cent in the year ending March 1978. On average, the money stock grew by 22 per cent in 1977 compared with a 33 per cent growth in nominal GDP, but is expected to be reduced to about 18 per cent against an anticipated growth in nominal GDP of

about 27 per cent in the year to March 1979. Taking this into account along with the target for the balance of payments, net domestic credit of the banking system, the total of which amounted to Esc 654.0 billion on December 31, 1977, will not be permitted to exceed Esc 701.6 billion on or before June 30, 1978; Esc 738.6 billion on or before September 30, 1978; Esc 795.7 billion on or before December 31, 1978; and Esc 811.4 billion on or before March 31, 1979. The resulting increase in net domestic credit in the program year is estimated at about 23 per cent of money stock at the beginning of the period.

9. To give effect to these limits, the authorities have introduced indicative credit ceilings on individual banks and are prepared to make them mandatory should the need arise. To tighten credit control, domestic bank lending in escudos but denominated in foreign currencies has been included under the ceilings. More fundamentally, however, the monetary authorities intend to keep the development of the monetary base under close and continuous scrutiny and have set the following indicative targets for the program year: Esc 143.6 billion by June 30, 1978; Esc 143.6 billion by September 30, 1978; Esc 151.0 billion by December 31, 1978; and Esc 149.2 billion by March 31, 1979. To ensure that these limits are kept, the monetary authorities have gradually reduced rediscount quotas and introduced a uniform reserve requirement of 7 per cent on all monetary deposits, with the result that the banks' liquidity position has already become very tight. Finally, interest rates are being managed flexibly. Recent increases will help contain the demand for domestic credit and thus minimize the need for credit rationing.

10. A further contribution to domestic stabilization will come from fiscal restraint. A significant reduction in the deficit of the public sector was achieved in 1977, taking it down from 11 per cent of GDP in 1976 to 8 per cent in 1977, mainly in consequence of tax increases and the containment of public consumption. This improvement is to be consolidated in 1978 on the basis of the budget recently passed by Parliament. New tax measures have been authorized to raise revenues by the equivalent of 2 per cent of GDP over what they would otherwise have been. In addition, the administered price increases referred to in paragraph 12 below, will serve to limit the need for subsidies to state trading agencies and public utilities and corporations. After allowance for normal underspending, a surplus in the current account of the public sector will be achieved for the first time since 1974. There is still to be a rise in real capital expenditures, resulting mainly from an increase in equity capital subscriptions to public enterprises. Although the overall deficit of the public sector will thus remain unchanged in nominal terms, it will decline further in relation to GDP to 6 per cent in the year to March 1979.

11. The authorities intend to take every precaution to ensure that these budget outturns are realized. The revenue effort will be supplemented as necessary to make up for any revenues lost as a result of the phasing out of the import surcharge referred to in paragraph 15 below. Furthermore, any revenues from existing taxes that may exceed budgeted amounts will be used to reduce the public sector deficit and not to finance additional expenditures. Finally, during the period of the stand-by arrangement, the use of government securities to discharge tax obligations will be limited to arrears in direct taxes prior to 1977, as presently permitted by law. Thus, after allowing for other sources

of finance, the net claims of the banking system on the public sector, the total of which amounted to Esc 129.8 billion on December 31, 1977, will not be permitted to rise above Esc 143.8 billion on or before June 30, 1978; Esc 148.8 billion on or before September 30, 1978; Esc 166.8 billion on or before December 31, 1978; and Esc 183.8 billion on or before March 31, 1979.

12. To take account of increasing costs and to moderate the need for government subsidies, certain administered prices were increased substantially in April of this year. Utility rates for water, electricity and gas as well as transportation prices were raised by 35-50 per cent, while the prices of essential food products, which had been frozen since February 1977, were raised by more than 20 per cent. To ease the adjustment, the minimum wage, which had remained unchanged since January 1977, was raised by approximately 30 per cent, unemployment benefits were increased by about 25 per cent, and pensions were raised by up to 22 per cent. To help contain cost increases in the future, however, wage policy will have to remain firm, and legislation was therefore passed in April of this year limiting increases in contractual wages to 20 per cent in 1978, and requiring a minimum contract period of 12 months. Legislation was also passed in August 1977 allowing firms in financial distress to suspend wage contracts if their work force concurs.

13. Portugal's external medium and long-term debt, excluding obligations of the banking system, increased from US$1,125 million at the end of 1975 to US$1,469 million at the end of 1976 and further to US$1,848 million at the end of 1977. Most of this is either guaranteed by the Government or an obligation of public enterprises, including enterprises brought within the framework of the public sector since 1974, but not officially guaranteed. The ratio of debt service payments to exports of goods and services is estimated at 15 per cent in 1977 and is expected to rise to 19 per cent in 1978. In addition, short-term private debt has risen from US$145 million at the end of 1976 to US$717 million at the end of 1977. The Government will seek to avoid any further increase in such short-term debt during the program year. It will strengthen its efforts to avoid excessive external indebtedness and to improve the maturity profile, by continuing its policy of monitoring overall external debt developments and of coordinating foreign borrowing by public sector agencies and enterprises. Particular attention will be paid to limiting external borrowing to the financing of productive investment projects.

14. All imports are effected on the basis of import bulletins, which for imports not subject to quantitative restrictions serve a statistical purpose and enable the importer to obtain the necessary foreign exchange. For imports subject to restrictions, the bulletin is equivalent to an import license. Import bulletins are normally issued without delay. However, in late 1977 the process of authorizing import bulletins was subject to some delays, partly in conjunction with the introduction of new administrative procedures. As a result, a backlog of applications has been built up and the Government is seeking, in cooperation with private sector importers, to devise means of eliminating this problem. Already, the Government decided on May 2, 1978, that thenceforth all applications for imports of raw materials and intermediate goods would be

authorized automatically. It is the intention of the Government that this automatic procedure will be extended, no later than June 30, 1978, to all other categories of imports not subject to quantitative restrictions, and that by the same date, the backlog of import applications will have been fully eliminated.

15. The Government of Portugal abolished its import deposit requirement at the end of 1977, but still imposes an import surcharge of 30 per cent on the value of items covering about 29 per cent of total imports in 1976, and one of 60 per cent covering 2 per cent of 1976 imports. The 30 per cent surcharge will be phased out gradually: effective October 1, 1978 the rate will be reduced to 20 per cent; further to 10 per cent effective April 1, 1979; and fully abolished effective October 1, 1979. The 60 per cent import surcharge, applicable mostly to luxury goods, will be maintained temporarily, but the Government intends to study alternative domestic tax measures with a view to phasing it out beginning in 1979.

16. The temporary value quotas for certain consumer goods, applicable to about 4 per cent of 1976 imports, have been raised with effect from April 1, 1978 to an annual rate of Esc 3.405 billion, which is equivalent in foreign exchange terms to the value of these quotas in the year to March 1978. The value quotas for knocked-down automobiles, applicable to about 2.8 per cent of 1976 imports, remain unchanged in 1978 at their escudo level of 1977. All import quotas are strictly temporary and the Portuguese Government intends to review them with the Fund before the end of January 1979 with a view to reaching understandings with the Fund about steps to reduce or eliminate the restrictiveness of these quantitative import restrictions in 1979.

17. The Government establishes an annual foreign exchange budget for its own operations as well as foreign exchange budgets for the various state agencies in charge of monopoly imports of certain basic commodities, primarily foodstuffs. These budgets are, however, only indicative and the Government intends to amend these budgets from time to time so as to avoid restricting imports through rationing of foreign exchange. The Government of Portugal does not intend to introduce any multiple currency practices, or any new restrictions, or intensify existing ones, on payments and transfers for current international transactions, or to conclude any new bilateral payments agreements with the Fund members, or to introduce restrictions, or intensify existing ones on imports for balance of payments reasons.

18. Given the many uncertainties of the international and domestic economic situation, it is the intention of the Government to review the evolution of the program in January 1979 and on that occasion to reach such understandings with the Fund as may be necessary.

19. During any period of the stand-by arrangement in which the ceilings on net foreign liabilities of the banking system in paragraph 6, or the credit ceilings in paragraph 8, or the ceilings on government borrowing in paragraph 11 are not observed, or the intentions in the last sentence of paragraph 14, in the penultimate sentence of paragraph 15, and in the ultimate sentence of paragraph 17, are not carried out, or during any period after

January 1, 1979 in which understandings have not been reached with the Fund as indicated in the ultimate sentence of paragraph 16 and in paragraph 18, the Banco de Portugal will not request any purchases under the stand-by arrangement which would raise the Fund's holdings of its currency beyond the first credit tranche, except after reaching understandings with the Fund regarding the circumstances in which such purchases may be made.

20. The Government of Portugal believes that the policies set forth in this letter are adequate to achieve the objectives of the program but will take any further measures that may become appropriate for this purpose. During the period of the stand-by arrangement, the Government will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 19 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the stand-by arrangement and while any Fund holdings of escudos above the first credit tranche include currency resulting from purchases under the stand-by arrangement, the Government will consult the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Portugal's balance of payments policies.

Sincerely yours,

Dr. Vitor Constancio
Minister of Finance
and Planning

Dr. Jose da Silva Lopes
Governor
Banco de Portugal

Portugal 1760

May 8, 1978

Dear Mr. Cross:

At the request of the authorities of Portugal I am pleased to inform you that understandings have recently been reached with the authorities of Portugal on the policies and measures for a stabilization program for Portugal. These policies and measures have been set forth in a letter of intent that has been signed by the Minister of Finance and Planning and the Governor of the Banco do Portugal and has been dispatched to the Fund. The management of the Fund will recommend that the Executive Board support the program set forth in that letter by granting Portugal a stand-by arrangement in the second credit tranche. Accordingly, I am able to notify you formally at this time that the discussions that the staff of the International Monetary Fund held with the authorities of Portugal regarding a stabilization program by Portugal that I believe the International Monetary Fund can support with a stand-by arrangement in the second credit tranche have been successfully concluded.

Sincerely yours,

William B. Dale
Acting Managing Director

Mr. Sam Y. Cross
U.S. Executive Director
International Monetary Fund
Washington, D.C. 20431

bcc: The Managing Director
Mr. Pieske
Mr. Ruding
Mr. Gold
Mr. Whittome

May 8, 1978

Dear Mr. Cross:

At the request of the authorities of Portugal I am pleased to inform you that understandings have recently been reached with the authorities of Portugal on the policies and measures for a stabilization program for Portugal. These policies and measures have been set forth in a letter of intent that has been signed by the Minister of Finance and Planning and the Governor of the Banco de Portugal and has been dispatched to the Fund. The management of the Fund will recommend that the Executive Board support the program set forth in that letter by granting Portugal a stand-by arrangement in the second credit tranche. Accordingly, I am able to notify you formally at this time that the discussions that the staff of the International Monetary Fund held with the authorities of Portugal regarding a stabilization program by Portugal that I believe the International Monetary Fund can support with a stand-by arrangement in the second credit tranche have been successfully concluded.

Sincerely yours,

William B. Dale
Acting Managing Director

Mr. Sam Y. Cross
U.S. Executive Director
International Monetary Fund
Washington, D.C. 20431

bcc: The Managing Director
Mr. Wiesle
Mr. Ruding
Mr. Gall
Mr. Whittome

Portugal 1760

447244

1

MINISTÉRIO DAS FINANÇAS

GABINETE DO MINISTRO

5/8/78

ORIG: EURO
CC: MD
DMD
MR. DINI
LEG
RES
TRE
ETR
SEC

Dear Mr. Witteveen,

Our letter of intent date May 8, 1978, describes the Government's stabilization program that supports the Banco de Portugal's request for a stand-by arrangement with the Fund in the second credit tranche. This side-letter interprets the meaning of paragraph 18 of that letter.

The paragraph commits us to review the evolution of the program in January 1979 and on that occasion to reach such understandings with the Fund as may be necessary. The Portuguese authorities accept that such a review by the Executive Board of the Fund should take place not later than January 1979, and that the Banco de Portugal will not request any drawings under the stand-by arrangement after January 1, 1979, until the required understandings are reached.

The Portuguese authorities understand that the exchange rate question will be a central topic in that review. As you know, Portugal adopted a crawling peg system for the escudo in August of 1977. This framework is to be maintained, but the Bank of Portugal's practice of guaranteeing in advance the rate at which it will buy and sell forward exchange has been abolished. Exchange rate policy is now guided by the Government's decision not to allow the net foreign liabilities of the banking system to rise beyond the limits specified in paragraph 6 of the letter of intent.

The Portuguese authorities accept that meeting such a balance of payments test will require a further progressive depreciation of the escudo during the program year. For this purpose they undertake to depreciate the effective exchange rate by no less than the amounts given in the attached schedule. The adequacy of the present schedule of minimum effective depreciation rates will be reconsidered during the January 1979 review with the Fund.

Lisbon, 8th May, 1978

Sincerely yours,

Dr. Vitor Constâncio
Minister of Finance and Planning

José da Silva Lopes

Dr. José da Silva Lopes
Governor
Banco de Portugal

Portugal, 1760

447245

MINISTÉRIO DAS FINANÇAS

GABINETE DO MINISTRO

5/8/78

ORIG: EURO
CC: MD
DMD
MR. DINI
LEG
RES
TRE
ETR
SEC

Dear Mr. Witteveen,

1. The pressures on Portugal's balance of payments have continued strong this past year, as internal and external disequilibria proved considerably more intractable than had earlier been expected, complicated as they are by serious structural maladjustments in the economy. In fact, it is mainly through a policy directed to overcome these structural problems of the economy that the external imbalance can be controlled on a more permanent basis. A medium-term strategy to restructure and increase productivity in industry and modernize agriculture will be implemented by the authorities to achieve that aim.

2. Meanwhile a substantial stabilization effort is clearly called for to provide a solid foundation for long-term economic reconstruction and development in Portugal. Accordingly, the Government of Portugal authorizies the Banco de Portugal to request a stand-by arrangement from the Fund, under which the Banco de Portugal will have for a period of one year the right, after making full use of any reserve tranche it may have, to purchase from the Fund the currencies of other members in exchange for escudos up to an amount equivalent to SDR 57.35 million. Before making purchases under this stand-by arrangement, the Banco de Portugal will consult with the Managing Director on the particular currencies to be purchased.

3. The purpose of this request is to support the stabilization program recently adopted by the Government of Portugal, to strengthen the balance of payments and reduce inflationary pressures while maintaining

a positive rate of growth of the economy to keep unemployment in check. These objectives are to be achieved through fiscal, monetary, and wage restraint combined with an exchange rate policy as outlined below. By these means the external current account deficit is to be reduced from about US$ 1,500 million in the period April 1977-March 1978 to about US$ 1,000 million in the period April 1978-March 1979. Net non-monetary capital inflows are expected to increase from US$ 150 million to US$ 200 million. This improvement in the external balance is to provide the main source of economic growth in the program period.

4. After a decline in real gross domestic product of nearly 4 per cent in 1975, the Portuguese economy recovered sharply in 1976, with real growth estimated at close to 6 per cent. It is estimated that a comparable expansion was achieved in 1977, despite a major decline in agricultural production. A shift of resources from consumption to investment and exports accompanied that expansion. Nevertheless, unemployment remained at about 7 per cent of the labor force at end-1977. At the same time, the rate of wage increases which moderated substantially in 1976 declined further in 1977, in line with the ceiling of 15 per cent placed upon it by law. Real wages appear to have been reduced in the course of 1977 by at least 7 per cent, as the rate of domestic price increases accelerated in late 1976, peaking at a very high level in May 1977 before moderating somewhat later in the year.

5. Despite the depreciation of the escudo in February 1977 and the maintenance of some import restrictions, a continued high rate of increase in domestic demand, due to the recovery of production and investment and the speculative accumulation of stocks, contributed to a further increase in the trade deficit to US$ 2,530 million in 1977. This deterioration was offset to some extent by significant increases in tourist receipts and emigrants' remittances, but not by enough to keep the current account deficit from rising from US$ 1,244 million or some 8 per cent of GDP in 1976, to US$ 1,495 million or about 9 per cent of GDP in 1977. The overall deficit rose from US$ 1,268 million to

US$ 1,462 million, largely financed by compensatory borrowing and the use of gold reserves. As commercial banks also increased their foreign liabilities, the net foreign assets of the banking system turned negative in early 1977, if the official reserves of gold are valued at the traditional price.

6. The Government considered it appropriate, after an initial effective depreciation of 4 per cent in late August 1977, to move to a crawling peg system for the escudo. Thus the effective rate depreciated by a total of 14.3 per cent in the 12 months through April 1978. A further adjustment of 7.0 per cent in the effective exchange rate was made in early May 1978. The authorities intend to continue the policy of the crawling peg. Exchange rate policy will in future be guided by the Government's decision not to allow the net foreign liabilities of the banking system, which stood at US$ 1,352 million on December 31, 1977, to exceed US$ 1,922 million on June 30, 1978; US$ 2,092 million on September 30, 1978; US$ 2,297 million on December 31, 1978; and US$ 2,457 million on March 31, 1979.

7. The authorities are determined to reduce inflationary pressures despite the prospective shift of resources to the external sector. Accordingly, to limit unnecessary pressure on the external value of the escudo, interest rates were raised in both February and August 1977. The Government decided on further substantial increases in May 1978, when the discount rate of the Banco de Portugal was raised from a range of 13-18 per cent to a range of 18-23 per cent. Interest rates on time deposits were raised by 4 percentage points to levels of 19 per cent and up on deposits of six months or more. Basic lending rates were raised 3.5 percentage points, but those for housing by only 1-2 percentage points, and those for agriculture, exports and priority investments by 2-3 percentage points, so as to minimize the impact of credit restraint on these vital sectors. The authorities consider these rates necessary

for the present to check increases in the velocity of money, speculation in stocks, or adverse capital movements. They intend to raise or lower them in response to changing circumstances.

8. Monetary policy is designed to contribute substantially to the prospective improvement in the external balance and to the containment of inflation. By the close of 1977, the rate of domestic credit expansion had reached 34.5 per cent of the initial money stock, substantially exceeding the rate of growth in the money stock itself, before moderating to 32 per cent in the year ending March 1978. On average, the money stock grew by 22 per cent in 1977 compared with a 33 per cent growth in nominal GDP, but is expected to be reduced to about 18 per cent against an anticipated growth in nominal GDP of about 27 per cent in the year to March 1979. Taking this into account along with the target for the balance of payments, net domestic credit of the banking system, the total of which amounted to Esc 654.0 billion on December 31, 1977, will not be permitted to exceed Esc 701.6 billion on or before June 30, 1978; Esc 738.6 billion on or before September 30, 1978; Esc 795.7 billion on or before December 31, 1978; and Esc 811.4 billion on or before March 31, 1979. The resulting increase in net domestic credit in the program year is estimated at about 23 per cent of money stock at the beginning of the period.

9. To give effect to these limits, the authorities have introduced indicative credit ceilings on individual banks and are prepared to make them mandatory should the need arise. To tighten credit control, domestic bank lending in escudos but denominated in foreign currencies has been included under the ceilings. More fundamentally, however, the monetary authorities intend to keep the development of the monetary base under close and continuous scrutiny and have set the following indicative targets for the program year: Esc 143.6 billion by June 30, 1978; Esc 143.6 billion by September 30, 1978; Esc 151.0 billion by December 31, 1978; and Esc 149.2 billion by March 31, 1979. To ensure that these

limits are kept, the monetary authorities have gradually reduced rediscount quotas and introduced an uniform reserve requirement of 7 per cent on all monetary deposits, with the result that the banks' liquidity position has already become very tight. Finally, interest rates are being managed flexibly. Recent increases will help contain the demand for domestic credit and thus minimize the need for credit rationing.

10. A further contribution to domestic stabilization will come from fiscal restraint. A significant reduction in the deficit of the public sector was achieved in 1977, taking it down from 11 per cent of GDP in 1976 to 8 per cent in 1977, mainly in consequence of tax increases and the containment of public consumption. This improvement is to be consolidated in 1978 on the basis of the budget recently passed by Parliament. New tax measures have been authorized to raise revenues by the equivalent of 2 per cent of GDP over what they would otherwise have been. In addition, the administered price increases referred to in paragraph 12 below, will serve to limit the need for subsidies to state trading agencies and public utilities and corporations. After allowance for normal underspending, a surplus in the current account of the public sector will be achieved for the first time since 1974. There is still to be a rise in real capital expenditures, resulting mainly from an increase in equity capital subscriptions to public enterprises. Although the overall deficit of the public sector will thus remain unchanged in nominal terms, it will decline further in relation to GDP to 6 per cent in the year to March 1979.

11. The authorities intend to take every precaution to ensure that these budget outturns are realized. The revenue effort will be supplemented as necessary to make up for any revenues lost as a result of the phasing out of the import surcharge referred to in paragraph 15 below. Furthermore, any revenues from existing taxes that may

exceed budgeted amounts will be used to reduce the public sector deficit and not to finance additional expenditures. Finally, during the period of the stand-by arrangement, the use of government securities to discharge tax obligations will be limited to arrears in direct taxes prior to 1977, as presently permitted by law. Thus, after allowing for other sources of finance, the net claims of the banking system on the public sector, the total of which amounted to Esc 129.8 billion on December 31, 1977, will not be permitted to rise above Esc 143.8 billion on or before June 30, 1978; Esc 148.8 billion on or before September 30, 1978; Esc 166.8 billion on or before December 31, 1978; and Esc 183.8 billion on or before March 31, 1979.

12. To take account of increasing costs and to moderate the need for government subsidies, certain administered prices were increased substantially in April of this year. Utility rates for water, electricity and gas as well as transportation prices were raised by 35-50 per cent, while the prices of essencial food products, which had been frozen since February 1977, were raised by more than 20 per cent. To ease the adjustment, the minimum wage, which had remained unchanged since January 1977, was raised by approximately 30 per cent, unemployment benefits were increased by about 25 per cent, and pensions were raised by up to 22 per cent. To help contain cost increases in the future, however, wage policy will have to remain firm, and legislation was therefore passed in April of this year limiting increases in contractual wages to 20 per cent in 1978, and requiring a minimum contract period of 12 months. Legislation was also passed in August 1977 allowing firms in financial distress to suspend wage contracts if their work force concurs.

13. Portugal's external medium and long-term debt, excluding obligations of the banking system, increased from US$ 1,125 million at the end of 1975 to US$ 1,469 million at the end of 1976 and further to US$ 1,848 million at the end of 1977. Most of this is either guaranteed by the Government or an obligation of public enterprises, including

enterprises brought within the framework of the public sector since 1974, but not officially guaranteed. The ratio of debt service payments to exports of goods and services is estimated at 15 per cent in 1977 and is expected to rise to 19 per cent in 1978. In addition, short-term private debt has risen from US$ 145 million at the end of 1976 to US$ 717 million at the end of 1977. The Government will seek to avoid any further increase in such short-term debt during the program year. It will strengthen its efforts to avoid excessive external indebtedness and to improve the maturity profile, by continuing its policy of monitoring overall external debt developments and of coordinating foreign borrowing by public sector agencies and enterprises. Particular attention will be paid to limiting external borrowing to the financing of productive investment projects.

14. All imports are effected on the basis of import bulletins, which for imports not subject to quantitative restrictions serve a statistical purpose and enable the importer to obtain the necessary foreign exchange. For imports subject to restrictions, the bulletin is equivalent to an import license. Import bulletins are normally issued without delay. However, in late 1977 the process of authorizing import bulletins was subject to some delays, partly in conjunction with the introduction of new administrative procedures. As a result, a backlog of applications has been built up and the Government is seeking, in cooperation with private sector importers, to devise means of eliminating this problem. Already, the Government decided on May 2, 1978, that thenceforth all applications for imports of raw materials and intermediate goods would be authorized automatically. It is the intention of the Government that this automatic procedure will be extended, no later than June 30, 1978, to all other categories of imports not subject to quantitative restrictions, and that by the same date, the backlog of import applications will have been fully eliminated.

15. The Government of Portugal abolished its import deposit requirement at the end of 1977, but still imposes an import surcharge of 30 per cent on the value of items covering about 29 per cent of total imports in 1976, and one of 60 per cent covering 2 per cent of 1976 imports. The 30 per cent surcharge will be phased out gradually: effective October 1, 1978 the rate will be reduced to 20 per cent; further to 10 per cent effective April 1, 1979; and fully abolished effective October 1, 1979. The 60 per cent import surcharge, applicable mostly to luxury goods, will be maintained temporarily, but the Government intends to study alternative domestic tax measures with a view to phasing it out beginning in 1979.

16. The temporary value quotas for certain consumer goods, applicable to about 4 per cent of 1976 imports, have been raised with effect from April 1, 1978 to an annual rate of Esc 3,405 billion, which is equivalent in foreign exchange terms to the value of these quotas in the year to March 1978. The value quotas for knocked-down automobiles, applicable to about 2.8 per cent of 1976 imports, remain unchanged in 1978 at their escudo level of 1977. All import quotas are strictly temporary and the Portuguese Government intends to review them with the Fund before the end of January 1979 with a view to reaching understandings with the Fund about steps to reduce or eliminate the restrictiveness of these quantitative import restrictions in 1979.

17. The Government establishes an annual foreign exchange budget for its own operations as well as foreign exchange budgets for the various state agencies in charge of monopoly imports of certain basic commodities, primarily foodstuffs. These budgets are, however, only indicative and the Government intends to amend these budgets from time to time so as to avoid restricting imports through rationing of foreign exchange. The Government of Portugal does not intend to introduce any multiple currency practices, or any new restrictions, or intensify

existing ones, on payments and transfers for current international transactions, or to conclude any new bilateral payments agreements with Fund members, or to introduce restrictions, or intensify existing ones on imports for balance of payments reasons.

18. Given the many uncertainties of the international and domestic economic situation, it is the intention of the Government to review the evolution of the program in January 1979 and on that occasion to reach such understandings with the Fund as may be necessary.

19. During any period of the stand-by arrangement in which the ceilings on net foreign liabilities of the banking system in paragraph 6, or the credit ceilings in paragraph 8, or the ceilings on government borrowing in paragraph 11 are not observed, or the intentions in the last sentence of paragraph 14, in the penultimate sentence of paragraph 15, and in the ultimate sentence of paragraph 17, are not carried out, or during any period after January 1, 1979 in which understandings have not been reached with the Fund as indicated in the ultimate sentence of paragraph 16 and in paragraph 18, the Banco de Portugal will not request any purchases under the stand-by arrangement which would raise the Fund's holdings of its currency beyond the first credit tranche, except after reaching understandings with the Fund regarding the circumstances in which such purchases may be made.

20. The Government of Portugal believes that the policies set forth in this letter are adequate to achieve the objectives of the program but will take any further measures that may become appropriate for this purpose. During the period of the stand-by arrangement, the Government will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 19 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the stand-by arrangement and while any Fund holdings of escudos above the first credit tranche include currency

resulting from purchases under the stand-by arrangement, the Government will consult the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Portugal's balance of payments policies.

Lisbon, 8th May, 1978

Sincerely yours,

Dr. Vitor Constâncio
Minister of Finance and Planning

Dr. José da Silva Lopes
Governor
Banco de Portugal

MINISTÉRIO DAS FINANÇAS

GABINETE DO MINISTRO

PORTUGAL: EXCHANGE RATE PATTERN

	Effective Exchange Rate[1] (March 31, 1978 = 100.0)	Percentage Depreciation in Effective Terms Since Preceding Date
March 31, 1978	100.0	
April 21, 1978	101.0	1.00
May 5, 1978	108.6	7.50
May 31, 1978	110.0	1.30
June 30, 1978	111.4	1.25
September 30, 1978	115.6	3.8
December 31, 1978	120.0	3.8
March 31, 1979	124.5	3.8

1. For purposes of calculating this index, the currencies and their weights are:

US dollar	0.27327	Can.$	0.01329	F.	0.13996	Y	0.02111
D.M.	0.12812	D.Kr.	0.01641	f.	0.03740	N.kr.	0.01872
Sh.	0.01116	Ptas.	0.03756	£	0.13515	S.kr.	0.05129
B.F.	0.03193	F.mk.	0.01092	Lit.	0.04074	Sw.F.	0.03297

Portugal 1760

M.Wac

Office Memorandum

TO : The Managing Director

DATE: April 17, 1978

FROM : L. A. Whittome LAW

SUBJECT : Portugal: Negotiations for a Stand-by Arrangement in the Second Credit Tranche

The stand-by arrangement with Portugal in the first (enlarged) credit tranche which was negotiated in March 1977 was based on a program aimed at reducing the external current account deficit from US$1,225 million in 1976 (8 per cent of GDP) to US$800 million in 1977 (5 per cent of GDP), and the overall deficit to US$640 million. A group of industrial countries agreed in June 1977 to provide about US$750 million in medium-term credits over an 18-month period to support this program and to cover part of the expected 1978 deficit, provided that the Fund entered into a stand-by arrangement in the second credit tranche with Portugal.

Staff discussions with the Portuguese have taken place on an almost continuous basis since September 1977. Last fall it was already clear that the current account objective for 1977 would not be attained; indeed at that time it seemed that the deficit would be some $1.1 billion. In our early discussions we, therefore, set out to secure agreement that a deficit of $800 million in 1978 should be the objective to be sought. As the talks dragged on, so did the estimate of the current account deficit in 1977 rise, and so, therefore, the size of the adjustment being sought became increasingly more formidable.

Early this year it became clear that policies to limit the deficit to $800 million in this calendar year were not obtainable. We, therefore, shifted to discussing a deficit of $800 million in the 12-month period, April 1978 to March 1979, and indeed the Portuguese Government endorsed this objective and claimed it as its own. However, the current discussions in Lisbon have now shown that a current account deficit in 1977 reached $1.5 billion with an overall deficit of the same order.

The discussions of the past three weeks have made it clear that maintaining the original targets for the program year would necessitate an adjustment effort that is not achievable given the political constraints. For this reason, discussions have centered around a set of policies that, in the view of the staff team, could reduce the current account deficit by about one third to US$1,000 million and the overall deficit to US$800 million in the 12 months from April 1978. These amounts seem financeable, although they would require gold sales of about US$150 million, or alternatively, additional foreign bank borrowing of a similar magnitude.

The proposed program implies a reduction in the domestic real rate of growth from about 6 per cent in the base period (April 1977 to March 1978) to about 2 per cent in the program period, and a decline in the volume of domestic demand of about 1.7 per cent after an increase in 1977 of about 6.8 per cent. Both private and public consumption are projected to be unchanged, while the volume growth in gross fixed capital investment is expected to be limited to 5 per cent, compared with 12.8 per cent in 1977. The volume of exports is expected to rise by some 8 per cent and that of imports to fall by some 5 per cent.

In order to achieve these targets, the authorities are prepared to take a series of measures some of which imply a considerable concession on their part. The Minister has provisionally agreed to raise the Central Bank's rediscount rate by 5 percentage points to 18 per cent and deposit rates by 4 percentage points. Some lending rates, notably for housing, agriculture, and exports, will be raised by only 2-3 percentage points, but lending rates for many other purposes will be raised correspondingly more. The authorities have proposed a domestic credit ceiling, which would reduce the rate of increase in net domestic credit to 23 per cent over initial money stock, compared with 34.5 per cent in 1977. With respect to fiscal policy, the authorities expect on the basis of the budget passed last week, to generate a surplus on current balance equivalent to 0.6 per cent of GDP, compared with a deficit of 1.3 per cent in the base year. There is some risk that this might be offset by sharply rising capital expenditures, but we have been assured that there is an inbuilt safety margin in that the rate of implementation of projects may well be lower than anticipated. A subceiling on net domestic credit to the Government of about Esc 40 billion (about 30 per cent of the overall credit ceiling and 4.7 per cent of GDP) has been proposed.

As to the exchange rate, the authorities have proposed a depreciation, in effective terms, of about 6.5 per cent in April, to be followed by a continuation of their current policy of depreciating the effective rate by 1 per cent per month, leading to an average depreciation against the U.S. dollar of about 16.5 per cent during the program year. The Minister of Finance has, however, privately indicated that he might be prepared to make a somewhat more substantial adjustment in April, by possibly as much as 10 per cent and the staff team expects that an exchange rate policy designed to lead to about a 19 per cent average depreciation against the U.S. dollar (24 per cent in effective terms) would be consistent with the external targets.

The need for external debt ceilings has been largely avoided by the Portuguese authorities' decision to include in the foreign liabilities and domestic credit of the commercial banks all foreign credits with a Portuguese commercial bank guarantee.

A problem remains with respect to import restrictions. Since the beginning at the end of 1977, import lincenses have been granted on a more restrictive basis than in the past. The magnitude of this problem is not clear, but it is likely that some substantial delays in processing import licenses have occurred. The staff team has insisted that this restrictive practice must cease before a stand-by arrangement is approved.

I think we now have a basis for an agreement on a second credit tranche stand-by provided that the various proposals--some of them given on a personal basis by the Minister--can be translated into formal commitments.

A reduction of the current account deficit from its present rate of $1.5 billion per annum to one of $1.0 billion is a sizable achievement in itself. We would hope that further progress can be made next year when we would be expecting to discuss a further use of Fund resources.

The program hangs together. As often, one must have some doubts as to the ability of the authorities to carry it through fully. Their control over various public sector autonomous agencies is a particular weakness. But I believe that these very long discussions can and should now be properly closed if agreement can be obtained on the lines suggested above.

cc: The Deputy Managing Director
Mr. Ware

Office Memorandum

TO : The Acting Managing Director

DATE: February 10, 1978

FROM : L. A. Whittome

SUBJECT : Portugal

We have now held several hours of discussions with the technical team sent to Washington by the Portuguese authorities. This team is headed by Mrs. M. Constancio who is Director of Global Planning at the Ministry of Finance, and also the wife of the new Minister of Finance and Planning.

These discussions have disclosed a disquieting picture. The new coalition government has made a feature of its intention to reduce the rate of price increase to 20 per cent this year as against 27 per cent last year. In order to achieve this target it has become more convinced than before that the present rate of depreciation (1 per cent effective depreciation per month) is the most that can be allowed. This policy promises no improvement in Portugal's competitive position. In the absence of any special inducement to exports one would have supposed that the authorities would have decided on a tighter restraint over the growth of domestic demand. However, this does not appear to be their present intent and indeed the growth of credit foreseen in the first quarter of this year is some three times the level forecast to the mission three months ago. Moreover, much the greater part of this increase is due to increased deficit of the public sector.

In brief on present policies the current account deficit of \$1.3 billion recorded in 1977 is unlikely to fall other than marginally in 1978. The Portuguese are already facing acute financial difficulties. They have used to the full extent possible drawings on the \$750 million assistance. They have also been borrowing from international banks and they have rescheduled some commercial payments. Lastly, it seems very likely that the restrictive system is gradually being tightened. In the light of this picture I have formally told Mrs. Constancio to tell the Minister of Finance and Planning and the Governor of the Bank of Portugal that I see see no possibility of concluding a Fund stand-by arrangement unless present policies are changed. I have added that we shall be forced shortly to inform those countries that have contributed to the \$750 million credit that virtually no adjustment is likely to occur in 1978. And that in the circumstances it is not possible for the Fund to conclude any stand-by arrangement. I said that before taking such a step I would hope that the Portuguese Government would seriously reconsider the position and I suggested that together with Mr. Schmitt I might pay a brief visit to the Minister at a place of his choosing (or alternatively he could come if he were free to Washington) in order to see what measures the Government might feel able to take. I have asked for a reply from Lisbon by the end of next week and I have stressed that there is a shortage of time on both sides. On our side because some report to the creditor countries is overdue and on their side because their official reserves are very low and their further borrowing capabilities are very limited.

cc: The Managing Director (o/r)
Mr. Ware

Mr. Ware

The Managing Director

December 12, 1977

L. A. Whittome

Portugal

I think the attached letter from the Governor of the Bank of Portugal can help us feel more at ease in absorbing some of the criticism of over-harshness that is being directed at us.

The U.S. Government have just completed an inter-departmental review of their policy stance on Portugal. We have supplied the U.S. Treasury with our figuring to help them prepare their case. They now tell us that the review concluded that they should maintain their present support of the Fund's position in Portugal and should not be unduly concerned about recent political developments in Lisbon.

Attachment

cc: Deputy Managing Director
Mr. Ware

Banco de Portugal

Lisbon, December 5, 1977

Dear Mr. Schmitt,

As you may already have heard, I asked from the Government, on the beginning of October, the resignation from my functions of Governor of the Central Bank. When my decision to resign was made known, there was some speculation in the Portuguese press. One of the newspapers attributed it, at least in part, to the difficulties of the negotiations with the IMF while another hinted that I was in favour of expansionary policies.

I was asked by the Government not to enter in great explanations about the reasons of my resignation. However, in order to correct the wrong information which appeared, I stated formally to the press:

- that my resignation has nothing to do with the IMF negotiations; that I consider those negotiations of the utmost importance to the Portuguese economy; and that I regret that their conclusion is being postponed by the present political crisis in Portugal;
- that I am in no way in favour of an expansionary demand policy in the present circumstances, because of its effects on the balance of payments, although that does not mean that we should not stimulate the growth of production in the export sector and in the agricultural and fisheries sector;
- that I intend to remain in the Central Bank until the negotiations with IMF are concluded (in the assumption that the conclusion will not be excessively delayed) and until the current political crisis is over and the Government has had a reasonable period to appoint my successor.

I am sending you this clarification about my position in order to avoid the misunderstandings that might be created by the wrong news of some Portuguese newspapers. I enclose two newspapers clips which present my views quite correctly.

Yours truly,

José da Silva Lopes

José da Silva Lopes

Mr. Hans Schmitt
International Monetary Fund
Washington, D.C. 20431

Silva Lopes pede demissão a prazo de governador do Banco de Portugal

• Saída não está relacionada com negociações com F.M.I.

O governador do Banco de Portugal, dr. Silva Lopes apresentou em 10 de Outubro o pedido de demissão do cargo que vem desempenhando, mas manter-se-á em funções pelo menos até que se concluam as negociações com o Fundo Monetário Internacional.

Desmentindo uma notícia hoje publicada por um semanário, segundo a qual as razões da demissão assentariam sobre "a dificuldade e o melindre das negociações em curso com o Fundo Monetário Internacional", disse-nos esta manhã Silva Lopes:

"Isso não é verdade. O meu pedido de demissão não tem nada a ver com as negociações com o F.M.I. Eu considero que elas são necessárias e urgentes e lamento que estejam a ser atrasadas pela crise política."

Um matutino afirmava por seu turno que a demissão se deve a "um certo menosprezo perfilhado pelas entidades económicas governamentais quanto às recomendações defendidas pelos altos funcionários do banco central no que respeita às linhas fundamentais da economia portuguesa". Silva Lopes considerou não terem fundamento estas afirmações declarando, contudo, que não considera oportuno divulgar, para já, as causas da sua demissão.

Adiantou, por outro lado que elas não têm nada a ver com a crise política, já que, inclusivamente, pediu a demissão muito antes do seu desenvolvimento.

Para além disso, Silva Lopes disse que continuará no cargo até ao fim das negociações com o Fundo Monetário Internacional e eventualmente até que seja nomeado outro governo ou se proceda à remodelação do actual, só abandonando definitivamente a função depois de cumpridos os compromissos que assumiu e de ser nomeado um sucessor.

Segundo apuramos a demissão funda-se em grande parte em razões particulares a que não é alheio um certo cansaço pela actividade desenvolvida desde 1975, data em que Silva Lopes foi empossado no cargo de governador do banco, sucedendo a Jacinto Nunes.

"A LUTA" – 3.12.77

Demite-se governador do Banco de Portugal

"NAS CIRCUNSTÂNCIAS ACTUAIS É IMPOSSÍVEL POLÍTICA EXPANSIONISTA"

«Nesta altura não há utilidade em revelar os motivos da minha decisão», declarou hoje a «A Capital» o dr. José da Silva Lopes, ao confirmar a notícia do seu pedido de demissão do cargo de governador do Banco de Portugal, formulado no dia 10 de Outubro passado em carta dirigida ao ministro das Finanças.

O dr. José da Silva Lopes desmentiu, todavia, que na origem da sua decisão estejam as dificuldades das negociações com o Fundo Monetário Internacional, como insinua o «Expresso».

Ora «isso não é verdade», disse o dr. Silva Lopes, que acrescentou a este respeito: «Eu considero que as negociações com o F. M. I. são fundamentais e lamento até o atraso que elas estão a sofrer em consequência da conjuntura política.» O governador do Banco de Portugal adiantou ainda que não tem também qualquer fundamento a notícia de «O Dia», segundo a qual se poderia concluir que «eu defendo uma política expansionista para a nossa economia». E acrescentou: «Nas circunstâncias actuais é impossível uma política expansionista pelos reflexos negativos que teria na balança de pagamentos, o que não quer dizer que não se possa seguir uma política de expansão em sectores com menores reflexos na balança cambial.»

A uma pergunta do nosso redactor, o dr. Silva Lopes, que se manterá no cargo de governador até à conclusão das negociações com o F. M. I. e até que o novo elenco governativo, se for caso disso, estiver em condições de nomear o seu sucessor, declarou que está «perfeitamente de acordo com as posições defendidas pelo dr. Vítor Constâncio, vice-governador do Banco de Portugal, quando há dias foi entrevistado na RTP». Recorde-se que Vítor Constâncio justificou a política de contenção da taxa de crescimento da produção interna, como uma forma de reduzir o desequilíbrio da balança de pagamentos.

Silva Lopes: «É possível uma política de expansão em sectores com menores reflexos na balança cambial»

"A CAPITAL" - 3.12.77

Managing Director (O/C)

E

Office Memorandum

TO : The Acting Managing Director

DATE: May 18, 1977

FROM : Hans Schmitt HS

SUBJECT : Portugal--Paris Meeting on Balance of Payments Assistance

At the invitation of the United States potential participants in a "coordinated bilateral approach" to balance of payments assistance for Portugal met "informally" in Paris on May 16, 1977, to gain a common understanding of the size of the Portuguese payments problem and of the type of assistance that might be most appropriate to it. The United States took pains to down-play their leadership in the operation; the French and Belgians nevertheless stressed that they were present as observers only. A list of participants is attached.

We had been asked beforehand to supply an estimate of the size of the problem. I presented the attached table (with which the Portuguese, the EEC, and the IBRD expressed broad agreement) and said that it should be possible, with some additional effort, to contain the overall deficit within SDR 1,000 million over the two years 1977/78 combined. The BIS and various European central banks had already helped to mobilize Portuguese reserves by lending short-term against gold collateral, and the IBRD and the European Investment Bank had begun to step up long-term development assistance to Portugal. There remained the need for temporary medium-term balance of payments support to fill a gap between those two forms of assistance, which our own present resources were clearly inadequate to meet. We had just concluded a stand-by arrangement in the first credit tranche, and were prepared in principle to negotiate a second tranche arrangement this coming autumn. We looked forward to supplementing future stand-by arrangements from the "Witteveen facility" now being negotiated. The World Bank representative followed with a presentation in which he stressed the need for an early start on project preparation to ensure that disbursements under project assistance could begin within the next two or three years.

The Governor of the Bank of Portugal reported that his government had already decided to request a stand-by with the Fund in the second credit tranche this coming autumn. At that time preliminary results under the present stand-by could begin to be evaluated, and policies for 1978 would have to be formulated. He specified five "guidelines" that would shape future as well as present policies. These were: (i) a continued effort to shift resources from consumption to investment; (ii) a continued effort to increase the "efficiency" of investment; (iii) a continued commitment to maintaining the "competitiveness" of Portuguese enterprises at home and abroad; (iv) a continued commitment to "open" trade and payments arrangements; and (v) a continued commitment to restoring the "normal" working of the market mechanism.

The United States representative then offered four characteristics he thought appropriate for the additional assistance the Portuguese now required: (i) it would have to be medium-term assistance "toward the longer end" of maturities; (ii) it should be untied either to projects or to country of procurement; (iii) it should not be secured against Portuguese reserves; and (iv) it should be linked to IMF conditionality so as to ensure that the need for "extraordinary" lending would not extend beyond the end of 1978. The stress on the "extraordinary"

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character of the assistance, which would keep it from setting any precedent for application elsewhere, was picked up by most subsequent speakers. Another recurring theme was the need for broad participation if the scheme was to come off at all; the U.S. representative privately expressed some concern that even German participation might be in jeopardy if France stayed out.

For its own part, the United States offered to contribute US$300 million for the 1978 fiscal year beginning October 1, 1977. They were thinking in terms of a ten-year credit including three years grace, at a rate of interest equal to the cost of money to the U.S. Treasury, which at present stood at 7 1/2 per cent. This credit would be conditional on a "schedule of negotiation and cooperation with the Fund." In concrete terms, they hoped to be in a position to disburse the first of two tranches in the fall of 1977 as long as second tranche negotiations with the Fund were in progress or firmly scheduled, and a second tranche in the spring on condition that such negotiations had been successfully completed and all performance clauses were being met. The authorization process in Congress was nearly complete, though appropriation would be contingent on broad participation by other countries in the effort. The U.S. representative stressed that such participation could of course take various forms, depending upon each country's circumstances, as long as it met the four general criteria he had previously proposed.

As the meeting was mainly intended to serve an informational purpose, no effort was made to solicit pledges from participants, and the responses varied widely. Germany was prepared to offer a US$200 million contribution on a similar basis as the United States, and Norway US$10 million. France and Belgium, at the other extreme, stressed their observer status and referred to the sizable aid they had already extended bilaterally, through the EEC, or through the BIS; in addition Belgium stated its intention to channel all future assistance through the EEC.

Other countries had not had the opportunity to formulate a position in advance of the meeting, but promised on the basis of the information supplied to consider what their response might be. A further meeting was tentatively agreed for some time toward the end of June, perhaps in conjunction with an OECD Ministerial meeting that was scheduled to take place in Paris on June 22-26, 1977. In the interim, countries would communicate any decisions they might take to the others through the U.S. representative who offered his services as a clearinghouse for information. If progress were to turn out to be substantial, the need for such a second meeting might disappear.

My own impressions on where countries tended to lean on this occasion can be summarized as follows. On the positive side the Venezuelans seemed very much interested in participating though they could not yet specify any amounts or conditions. On the negative side, the Japanese and the Swiss stressed legislative difficulties. The Japanese thought it unlikely they could do more than encourage their commercial banks to launch a consortium loan without government guarantee. The Swiss said privately afterwards that they could probably not go beyond consolidating their outstanding short-term gold collateral credits. The Irish also showed considerable hesitation.

A number of other countries expressed themselves positive in principle but thought they needed more information particularly with regard to the role of the Fund. The Austrians hoped future talks could be held in a more "multilateral framework" and wanted more specific information than we could give on the potential contribution of the "Witteveen facility." The Canadians thought that the term "coordinated bilateral approach" should more explicitly engage the Fund as the "coordinating factor." The Swedes recognized the need to supplement Fund resources but thought their contribution would depend on what role the Fund would play in the arrangement. The Netherlands also attached "great importance" to a Fund link as well as to a "coherent approach" with the EEC.

I believe this interest in the Fund was of three kinds. There was first the convenience of relying on Fund conditionality; there was also the hope that much of the required aid could eventually be drawn from the Witteveen facility; and finally, there may also have been some thought that a more prominent role for the Fund could help to draw the French into the exercise.

Finally, the United Kingdom and Italy offered to explore most sympathetically what contribution they might be able to make within their means.

Attachments

cc: The Managing Director (o/r)
Mr. Gold
Mr. Polak
Mr. Habermeier
Mr. Sturc
Mr. Whittome (o/r)
Mr. Rose
Mr. Green

May 16, 1977

PARTICIPATION IN MAY 16 MEETING ON PORTUGAL

Austria

Klas Daublebsky
Counselor, Austrian Embassy - Paris

Rudolf Martins
Envoy extraordinary and Minister Plenipotentiary
Federal Ministry for Foreign Affairs

Walter Neudörfer
Director General, Ministry of Finance

Belgium

Luc Ceyssens
Deputy Permanent Representative, Belgian Delegation to OECD

Guy Noppen
Financial Counselor, Belgian Delegation to OECD

Canada

Yves Fortin
Chief, International Finances, Ministry of Finance

Louise Fréchette
Ministry of Foreign Affairs

Bruce Williams
Executive Vice-President, Canadian International Development Agency

European Communities

Roland de Kergorlay
Deputy Director General for External Relations

Herman Burgard
Department Head, International Monetary Relations, Directorate General for Economic and Financial Affairs

France

Isobelle Cheyvialle
Administrateur, CIME, Ministry of Economy and Finance

Jacques Moreau
Secretary of Foreign Affairs, Ministry of Foreign Affairs

Germany

Geva Willmann
Director, Country Studies, Ministry of Finance

Hans von Stein
Director, Foreign Office

Ireland

W.D. Connolly
Counselor, Development Division, Department of Foreign Affairs

Italy

Giuseppe Scaglia
Director, Office I, Ministry of Foreign Affairs

Augusto Zodda
Head of Division, Department of Treasury

Japan

Kunio Muraoka
Director, 2nd West European Division, European and Oceanic Affairs Bureau, Ministry of Foreign Affairs

Moriyuki Saito
Counselor, Japanese Embassy - Paris

Kichi Watanabe
Deputy Director General, International Finance Bureau, Ministry of Finance

Tatsuo Yamaguchi
Director, Overseas Private Investment Division, International Finance Bureau, Ministry of Finance

Netherlands

Jan Karel Bout
Financial Attaché, Netherlands Delegation to OECD

Robert Jan Van Schaik
Director, Economic Cooperation, Ministry of Foreign Affairs

Norway

Tore Boegh
Director General, Ministry of Foreign Affairs

Kjell Myhre-Jensen
Counselor, Ministry of Commerce and Shipping

Jens Otterbech
Counselor, Norwegian Embassy - Paris

Portugal

Governor Silva Lopes
Central Bank of Portugal

Victor Constancio
Vice-Governor, Central Bank of Portugal

Sweden

Olov Poluha
Head of Section of Development Assistance, Ministry of Foreign Affairs

Michael Sohlman
Economic Attaché, Swedish Delegation to OECD

Bengt Wahlstedt
Head of Development Assistance, Ministry of Economic Affairs

Switzerland

Christian Bohner
Economist, National Bank of Switzerland

P.L. Girard
Federal Department of Public Economy

Daniel Kaeser
Advisor for Monetary and Economic Affairs, Federal Finance and Customs Department

E. Thurnheer
Federal Politics Department

R. Walser
Swiss Delegation to OECD

United Kingdom

Michael Balfour
Chief Advisor, Bank of England

Geoffrey Edward Fitchew
Assistant Secretary, H.M. Treasury

United States

Paul Boeker
Deputy Assistant Secretary, U.S. State Department

James Ferrer
Economic Counselor, U.S. Embassy - Lisbon

James M. Lister
Financial Advisor to OECD

Edward Rowell
Director, West European Affairs, U.S. State Department

Donald E. Syvrud
Director, Office of International Monetary Affairs,
U.S. Treasury Department

Venezuela

Ambassador Alfredo Baldo
Ministry of Foreign Affairs

Victor Hernandez Dedordy
International Finance Manager, Venezuelan Investment Fund

IBRD

M. G. Sri-ram Aiyer
Division Chief

Martijn Paijmans
Director

International Monetary Fund

Hans Schmitt
Division Chief

OECD

Basil Gondicas
Deputy Director, Country Studies and Economic Prospects Branch,
Economics Department

Harry Travers
Counselor for International Monetary Questions, Economics Department

Portugal - Balance of Payments

(In millions of SDRs)

	1976	Variant A 1/ 1977 3/	Variant A 1/ 1978 4/	Variant B 2/ 1977 3/	Variant B 2/ 1978 4/
Exports	1,571	1,920	2,220	1,835	2,120
(Per cent change)	(-1.4)	(22.2)	(15.6)	(16.8)	(15.6)
Imports	3,385	3,495	4,120	3,565	4,200
(Per cent change)	(14.0)	(3.2)	(17.9)	(5.3)	(17.9)
Trade balance	-1,814	-1,575	-1,900	-1,730	-2,080
Services and transfers	752	875	1,045	1,010	1,090
Current balance	-1,062	-700	-855	-720	-990
(Per cent of GDP)	(8.0)	(5.1)	(5.1)	(5.2)	(6.0)
Capital flows	220	150	...	150	...
Overall balance	-842	-550	...	-570	...
Memorandum items:					
Gross domestic product	13,324	13,780	16,470	13,780	16,470
External reserves	1,121	...	...	...	...
Conversion factor (Esc/SDR)	34.9	43.1	43.1	43.1	43.1
Effective depreciation (per cent)	7.6	19.4	—	19.4	—

Sources: Portuguese authorities and staff estimates.

1/ Based on stand-by targets for 1977.
2/ Based on alternative projections for 1977.
3/ Assumes a 15 per cent increase in money wages, an increase in productivity of 5 per cent, an effective depreciation of 19.4 per cent, and therefore a decrease of 9.4 per cent in unit labor costs in foreign currency terms.
4/ Assumes a further 15 per cent increase in money wages, an increase in productivity of 3 per cent, and with stable exchange rates, an increase of 12 per cent in unit labor costs in foreign currency terms.

IMF
May 13, 1977

Portugal 1760 13

424287

Banco de Portugal

Governador

Lisbon, May 12, 1977

Dear Ms. Watkins,

I acknowledge receipt of the text of the stand-by arrangement for Portugal sent with your letter of April 29, for which I am very grateful.

ORIG: TRE
CC: MD
DMD
MR. DINI
LEG
RES
EURO
ETR
SEC

Sincerely yours,

José da Silva Lopes

José da Silva Lopes
Governor

Ms. Anna Watkins
Chief
Operation Division
International Monetary Fund
WASHINGTON

Portugal 1760

APR 29 1977

Gentlemen:

I am enclosing herewith the text of the stand-by arrangement for Portugal agreed by the Fund on April 25, 1977.

Sincerely yours,

Anna Watkins
Chief, Operations Division

Enclosure

Banco de Portugal
Rua do Comercio, 148
Lisboa 2, Portugal

CC: MR. DINI
EUR
TRE

PGGyor/hr
April 28, 1977

c. files

Portugal 1760

April 27, 1977

MEMORANDUM

To: Treasurer
Internal Auditor
General Counsel
Director, European Department
Director, Exchange and Trade Relations Department

From: The Acting Secretary

Subject: Portugal - Request for Stand-By Arrangement

At EBM/77/62 (4/25/77), the Executive Board agreed to the request of Portugal for a stand-by arangement, approved the stand-by arrangement as set forth in EBS/77/100, Supplement 1 (4/27/77), and granted any necessary waiver of the conditions of Article V, Section 3(a)(iii) of the Articles of Agreement.

KF KFriedman:gag 4/27/77

Portugal
1760

EBS/77/100
Supplement 1

CONFIDENTIAL

April 27, 1977

To: Members of the Executive Board

From: The Acting Secretary

Subject: Portugal - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Portugal agreed at Executive Board Meeting 77/62, April 25, 1977.

Att: (1)

Stand-by Arrangement - Portugal

1. Annexed hereto is a letter dated April 12, 1977 from the Government of Portugal, setting forth the objectives and policies which the authorities of Portugal will pursue.

2. The International Monetary Fund grants this stand-by arrangement to support these objectives and policies.

3. Portugal will remain in close consultation with the Fund during the period of the stand-by arrangement and, in particular, will consult with the Fund in accordance with paragraph 12 of the annexed letter. These consultations may include correspondence and visits of officials of the Fund to Portugal or of representatives of Portugal to Washington, D.C. For the purpose of these consultations, Portugal will keep the Fund informed of developments in the exchange, trade, credit, and fiscal situations through reports at intervals or dates requested by the Fund.

4. For a period of one year from April 25, 1977, Portugal will have the right, after making full use of any gold tranche that it may have, to purchase from the Fund the currencies of other members in exchange for its own currency in an amount equivalent to SDR 42.4 million. The amounts available in accordance with this paragraph 4 shall be augmented by amounts equivalent to repurchases in respect of purchases under the stand-by arrangement, unless when any such repurchases are made, Portugal informs the Fund that it does not wish the stand-by arrangement to be augmented by the amount of that repurchase.

5. Portugal will pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

6. Portugal will have the right to engage in the transactions covered by this arrangement without further review by the Fund. This right can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally (under Article XIV, Section 1(a)(ii)) or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Portugal. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 6, purchases under this stand-by arrangement will be resumed only after consultation has taken place between the Fund and Portugal, and understandings have been reached regarding the circumstances in which such purchases can be resumed.

7. No later than three years after each purchase of exchange by Portugal under this arrangement Portugal shall repurchase an amount of the Fund's holdings of Portuguese escudos equivalent to the outstanding amount of the purchase. Repurchases shall be made with assets specified by the Fund at the time of the repurchase, in accordance with the Fund's policies and practices at the time of repurchase.

8. The rate of exchange at which Portugal will purchase currencies from the Fund in exchange for the currency of Portugal and at which the Fund will return the currency of Portugal in repurchase operations and made all other computations involving the currency of Portugal will be such rate as the Fund may from time to time determine under Article IV, Section 8, of the Fund agreement.

Annex to Stand-By Arrangement

Banco de Portugal
Lisbon, Portugal

April 12, 1977

Dear Mr. Witteveen:

1. The Government of Portugal hereby authorizes the Banco de Portugal to request of the International Monetary Fund a stand-by arrangement under which the Banco de Portugal will have, for a period of one year, the right to purchase from the Fund the currencies of other members in exchange for escudos up to an amount equivalent to SDR 42.4 million. Before making purchases under this stand-by arrangement, the Banco de Portugal will consult with the Managing Director on the particular currencies to be purchased.

2. The purpose of the request is to support the policies adopted by the Government of Portugal to strengthen the balance of payments position and to create the conditions for the development of the Portuguese economy on a sound basis beyond the program period.

3. In the second half of 1974 and in 1975, Portugal experienced serious economic difficulties caused mainly by the increase in energy prices and ensuing world recession, political and social changes, the granting of independence to its overseas territories, and the barriers erected in certain countries against the admission of Portuguese workers and exports. The decline in output and the sharp increase in the labor force resulted in unemployment which, at the end of 1975, exceeded 10 per cent of the total labor force. Large increases in labor costs and in import prices contributed to inflationary pressures, and the balance of payments, which had traditionally been in surplus, recorded sizable deficits in both 1974 and 1975. Some recovery of production took place in 1976, but the current account deficit of the balance of payments increased further to over US$1 billion and inflation accelerated despite a more moderate rise in wage rates. Unemployment continued to rise, and reached 14 per cent by the end of the year. Official reserves, which represented more than 12 months of imports in 1973, are now down to little more than gold holdings, of which 40 per cent has been pledged for various compensatory borrowings.

4. On December 30, 1976 the National Assembly of the Republic approved the 1977 budget and economic plan presented by the Government. The policies described in these documents, together with the action taken on February 25, to depreciate the escudo by 15 per cent are the mainstay of the Government's program for 1977. This program aims at reducing the deficit of the balance of payments for this year from about US$1 billion to about US$650 million by curbing the growth of consumption and imports and fostering exports. At the same time, a substantial effort is to be made to expand investment on which the country's employment and capacity to export will depend in the future.

5. The budget for 1977 provides for a reduction in the current deficit of the public sector to about three quarters of its 1976 level. A major increase has been provided in budgetary appropriations for public investment designed to arrest the decline in the country's capital stock and reduce

unemployment, and any increase in the overall deficit realized by the Central Government will be due to the growth of public investment. Increases in taxes and social security premiums, decided in 1976 and early 1977, will contribute to this result and the growth of total expenditures will be slowed; salary raises for the civil service will be limited and transfers and subsidies will be reduced. Moreover, in order to contain the financial impact of the budget, the authorities intend that no new expenditure appropriations will be authorized during 1977 unless offsetting tax increases are introduced within the calendar year, no funds will be transferred from the capital budget to the current budget, and no tax collections will be postponed from 1977 to 1978. The budget provides for borrowing Esc 16 billion from the private nonbank sector in 1977. The Social Security accounts will be kept in balance for the current fiscal year, and the autonomous funds will show an overall surplus for the year. The authorities intend to limit the growth of credit from the banking system to the public sector (Central Government, Social Security, autonomous funds and services, and local authorities) in the year ending December 31, 1977, to no more than the Esc 39 billion implied by the 1977 budget. This amount may be raised by Esc 3 billion to allow for the possible introduction of fiscal incentives for investment in the export sector.

6. The growth of money and credit was moderate in 1974 and 1975 as the demand for credit by the private sector remained abnormally low; the growth of credit showed signs of accelerating during 1976. The money stock broadly defined increased by 13 per cent and 18 per cent, respectively, during 1975 and 1976 compared with a growth of nominal GDP at factor cost of 12 per cent in 1975 and nearly 25 per cent in 1976. For 1977, monetary policy will aim at contributing to the improvement in the balance of payments and the price situation while allowing for the desired expansion of investment and exports. The targeted rate of increase of the money supply will be 23 per cent, which would be below that projected for nominal income. The authorities intend, therefore, to limit the increase in total domestic credit of the banking system in the year ending December 31, 1977, to no more than Esc 130 billion, consistent with the targeted improvement in the balance of payments. Furthermore, in order to avoid an excessive utilization of credit by nonviable enterprises, it is intended that the guarantees extended by the Central Government in 1977 will not bring the total amount of guarantees above Esc 70 billion, and that most of the increase would be in support of international borrowing. The authorities have recently increased interest rates for both loans and time deposits by an average of 1.5 percentage points.

7. The recent exchange rate adjustment, added to the effective depreciation of the escudo in the course of 1976 and early 1977, is expected to restore the competitive position of Portuguese products. This improvement will encourage the necessary reallocation of resources toward the export sector and promote import substitution. Together with the intensified effort to expand investment mentioned above and the steps taken to normalize labor relations, this action will provide the foundation for economic growth in the medium term consistent with a more balanced external position. In their efforts to achieve these objectives, the authorities intend to collaborate with the Fund in accordance with the provisions of Article IV, Section 4(a).

8. Real wages declined in 1976 as price controls and food subsidies did not prevent an acceleration of inflation. For 1977, the authorities intend to allow the exchange rate adjustment to produce its desired effect on international competitiveness and domestic employment. Accordingly, the Government has decided to limit increases in salaries to 15 per cent. It is also the intention to allow increases in import prices to be fully reflected in domestic prices with the exception of a few essential products, for which subsidies will be kept within the limits set by the budget. The system of price controls has been revised to allow greater flexibility in its application. As already indicated, budgetary expenditure for price subsidies will be reduced and this reduction will not be offset by allowing a deterioration in the financial position of the Supply Fund.

9. Portugal's external public debt (direct and guaranteed; excluding compensatory borrowings) increased by about 50 per cent from US$426 million at the end of 1973 to about US$640 million at the end of 1976. Obligations of public enterprises, including enterprises brought within the framework of the public sector since 1974, and of the private sector were estimated at around US$1.4 billion at end-1976. Debt service payments in 1977 (excluding any amortization of loans against gold collateral) are estimated at around US$600 million, about 25 per cent of receipts from exports of goods and services in 1976. Much of the debt is short- and medium-term; about three quarters of total repayments are due during the next five years. With the expected improvement in the balance of payments in the period ahead, the Government intends to slow the rate of increase of the external debt and to strengthen the maturity profile by reducing reliance on financing with maturity of five years or less, insofar as availability of longer-term official development loans and conditions in international financial markets allow. The authorities will therefore monitor carefully overall external debt developments and the Treasury will coordinate borrowing by public sector entities. The contracting of supplier credits will be subject to authorization by the Banco de Portugal so as to avoid excessive increases in such borrowing and bunching of maturities. The authorities are instituting a comprehensive debt registration system to be centralized in the Banco de Portugal.

10. Despite the deterioration of the external account since 1974, all bona fide payments and transfers for current international transactions have continued to be authorized. However, the standard travel allocation of foreign exchange has been progressively reduced. Importers of capital equipment goods are now required to arrange for foreign financing in order to qualify for domestic bank credit. Foreign exchange budgets are specified for transactions of the Central Government, and indicative exchange budgets for government agencies charged with importing essential foodstuffs, fuel, and raw materials. In May 1975, Portugal introduced a temporary import surcharge on about 30 per cent of total imports. Exemptions were provided for in cases of items essential for domestic production. In October 1976, in view of the further deterioration of the balance of payments, the rates of surcharge were raised to 60 per cent on about 1.3 per cent of imports and 30 per cent on about 28 per cent. A proposal currently before the Parliament would increase the coverage of the 60 per cent surcharge to about 2.3 per cent of total imports. An import deposit requirement of 50 per cent, to be blocked without interest for six months, was applied to about 7.5 per

cent of import items within the group already subject to the surcharge. In February 1977, Portugal introduced temporary value quotas on some 6 per cent of imports, including automobile components, household appliances, coffee, and bananas. The 1977 quotas are equal to average imports for the years 1975 and 1976, but may be enlarged by the amounts of increased exports of certain of the manufactured goods involved. The Portuguese authorities intend to eliminate the import deposit requirement and to review the quantitative restrictions with the Fund before the end of 1977. The import surcharge will be phased out gradually as soon as the balance of payments position permits.

11. During the period of the proposed stand-by arrangement, the Government does not intend to introduce any multiple currency practices or impose new or intensify existing restrictions on payments and transfers for current international transactions or enter into any bilateral payments arrangements with Fund members or to introduce new or intensify existing restrictions on imports for balance of payments reasons.

12. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of the program but will take any further measures that may become appropriate for this purpose. During the period of the stand-by arrangement, Portugal will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of Portugal or whenever the Managing Director advises that consultation on the program is desirable. In any case, Portugal will consult with the Fund before the end of the program period.

Sincerely yours,

/s/

Dr. Medina Carreira
Minister of Finance

Dr. Jose da Silva Lopes
Governor
Banco de Portugal

Office Memorandum

TO : The Managing Director

DATE: April 26, 1977

FROM : L. A. Whittome / AW

SUBJECT : Portugal

The Americans are suggesting to the main industrial countries that a package of $1.5 billion over three years should be jointly provided to provide finance for Portugal's external payments. I am told that they are now concentrating on the first 15 months of this period only and are therefore looking for $700-$800 million. They are prepared to shoulder some 40 per cent of this sum ($300 million is provided for in the 1978 U.S. budget) but are looking to other countries to provide the balance; they have even approached the United Kingdom for a token contribution of $20-$25 million. They envisage the second $750 million as coming primarily, or even wholly, from the Fund's new facility.

The question bothering some Europeans has been whether these suggestions do not by-pass the Fund and they wonder how we view the matter. The Germans are particularly worried, but others as well. I have said that I have not discussed their latest thinking with the Americans in any detail. However, unless drawings under the new facility were to be very largely divorced from quotas, then it would be difficult to see that the whole of Portugal's needs either over the whole three years or even the second eighteen months of it could or should be financed by the Fund alone. Moreover, there is the difficult question of conditionality and it would undoubtedly take some time before Portugal was able to meet satisfactorily what would normally be called fourth credit tranche conditionality. Under these circumstances, I saw nothing difficult for the Fund in the U.S. approach though for myself I would like to see the bilateral disbursements tied to a continuing requirement for the Portuguese to enter into successive stand-by arrangements with the Fund. In this case, we could ensure a gradual increase in conditionality and the relatively small amounts that we might be able to disburse would carry a great weight. In particular, we would be better placed to combat the very real danger that the Portuguese may increasingly follow the road of restrictions.

cc: The Deputy Managing Director
Mr. Green

copy 5 1195

Portugal 1760

INTERNATIONAL MONETARY FUND

Washington, D.C. 20431

PRESS RELEASE NO. 77/31

FOR IMMEDIATE RELEASE
April 25, 1977

The International Monetary Fund has approved a stand-by arrangement for the Government of Portugal authorizing purchases up to the equivalent of 42.4 million special drawing rights (SDRs) over the next twelve months.

In the second half of 1974 and in 1975, Portugal experienced serious economic difficulties caused mainly by the increase in energy prices and ensuing world recession, political and social changes, the granting of independence to its overseas territories, and the barriers erected in certain countries against the admission of Portuguese workers and exports. The decline in output and the sharp increase in the labor force resulted in unemployment which, at the end of 1975, exceeded 10 per cent of the total labor force. Large increases in labor costs and in import prices contributed to inflationary pressures, and the balance of payments, which had traditionally been in surplus, recorded sizable deficits in both 1974 and 1975. Some recovery of production took place in 1976, but the current account deficit of the balance of payments increased further to over US$1 billion and inflation accelerated despite a more moderate rise in wage rates. Unemployment continued to rise and reached 14 per cent by the end of 1976. Official reserves are down to little more than gold holdings, part of which has been pledged for borrowing abroad.

The Government's economic program, in support of which the present stand-by arrangement has been approved, is to reduce the balance of payments deficit by containing consumption and imports and to stimulate investment and exports. The former objective is to be achieved by limiting wage increases, by allowing prices to reflect cost developments, and by fiscal policy; the latter is to be sought through stepped-up public capital expenditure and measures to improve the financial position of enterprises, particularly changes in labor legislation designed to improve productivity. The depreciation of the escudo in February 1977 is an essential part of the program: by raising the domestic cost of imports and restoring the competitiveness of Portuguese exports it can be expected to make a substantial contribution, in combination with the restraints placed on credit expansion, to the desired reduction in the balance of payments deficit.

Portugal's quota in the Fund is equivalent to SDR 117 million. The Fund's holdings of escudos representing purchases from the Fund which are subject to repurchase are equivalent to SDR 202.5 million, including SDR 114.8 million resulting from purchases under the oil facility and SDR 58.5 million resulting from a purchase under the compensatory financing facility.

1160 12

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OFFICIAL MESSAGE
INTERNATIONAL MONETARY FUND

Washington, D.C. 20431

TIME RECEIVED APR 25 PM 6 35

ADDRESS

BANCO DE PORTUGAL
RUA DO COMERCIO, 148
LISBON 2, PORTUGAL

Special Instructions

Cleared with Secretary's

NO. 6

PRIMO. EXECUTIVE BOARD TOOK FOLLOWING DECISIONS ON APRIL 25, 1977.

QUOTE

1. THE GOVERNMENT OF PORTUGAL HAS REQUESTED A STAND-BY ARRANGEMENT FOR A PERIOD OF ONE YEAR FROM APRIL 25, 1977, AND FOR THE EQUIVALENT OF SDR 42.4 MILLION. THE FUND APPROVES THE STAND-BY ARRANGEMENT SET FORTH IN EBS/77/100, SUPPLEMENT 1, AND GRANTS ANY NECESSARY WAIVER OF THE CONDITIONS OF ARTICLE V, SECTION 3(A)(III), OF THE ARTICLES OF AGREEMENT.

2. THE FUND APPROVES THE RETENTION BY PORTUGAL OF THE MULTIPLE CURRENCY PRACTICES AND RESTRICTIONS ON PAYMENTS AND TRANSFERS FOR CURRENT INTERNATIONAL TRANSACTIONS AS DESCRIBED ABOVE UNTIL THE ~~EN~~ NEXT ARTICLE XIV CONSULTATION WITH PORTUGAL.

UNQUOTE

/C

Distribution

CC: TRE
MD
DMD
MR. DINI
LEG
RES
EURO
ETR
SEC

copy 4/17 10

MESSAGE MUST END HERE

Drafted by: PGGyor/mw	David S. Cutler — NAME (TYPE) — SIGNATURE
Department: TRE	NAME (TYPE) — SIGNATURE
Date: April 25, 1977	

FOR CABLE ROOM USE ONLY

No. of words: 7 min. Log: 347739 Route: WUI Operator: JEH

FC-17/OCR

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OFFICIAL MESSAGE
INTERNATIONAL MONETARY FUND

Washington, D.C. 20431

RECEIVED IMF

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TIME RECEIVED

ADDRESS

BANCO DE PORTUGAL

-2-

Special Instructions

SECUNDO. 1. TEXT OF ~~STANDBY~~ STAND-BY ARRANGEMENT FOLLOWS BY AIRMAIL.

2. CHARGE ON STAND-BY ARRANGEMENT AMOUNTS TO THE EQUIVALENT OF SDR 106,000. THIS CHARGE IS PAYABLE IN SPECIAL DRAWING RIGHTS, OR IN ACCORDANCE WITH ARTICLE V, SECTION 8(F) OF THE FUND AGREEMENT AND RULE I-5 OF THE FUND'S RULES AND REGULATIONS, OR IN U.S. DOLLARS INTO THE FUND'S NO. 1 ACCOUNT AT FEDERAL RESERVE BANK OF NEW YORK, NEW YORK. LATTER AMOUNT, CALCULATED ON BASIS OF RATE AT WHICH FUND PRESENTLY ACCOUNTS FOR ITS HOLDINGS OF U.S. DOLLARS, I.E., SDR 0.860184 PER U.S. DOLLAR IS U.S. DOLLARS 123,229.45.

3. IF YOU DESIRE TO PAY ABOVE CHARGE IN SPECIAL DRAWING RIGHTS, PLEASE ADVISE FUND BY CABLE AS FOLLOWS:

QUOTE

REFERENCE YOUR CABLE APRIL 25, 1977 WE /C

Distribution

MESSAGE MUST END HERE

Drafted by: PGGyor/mw

Department: TRE

Date: April 25, 1977

David S. Cutler

NAME (TYPE) SIGNATURE

NAME (TYPE) SIGNATURE

FOR CABLE ROOM USE ONLY

No. of words: Log: Route: Operator:

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CHECK SERVICE

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Full Rate ☐
Code ☐

OFFICIAL MESSAGE

INTERNATIONAL MONETARY FUND

Washington, D.C. 20431

DISPATCHED IMF

1977 APR 25 PM 6: 35

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ADDRESS

BANCO DE PORTUGAL

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Special Instructions

DESIRE TO PAY STAND-BY CHARGE IN SPECIAL DRAWING RIGHTS PURSUANT TO ARTICLE XXV, SECTION 7(C)(I) AND EXECUTIVE BOARD DECISION NO. 2901-(69/122) G/S, ADOPTED DECEMBER 18, 1969. ACCORDINGLY, PLEASE DEBIT PORTUGAL'S HOLDINGS ACCOUNT IN THE SPECIAL DRAWING ACCOUNT WITH SDR 106,000 UNDER CABLE ADVICE.

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1. PORTUGAL - STAND-BY ARRANGEMENT

The Executive Directors continued from the previous meeting (EBM/77/61, 4/25/77) their consideration of a request by Portugal for a stand-by arrangement, together with the staff's analysis and recommendation (EBS/77/100, 4/12/77; and Cor. 1, 4/21/77).

Mr. Leddy said that the request was welcome and he fully supported it. Portugal clearly faced extraordinary economic problems resulting from the fundamental changes in its political structure, the economic disruption caused by decolonization--including a sharp increase in the labor force--and the persistent weakness in the economies of some other European countries. The solutions to the present problems would take time and courageous action, and the proposed financial program was a step in the right direction. The fiscal measures that had already been introduced were encouraging; he hoped that the efforts to improve tax revenues and to increase charges on public utilities would enable the authorities to reduce both the overall deficit and public sector borrowing, thereby containing inflation and freeing resources for private investment.

Eliminating rigidities in the labor market and phasing out price controls and subsidies, Mr. Leddy commented, would help to improve resource allocation and productivity. The recently adopted import controls were probably unavoidable, but they should be removed as soon as possible. The proposal before the Parliament for increasing the coverage of the surcharge seemed inconsistent with the Government's commitment not to intensify the existing restrictions. The Government would have to mount a determined effort to deal with the deep-seated problems, and considerable foreign financial assistance would be required. He was pleased that the Fund was supporting the country's efforts.

Mr. Kent remarked that he generally accepted the proposed program and the staff analysis. The program obviously went in the right direction, but he wondered whether it went far enough. For instance, the public expenditure that had been delayed in 1976 might take place in 1977, thereby adding to public demand. In addition, the high rate of inflation would impose strains on the incomes policy and on activity in the private and external sectors.

The sharp increases in prices in 1976, Mr. Kent noted, had been largely corrective, but they were partly attributable to shortages of certain goods because of balance of payments constraints and distribution problems. It seemed best to rely on administrative measures rather than on price increases to correct the distribution difficulties. In its appraisal the staff had emphasized that some time would certainly lapse before the authorities could be expected to make the needed improvements in organization and management; in that respect the proposed stand-by arrangement represented merely a first step in the right direction.

The authorities expected improvements both in remittances from workers living abroad and in tourism, Mr. Kent observed. But he was worried that, while the present exchange rate might be appropriate in terms of Portugal's external competitiveness, it might not act to encourage workers' remittances or tourism. It seemed likely that the amount of workers' remittances would not increase as long as a further decline in the exchange rate was widely thought to be imminent. Such a decline would create a climate of instability that would probably discourage tourism to some extent.

The staff projection of an 8 per cent increase in market shares in 1977 seemed overoptimistic, Mr. Kent commented. And the meaning of Chart 3 was not clear. It depicted the movement in relative wages and in the effective exchange rate between 1973 and 1976, and it seemed to show that Portugal's competitiveness had not been fully restored. Did the staff mean to imply that Portugal's competitive position in 1976 was not as strong as it had been in 1973, and that further improvement should be made?

The Letter of Intent, Mr. Kent noted, showed that, while nominal income was to rise by 23 per cent in 1977, wages were to increase by only 15 per cent. He wondered whether the figure for nominal income was realistic. He also wondered what the term "non-viable enterprises" on page 15 meant. The debt registration system established within the Banco de Portugal was welcome and, as a general rule, the Fund should do more than it had in the past to encourage members to set up such monitoring mechanisms before difficulties arose, rather than afterward.

The statement in the decision on the retention of multiple currency practices, Mr. Kent said, seemed inconsistent with the statement in the Letter of Intent that "the Government did not intend to introduce any multiple currency practices." Finally, he hoped that the proposed program would be successfully implemented and that the Fund would be able to consider drawings by Portugal in the higher credit tranches in the near future.

Mr. Avillez, speaking on behalf of Mr. Kafka, stated that he fully approved the proposed decision. The way in which the Portuguese people had weathered the enormous difficulties of the previous several years was commendable, and the Government had adopted a courageous program for gradually restoring appropriate fiscal, financial, and balance of payments positions. The reduction of the overall public sector deficit from 11 per cent of GDP to 9.6 per cent was substantial in comparison with a number of previous cases. More important, the current deficit of the public sector had been reduced from 5.5 per cent of GDP to around 3 per cent. The authorities had faced the problem of excessive increases in wages squarely; they had maintained tight control over wages rather than resorting to the somewhat easier alternative of a further devaluation of the currency. Consumption was being reduced to make room for the necessary expansion of investment and exports.

The proposed targets for credit and the money supply seemed reasonable, Mr. Avillez continued. But the staff was inconsistent in maintaining on the one hand that the use of restrictions was regrettable while recognizing on the other that no realistic alternative had been available. He hoped that Portugal would receive a generous amount of international financial assistance.

Mr. de Vries considered that the authorities were making a reasonable effort to deal with the balance of payments problems and he accepted the draft decision. Unfortunately, they had been faced with massive economic problems that would probably continue to exist in the medium term. A large current account deficit and the substantial monetary financing of the budget deficit showed that major structural changes in the economy were needed. As Mr. Dini had emphasized, Portugal needed to find new export markets to replace those in the former colonies, but that would of course take some time and considerable long-term international assistance. The Fund assistance under the proposal represented no more than a partial solution to Portugal's difficulties.

In the short term, Mr. de Vries said, the profitability of state enterprises would have to be restored, and the line between the public and private sectors would have to be clearly established. The tax measures that had recently been introduced were welcome, and the goal of setting real wages at the 1973 wage level was impressive. A decline in real wages was certainly unfortunate for Portuguese workers, but it was a prerequisite for the achievement of the important goal of increasing production. Once gains in productivity had been registered, there would be room for real increases in wages.

The newly introduced restrictions were regrettable, Mr. de Vries remarked. While it was true that the authorities probably had no alternative in the short run, it would be difficult for them to remove the restrictions without changing the exchange rate. In any event, in the light of the high rate of inflation, the authorities would probably have great difficulty keeping the exchange rate pegged at its present level for very long. The recent adjustment of the rate had been late.

He agreed with Mr. Dini, Mr. de Vries said, that in the long run Portugal would require a considerable inflow of capital and know-how. But he did not agree that the case of Portugal demonstrated the inadequacy of the resources that the Fund could at present provide to members in need. As Mr. Pieske had noted, the proposed stand-by arrangement involved drawings only in the first credit tranche, leaving the higher credit tranches available for the future; the resources that Portugal would receive under the proposal were related more to the country's policies and economic situation than to the state of the Fund's resources. The authorities had made a major effort to deal with the problems, but they had started from a low point, and at the moment Portugal did not qualify for more assistance than would be provided under the proposed decisions. Still, progress was being made, and the Government was to be commended for the courageous steps that it had taken thus far.

Mr. de Groote commented that he warmly supported the proposed decisions. The problems facing the Government were certainly serious, but the country had just come through an unusually difficult period of major political and social change. He was pleased that the authorities had not presented a program until they had gathered sufficient domestic support for it; hence, while the proposed policies were relatively modest, they seemed quite realistic.

He was aware of Portugal's need for a considerable inflow of capital and know-how, Mr. de Groote remarked, and he was pleased that, as the staff had reported, some private capital inflow in the form of trade credits had been recorded in 1976. He hoped that the approval of the stand-by arrangement would open up other possibilities for assistance.

While the introduction of restrictions was certainly regrettable, Mr. de Groote considered, the authorities had probably had no alternative in the present difficult circumstances. Presumably, the measures were meant to be temporary.

The authorities faced two major tasks over the medium run, Mr. de Groote remarked. First, a decline in real wages over more than one year seemed a prerequisite for the needed reallocation of resources from the domestic sector to exports. Although it might cause social and political problems, there seemed no other way out of the present difficult situation. Second, the authorities would have to introduce incentives for investment, especially in the private sector; the proposed program contained none, and such measures would presumably be a topic of discussion during future consultations with the authorities.

Mr. Masunaga considered that, in the light of the present serious situation, the authorities had had no choice but to adopt very stringent policies--including a large reduction in the fiscal deficit, a restrictive monetary policy, and severe constraints on wage increases--as a means of transferring resources from consumption to exports and investment. The Government was to be commended for the policies that it had undertaken since the final months of 1976, especially in the fiscal field. The draft decisions were acceptable; the implementation of the proposed program would be a first, but important, step toward restoring confidence in the economy and regaining the sustained growth that had been recorded in the 1960s.

Some of the factors that had led to the present difficult situation, Mr. Masunaga observed, had been beyond the control of the authorities and would make it difficult for them to implement the proposed program. Still, the quality of their own economic management would be a crucial factor in the coming years, especially with respect to the containment of inflation and the smooth financing of the large balance of payments deficits that were forecast. In addition to Fund assistance in the higher credit tranches and other forms of international credit, he wondered whether it was acceptable for the Government to explore the possibility of mobilizing some of its gold holdings, especially in the light of the present high debt service ratio.

Mr. Hollensen said that his authorities approved the proposed decisions. The amount involved was modest in comparison with the actual size of the balance of payments deficit, and the Government obviously would have to rely on substantial long-term loans and grants. The root causes of many of the major problems in Portugal were the loss of the colonies and the large migration of settlers; further assistance for Portugal might have to come from sources that were more political than the Fund. At the same time, the Portuguese request was unusual; members wishing to make structural adjustments in the wake of important domestic political changes rarely still had their first credit tranche available.

Mr. Drabble commented that the unusual combination of massive problems in Portugal was striking. It would be difficult for any country to adjust to a loss of colonies, absorb a large number of former settlers, cope with the adverse effects of an international recession, weather a social and political revolution, and respond to long-pent-up ambitions for a major redistribution of income.

He was somewhat worried, Mr. Drabble said, that the authorities might not have sufficient control over public expenditures. The actual outcome in 1976 with respect to the performance of the public sector and the balance of payments was much less favorable than the authorities had predicted, and he would have welcomed some additional staff comments on the Government's efforts to institute budgetary controls, especially for current expenditures. A recurrence of the overruns of 1976 would undermine the successful implementation of the desirable and relatively ambitious public investment program. The intentions of the authorities were certainly commendable, and he hoped that they would be able to carry them out. But he had been struck by Mr. Pieske's remarks at the previous meeting to the effect that the efficiency of the economy could probably be improved even without an ambitious investment program. Such comments underscored the difficulties of financial management arising from the extension of public ownership in a number of major areas. The question could be raised whether the authorities had the administrative capacity to ensure that the high degree of efficiency that was needed would in fact be achieved.

While he too regretted the introduction of restrictions, Mr. Drabble commented, it was worth noting that in 1976 the volume of textile exports--traditionally Portugal's most important currency earner--had declined, primarily because of voluntary limitations on exports to the United Kingdom and to some important northern European markets. In considering the wisdom of providing Portugal with financial assistance, governments should appreciate that, in comparison with many other countries, Portugal faced many large problems.

Mr. Ng said that he welcomed the Government's courageous proposals for reducing the balance of payments deficit and containing inflation by gaining monetary and fiscal discipline and by moderating wage increases. The measures that had been introduced during the previous year had helped to deal with problems that had arisen earlier. That some problems remained to be solved was certainly understandable, and he hoped that they would be corrected early.

Mr. Nana-Sinkam stated that he warmly supported the draft proposals. The country's major difficulties stemmed largely from its courageous and laudable decision to grant independence to its colonies. Any lasting improvement in the economy of Portugal would be highly beneficial for its former colonies as well. The favorable impact on the balance of payments of the devaluation of the exchange rate in February 1977 had proven insufficient, and the proposed program and drawing should be seen as a first step toward a substantial improvement in the Portuguese economy; the authorities would have to make further efforts, especially to improve productivity, contain inflation, and strengthen their control over the budget.

The staff representative from the European Department explained that the authorities had decided to peg the exchange rate to a basket of currencies because they felt that the rate had reached an appropriate and competitive level. Chart 3 might seem to be misleading but only because it stopped in the third quarter of 1976. Staff calculations showed that the present exchange rate took into account price and cost developments up to the end of 1977. In the staff view, the present exchange rate was fully competitive. The authorities had made it clear that they wished to avoid the problems that had arisen in 1976 when the gradual depreciation of the currency had led to speculative imports and to delays by workers living abroad in remitting their earnings.

An improvement in productivity was needed, the staff representative commented, but that was a long-term goal that would involve a number of specific measures, such as training new managers. In the short run the authorities had no alternative but to reduce consumption. In 1975 total private and public consumption had exceeded GNP; such a situation obviously could not continue for long, especially in the light of the large balance of payments deficit. Much of the consumption was of imports, and a reduction in consumption in Portugal would not necessarily involve a decline in production.

The authorities' record with respect to restrictions was good, the staff representative said. They had conscientiously fulfilled their obligations under the oil facility to consult with the staff. It was the staff's understanding that the proposal to extend the 60 per cent surcharge had been accepted by the Parliament but had not yet been implemented.

As Mr. Kent had noted, the staff representative recalled, there would be some postponement of public expenditure from 1976 to 1977, which helped to explain why the budget situation for 1976 looked somewhat better than the figures for credit to the public sector from the banking system would suggest. As to the staff projection of an 8 per cent gain in market shares in 1977, that meant that the export volume for Portugal was expected to increase by 8 per cent more than the trading partners' volume of imports from Portugal. Total exports by volume in 1977 were expected to increase by 15 per cent; for a small economy like that of Portugal, such large figures were not unreasonable. The volume of exports had declined by 14 per cent in 1975.

"Non-viable enterprises," the staff representative explained, were enterprises that could not survive without substantial financial support from the Government. In a related area the authorities had decided to introduce incentives for investment, especially for export industries. The incentives had not been implemented yet and, therefore, they had not been mentioned in the proposed program. The staff expected the incentives to come into force soon.

The Deputy Director of the Exchange and Trade Relations Department added that the staff interpreted the Government's import deposit scheme as a multiple currency practice. The reference to restrictions in the stand-by arrangement would apply to any intensification of the import deposit scheme, as well as to the introduction of any further multiple currency practices or new restrictions on payments and transfers for current international transactions.

Mr. Dini said that in stating earlier that the case of Portugal demonstrated the inadequacy of Fund resources he had meant that the balance of payments deficit of Portugal was so large that the use of Fund resources alone could not be expected to be sufficient to cope with Portugal's extraordinary circumstances and difficult problems. Portugal was interested in obtaining further assistance from the Fund, and to that end the authorities would endeavor to set up a financial program that could be regarded as adequate for access to the higher credit tranches. However, even then the resources the Fund could make available to Portugal would be relatively small--given the quota limitation and present policies--in relation to Portugal's balance of payments need. It would not be reasonable for the Fund to seek to impose on Portugal stringent policy conditions--even for a stand-by in the highest tranches--to reduce drastically in the short run a balance of payments deficit that was the result of major structural changes that had taken place in the economy over the previous three years. Hence, he and other Executive Directors had indicated that external long-term loans and grants would be needed by Portugal in the coming years, in addition to the financing the Fund could make available under the credit tranche policies.

As to the possibility of mobilizing some of Portugal's gold holdings, one way was to obtain credit from other central banks by pledging gold, Mr. Dini said; Portugal was already doing so. Another possibility was to dispose of the gold altogether, which the authorities were less willing to do, especially if that were to require sales through the market rather than through official channels.

The Executive Board then turned to the proposed decision, which it approved.

The decision was:

1. The Government of Portugal has requested a stand-by arrangement for a period of one year from April 25, 1977, and for the equivalent of SDR 42.4 million. The Fund approves the stand-by arrangement attached to EBS/77/100, Supplement 1, and grants any necessary waiver of the conditions of Article V, Section 3(a)(iii) of the Articles of Agreement.

2. The Fund approves the retention by Portugal of the multiple currency practices and restrictions on payments and transfers for current international transactions as described above until the next Article XIV consultation with Portugal.

Decision No. 5389-(77/62), adopted
April 25, 1977

2. ZAIRE - PURCHASE TRANSACTION - COMPENSATORY FINANCING, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff's recommendation and analysis with respect to a request from Zaïre for a purchase under paragraphs 2, 3 and 4 of the Decision on Compensatory Financing of Export Fluctuations (EBS/77/120, 4/20/77; Cor. 1, 4/22/77; and Sup. 1, 4/25/77), and a request by Zaïre for a stand-by arrangement in an amount equivalent to SDR 45 million, together with the staff's analysis and recommendation (EBS/77/121, 4/20/77; and Cor. 1, 4/22/77).

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4. SWISS NATIONAL BANK - PROPOSED BORROWING AGREEMENT, AND BORROWING OF U.S. DOLLARS - REQUEST FOR APPROVAL OF THE UNITED STATES UNDER ARTICLE VII, SECTION 2(i)

The Executive Directors considered a paper proposing a borrowing agreement with the Swiss National Bank (EBS/77/117, 4/19/77) and a proposal to send a letter from the Managing Director to the Secretary of the Treasury of the United States requesting approval of the United States of the borrowing of U.S. dollars by the Fund (EBD/77/96, 4/19/77).

Without discussion, the Executive Board approved the proposed decisions.

The decisions were:

a. Proposed Borrowing Agreement

The Executive Board approves the letter attached to EBS/77/117 from the Managing Director to Dr. Fritz Leutwiler, President of the Directorate of the Swiss National Bank, which proposes the terms and conditions on which the Fund would borrow from the Swiss National Bank.

Decision No. 5387-(77/61), adopted
April 25, 1977

b. Borrowing of U.S. Dollars - Request for Approval of the United States Under Article VII, Section 2(i)

The letter from the Managing Director to the Honorable W. Michael Blumenthal, Secretary of the Treasury of the United States, requesting that the United States approve the borrowing of U.S. dollars by the Fund, attached to EBD/77/96, is approved.

Decision No. 5388-(77/61), adopted
April 25, 1977

5. PORTUGAL - STAND-BY ARRANGEMENT

The Executive Directors considered a request from Portugal for a stand-by arrangement in an amount equivalent to SDR 42.2 million, together with the staff's analysis and recommendation (EBS/77/100, 4/12/77; and Cor. 1, 4/21/77).

Mr. Dini made the following statement:

The dramatic changes that have taken place in Portugal since 1974 have brought about major imbalances in the country's economy.

The Executive Board then turned to the proposed decisions, which it approved.

The decisions were:

a. <u>1977 Article VIII Consultation</u>

In view of the present circumstances of Italy, the Fund approves the continued application of the restriction on the exchange available for travel as described in EBS/76/512 (12/10/76), until April 30, 1978.

Decision No. 5384-(77/61), adopted
April 25, 1977

b. <u>Stand-by Arrangement</u>

The Government of Italy has requested a stand-by arrangement for the period up to December 31, 1978 for the equivalent of SDR 450 million. The Fund approves the stand-by arrangement annexed to EBS/77/98, Supplement 1, and grants any necessary waiver of the conditions of Article V, Section 3(a)(iii), of the Articles of Agreement.

Decision No. 5385-(77/61), adopted
April 25, 1977

3. <u>GENERAL ARRANGEMENTS TO BORROW - PROPOSAL FOR FUTURE CALLS</u>

The Executive Directors considered a decision on the Managing Director's proposal to activate the General Arrangements to Borrow (EBS/77/101, Sup. 1, 4/22/77). They also had before them the text of a communication setting forth the Managing Director's proposal for future calls for exchange transactions under the proposed stand-by arrangement for Italy (EBS/77/101, 4/12/77).

Without discussion, the Executive Board approved the proposed decision.

The decision was:

Pursuant to Paragraph 7(a) of the General Arrangements to Borrow, the Executive Board approves the Managing Director's proposal of April 11, 1977 (EBS/77/101, 4/12/77) for future calls for exchange transactions under the stand-by arrangement for Italy (Executive Board Decision No. 5385-(77/61)).

Decision No. 5386-(77/61), adopted
April 25, 1977

Aside from the reorganization of the production and services sectors, in which the Government has assumed a major role, the decolonization has involved the loss of the overseas territories market for Portuguese exports and a large increase in population at a time when the domestic economy has been suffering from inevitable disruptions connected with the intervening structural changes.

Portugal is now taking action to tackle the problems that have emerged and to reduce the imbalances in the economy. By the end of 1976 substantial efforts had already been made in the fiscal field. In that year, with the introduction of tax reforms, total tax revenue increased much more rapidly than nominal GNP; both current and capital expenditures were contained below appropriations; and the current deficit of the public sector at 26 billion escudos was one third lower than budgeted. In 1977 the Government intends to cut further the current public sector deficit to 19 billion escudos, and to reduce the total deficit to some 9.5 per cent of GNP. To this end public utility rates have been increased and price subsidies have been reduced. These actions represent a sharp reversal of past trends, and are expected to restrain consumption substantially. Strong wage control measures have also been introduced. Real wages--which, according to my Portuguese authorities, declined by more than 5 per cent in 1976--are expected to fall further by 9 per cent in 1977, with the effect of more than offsetting the increase that had occurred in 1975 and bringing real wages back to the level prevailing in 1973.

With the reduction in real wages and the containment of private and public consumption, together with the substantial depreciation of the escudo and a restrictive monetary policy, the Government program aims at reducing pressures on resources and at bringing about a substantial reduction in the current account deficit of the balance of payments.

No doubt the adoption of these measures and policies has required major efforts on the part of the Government and has not been obtained without difficulties. Despite all this, and even with the success of the financial program that has been initiated, Portugal will continue to be confronted with serious economic problems. The balance of payments deficit remains very large, and inflationary pressures are still strong. At the same time, the creation of employment opportunities is urgently needed to reduce unemployment (currently equivalent to 14 per cent of the labor force), and a restructuring of the agricultural and industrial sectors is required to expand production both for the domestic market and for export.

The current balance of payments problems are mainly the consequence of the rapid decolonization process which has led to the loss of large traditional export markets for goods not easily shiftable to other markets, and to an increase in consumption and imports generated by the returnees from the former overseas territories, who represent some 6 per cent of total population. Other external factors are also having negative consequences for the balance of payments. Net emigration of Portuguese workers to other European countries has come to a halt because of high unemployment in those countries and, as a result, workers' remittances from abroad are currently at the 1973 level. In real terms, such remittances have declined by about one third, thus reducing sharply their contribution to financing the trade deficit. The behavior of export prices in the recent period has also been very unsatisfactory, reflecting among other things the sharp depreciation of the pound. However, with the substantial depreciation of the escudo since early 1976, the competitiveness of Portuguese exports has now been restored to the level prevailing in 1973. But competitiveness is not expected to bring about a major improvement in the trade balance, given Portugal's structure of commodity exports and imports. At present there exists considerable separation between goods produced for the domestic market and those destined for export and the scope for import substitution in the short run is also limited.

Portugal's present difficulties are in many respects extraordinary, resulting as they have from a rapid decolonization process and the major domestic changes that have taken place over a short period of time. In present circumstances, they cannot reasonably be expected to be resolved by demand management policies alone, and without a considerable inflow of foreign capital and know-how to supplement Portugal's own efforts. In this respect, the assistance and appropriate financial support of the international community will be of vital importance during the coming years to enable Portugal to regain financial stability, to maintain a trade and exchange system relatively free of restrictions, and to ensure an adequate rate of economic growth.

In conclusion, my Portuguese authorities are confident that the Executive Board will appreciate the difficult problems with which they are confronted and the major effort the Government is carrying out to gradually resolve them, and will fully support the proposed stand-by arrangement.

The case of Portugal clearly demonstrates the inadequacy of the resources that currently the Fund can provide to its members in need. Now that a well balanced economic program is being implemented, Portugal hopes that friendly countries will respond favorably to new and standing initiatives to extend further economic assistance, in order to complement the resources made available by the Fund.

Mr. Wahl remarked that the basic changes introduced into Portugal's political and economic situation had brought about unavoidable imbalances, which, to some extent, explained why the country had come close to economic collapse. Even before the developments of the past three years had added to an already worrying situation, Portugal had long been the poorest country in Western Europe. The dramatic changes since 1974, along with the decolonization process, had added to the sacrifices that the people had had to make and had led to an unbearable level of unemployment. Against such a background, it was remarkable that the productive system had not collapsed completely. While the present economic situation was difficult, there were some signs of recovery. He shared the staff view that the economy should be assessed in a medium-term perspective rather than in a short-term one, since it was unlikely that the major imbalances could be rectified in the near future. In passing, he endorsed Mr. Dini's comment about the inadequacy of the Fund's assistance to meet Portugal's needs.

Regarding demand management policy, Mr. Wahl agreed with the staff that the authorities should shift the focus of the domestic economy to export-oriented activities and productive investments. The authorities faced a difficult dilemma; it was necessary to foster investment in capital-intensive basic industries, but, in view of the high level of unemployment, it was also vital to stimulate labor-intensive activities. In that respect, the role of the public sector would be important. More generally, the respective roles of the public and private sectors needed to be clearly defined. The efficiency of the public enterprises needed to be restored, and particular attention should be given to implementing a training program aimed at solving the existing managerial difficulties in most enterprises. Further, domestic consumption should be reduced; however, to go beyond certain limits would be more detrimental than beneficial, and could be socially dangerous.

The Portuguese authorities should be commended for adopting a courageous and severe program, Mr. Wahl indicated. The policy stance based on a tight demand management policy, a severe incomes policy and export-oriented activities, together with import controls, was likely to result in a marked reduction of the balance of payments deficit, unless there were unexpected developments in world commodity prices or in the wages field. While the depreciation of the exchange rate in February constituted an essential element of the balance of payments strategy, it was regrettable that measures had not been taken earlier. Quicker action around the middle of 1976, for example, would have prevented lengthy and costly speculation. The potential development of tourism was an encouraging factor. With the situation back to normal, revenues from tourism and from emigrant workers' remittances should help to restore invisible receipts to their former high level, thus--it was to be hoped--reducing the deficit on the current account of the balance of payments.

The targets for investment and exports appeared rather ambitious, Mr. Wahl commented, since reaching them would involve structural changes that were unlikely to occur in the short term. Moreover, in the light of past experience, investment prospects were not encouraging. In that connection, the role of the public sector would be crucial for the revival of investments. Similarly, the objective of employment policy appeared somewhat ambitious, since the 1977 budget had been drawn up under heavy constraints that would not allow the Government much room for maneuver in its attempt to create jobs.

As to the restrictions recently introduced or intensified, Mr. Wahl said that he shared the staff's anxieties. However, the alternative solution to attaining the balance of payments target, namely, a further reduction of domestic demand, appeared socially and politically unacceptable, and a brisk increase of exports would be difficult to achieve given the time constraints of the program. Therefore, he conceded that the measures adopted were unavoidable. Nevertheless, Portugal now had more restrictions than most other countries experiencing similar balance of payments difficulties. The authorities should remove the restrictions as soon as possible and embark on a policy of import substitution, especially of food, with particular emphasis on the agricultural sector, where various actions such as irrigation projects could usefully be carried out.

Finally, Mr. Wahl remarked, he welcomed the policy that the authorities had adopted with respect to the external debt, and particularly the creation of a debt registration system centralized in the Banco de Portugal.

Mr. Pieske commented that the staff appraisal rightly started with the unusually strong words "Portugal's economic problems remain massive." The events of the past few years had created dislocations that would require some time to overcome, but time was not a commodity in ample supply for Portugal's Government because continued movement toward the firm establishment of a democratic regime necessitated tangible progress in the economic field. He welcomed the program described in the Letter of Intent as a significant step toward the solution of the country's problems. It certainly represented "a reasonable effort," and perhaps even more than that. Some of the elements, such as a 9 per cent decline in real wages, were rather severe. Although the reductions of 1976 and 1977 would offset only the increase that took place in 1974 and 1975, they would, if carried out, reduce real wages to, or slightly below, the levels of the prerevolutionary period.

Reducing real wages should not be a main feature of economic policy, Mr. Pieske continued. He was becoming increasingly worried about the frequency with which the Executive Directors observed and sometimes even applauded such a policy. Perhaps it could be justified in cases where real wages had moved ahead too quickly in preceding periods, but generally improvements in living standards--and that meant in particular real wages--

were, and should remain, the primary goal of economic policy, especially in the poorer countries of the world. He was therefore perturbed by the emphasis at the beginning of the second paragraph of the staff appraisal, which read "the authorities have rightly given priority to the containment of consumption." Although the phrase was qualified by a preceding statement that "the program elaborated by the authorities...addresses itself to the more immediate problems of economic management," he would have preferred greater emphasis on the need to improve the productivity of the economy.

The Government had taken some measures to improve labor relations, Mr. Pieske noted. However, much more needed to be done to restore the efficient operation of industrial, commercial and agricultural enterprises, to improve the organization of production and distribution, to encourage efficient management, and to bring private initiative to the fore again. Reversing the decline in investment was one way of increasing productivity, but considerable improvement in economic performance could be achieved, even without much additional investment, by better organization and management.

The precarious balance of payments situation was one reflection of the pressure on Portugal's resources, Mr. Pieske remarked. It was therefore pleasing to note that the current account deficit for 1977 was forecast to be significantly lower than the one for 1976. The charts in the staff paper indicated that the February depreciation had returned relative wages to their pre-1974 level, but he was less certain about the restoration of the competitiveness of Portuguese industry, which was affected by factors other than relative wage costs. The effects of the J-Curve and the pressures on costs and prices resulting from the depreciation would make themselves felt in 1977. In any event, the uncertainties were great and the debt service ratio was quite unfavorable. The figure of 25 per cent mentioned by the staff was incomplete, as it did not include amortization payments due in 1977 on some balance of payments loans.

He wondered whether pegging the escudo, which, technically at least, had been floating in recent years, was the right thing to do for a country with a high rate of inflation, Mr. Pieske said. He would welcome some explanation of the reasons for the decision to peg the escudo to a basket of currencies. The return to a pegged exchange rate could help to restore confidence and promote an inflow of foreign exchange only if the new rate was a credible one. In that respect, he had some doubts because of the repeated introduction and intensification of trade and payments restrictions. In view of the commitments in paragraph 10 of the Letter of Intent to eliminate the import deposit requirements before the end of 1977 and the other restrictions in due course and of the present balance of payments situation, he was prepared to support the temporary approval in paragraph 2 of the proposed decision. Notwithstanding those restrictions, Portugal would need official balance of payments financing for some time to come. Finally, he questioned the statement by Mr. Dini that the case of Portugal demonstrated the inadequacy of the resources that the Fund could provide. Since Portugal had requested a stand-by arrangement in the first credit tranche only, there were still ample resources available to it under present Fund policy. The problem was not with the adequacy of the resources of the Fund, but with the ability of governments to create the conditions for the utilization of the Fund's resources. Meanwhile, until the right conditions had been created for further assistance from the Fund, he would associate himself with the staff view that some of Portugal's gold could and should be used to finance its balance of payments deficit.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/77/60 (4/22/77) and EBM/77/61 (4/25/77).

6. GULF ORGANIZATION FOR DEVELOPMENT IN EGYPT AND THE ARAB REPUBLIC OF EGYPT - TECHNICAL ASSISTANCE

In response to a request from the Gulf Organization for Development in Egypt and the Arab Republic of Egypt for technical assistance, the Executive Board approves the proposal set forth in EBD/77/98 (4/19/77).

Adopted April 22, 1977

7. EXECUTIVE DIRECTORS - SHIPMENTS OF PERSONAL EFFECTS BY AIR FREIGHT

The Executive Board approves the recommendation set forth in EBAP/77/114 (4/21/77).

Adopted April 22, 1977

Portugal 1760

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

EBS/77/100

CONFIDENTIAL

April 12, 1977

To: Members of the Executive Board

From: The Acting Secretary

Subject: Portugal - Request for Stand-By Arrangement

Attached for the consideration of the Executive Directors is a request from Portugal for a stand-by arrangement equivalent to SDR 42.4 million, together with the staff's analysis and recommendation.

It is proposed that this subject be brought to the agenda for discussion on Monday, April 25, 1977.

Att: (1)

INTERNATIONAL MONETARY FUND

Portugal--Request for Stand-by Arrangement

Prepared by the European and Exchange and Trade Relations Departments

(In consultation with the Legal, Research, and Treasurer's Departments)

Approved by L.A. Whittome and Ernest Sturc

April 11, 1977

I. Introduction

In the annexed letter to the Managing Director from the Minister of Finance of Portugal and the Governor of the Bank of Portugal, Portugal has requested a stand-by arrangement for a period of one year in an amount equivalent to SDR 42.4 million. This amount, which corresponds to the enlarged first credit tranche, represents 36.2 per cent of Portugal's quota of SDR 117 million. The letter also sets out the economic policies and intentions of the Government of Portugal. A staff mission comprising P. de Fontenay (EUR), A. Mitchell (ETR), R. Hicks and B. Stuart (EUR), A. Muirragui (STAT), and, as secretary C. Nguyen (EUR) visited Lisbon from January 5 to January 22, 1977 to discuss the program that forms the basis of the request.1/

Portugal made a gold tranche purchase of SDR 22.28 million in July 1975 and purchased the remainder of the gold tranche (SDR 7 million) in December 1975. Portugal made purchases in January and April 1976 of SDR 73.12 million and SDR 41.64 million respectively under the 1975 oil facility. In July 1976 Portugal purchased SDR 58.5 million, equivalent to 50 per cent of its quota under the compensatory financing facility. At end-February 1977, the Fund's holdings of Portuguese escudos equaled 248.1 per cent of quota (100 per cent if the purchases under the oil and compensatory financing facilities are excluded).

After March 18, 1973 the escudo was allowed to float, although the exchange rate was in practice set by the Bank of Portugal. On February 25, 1977 the escudo was depreciated by 15 per cent and pegged against a basket of currencies. The effective (trade-weighted) depreciation of the escudo reached 30.7 per cent compared with May 1, 1970.

On July 22, 1975, Portugal became a participant in the Special Drawing Account. Its SDR holdings, which were acquired from the General Account to pay charges in connection with the use of Fund resources, amounted to SDR 5.6 million at the end of March 1977.

1/ A further visit was made by a team comprising P. de Fontenay, A. Mitchell and B. Stuart on March 16-18, 1977.

The 1976 Article XIV consultation discussions with Portugal took place in June 1976. The Staff Report (SM/76/186, 8/20/76 and Supplement 1) was discussed by the Executive Board at EBM/76/141, 9/19/76. Recent economic developments were reviewed in SM/76/188, 8/31/76.

II. Recent Economic Developments

During the two years following the revolution of April 25, 1974 Portugal actively undertook a basic restructuring of the economy. A major redistribution of income was attempted through the granting of large wage increases and an extension of the system of price controls and subsidies. Labor-management relations were fundamentally changed through the authorization of collective labor activity and the introduction of legislation preventing the dismissal of workers. The banking system was nationalized in March 1975 followed by other nationalizations, particularly of a large proportion of the country's heavy industry. An extensive land reform program was set in motion. The social and economic change that Portugal underwent during this period resulted in management problems, lowered productivity, and increased inflationary pressures. Meanwhile, the country's economic difficulties were being severely compounded by a large influx of refugees from the former Portuguese territories that were granted their independence in the aftermath of the revolution and by the worldwide recession. The outcome was a substantial external imbalance that was financed by the drawing down of once ample international reserves.

Following the formation of an elected government in August 1976 earlier efforts at re-establishing economic stability and growth, which had begun with the previous, provisional government, were accelerated. An assurance was given that no further nationalizations were intended. It was announced that full membership in the European Economic Community was to be sought. Measures related to labor relations which had caused absenteeism and discipline problems and discouraged new hirings were revised. The Government also began attempts to deal with problems resulting from the takeovers by workers of firms and large land holdings. Tax rates were increased and collection of existing taxes was stepped up. The public sector budget for 1977 called for restraint on public consumption and reductions in subsidies and transfers. Measures limiting the extent of wage increases in 1977 were introduced and legislation liberalizing the system of price controls was prepared. Having established a basis for releasing resources to the foreign sector the Government depreciated the exchange rate of the escudo by 15 per cent on February 25, 1977.

During the past year Portugal's economy has shown signs of recovery, although problems remain that can reasonably be expected to be solved only in the medium term. Total employment has increased only slightly and, with the continued influx of refugees, unemployment has continued to rise. Wage settlements moderated substantially during 1976 but price increases accelerated. A further deterioration in the balance of payments was experienced.

1. Output and demand trends

Real domestic product is estimated to have increased by 4-5 per cent in 1976 compared with a decline of a similar amount in 1975 and an average increase of 7 per cent in the years preceding the revolution. Industrial production and the output of the services sector increased at approximately the same rate as overall output, while construction activity, on the basis of available indicators, was considerably more buoyant. Agricultural production is estimated to have remained unchanged in 1976, as adverse weather conditions and difficulties associated with implementation of the land reform offset the effects of an expansion in the area under cultivation.

The index of industrial production rose on average by 4.5 per cent in 1976, with manufacturing output increasing by 6 per cent. Food processing, which had been stimulated by previous sharp increases in disposable income and which had increased by an average of 20 per cent during the first two postrevolutionary years, increased by only 3 per cent during 1976. Textile output reversed a steep decline and rose by 8 per cent, despite the continued decline in the volume of textile exports.

One of the main sources of demand expansion was the sharp increase in public consumption (Table 1). Investment also increased, buoyed by a strong recovery in construction and largely speculative increases in inventories of raw materials, intermediate goods, and consumer durables. Fixed investment by the public sector was affected by administrative delays while private sector nonresidential investment showed little sign of recovery. Exports of goods and services grew slightly in real terms; this increase represented to a considerable extent the selling off of accumulated stockpiles at abnormally low prices. The increase in imports of goods and services was due mainly to higher imports of raw materials and intermediate goods. Despite the growth in real output, private consumption is estimated to have increased only slightly, as taxes were raised without any increases in subsidies. There was also an apparent rise in the savings ratio, related to the decline in real wages.

2. Wages and prices

Following rises of 42 per cent and 18 per cent during 1974 and 1975, respectively, the rate of wage increase for workers in industry and transportation moderated substantially during 1976, and in the year ending in the third quarter 1976 was less than 12 per cent (Table 2). Collective bargaining did not resume on a broad scale following a period during which it was suspended by law.

Despite this moderating trend in wages, the rate of inflation accelerated beginning in the second half of 1976, and through the early months of 1977 consumer prices were increasing at an annual rate of 30 per cent. Administered price increases and higher indirect tax rates did contribute to the worsening price performance, but there were also pressures generated by shortages of certain essential goods, due in part to supply failure and the inadequacy of the distribution system. There was evidence as well of a reduction in the effectiveness of price controls as firms attempted to restore profit margins that had been reduced during the previous two years.

Imported inflation was not a major contributing factor, as the average increase in import prices in 1976 was estimated at approximately 13 per cent, of which 8 per cent was due to the average effective depreciation of the escudo.

3. Employment

A census completed at the end of 1976 put the refugee population at about 500,000, well below earlier estimates of between 700,000 and 800,000. The 2 per cent increase in total population during 1976 brought its increase over the past three years to 6 per cent, following a decade in which population remained virtually unchanged. Traditional opportunities for emigration remained blocked, but no reflow of workers from Western Europe has occurred.

Total employment is estimated to have increased by less than 1 per cent in 1976. With the expansion in the labor force of over 3 per cent resulting from the continued inflow of refugees plus the increase in participation rates of women and young people, the number of unemployed rose to over 500,000 or 14 per cent of the labor force by end-1976 compared with 11 per cent at end-1975. Laws prohibiting the collective and individual dismissal of workers discouraged new hirings and adversely affected productivity. In December 1976, measures were introduced to permit dismissal of workers in cases of destruction of property and unjustified absenteeism, as well as for reasons related to the financial position of the firm (after submission of the case to government officials). In addition, the employment of workers for short-term contract periods was permitted.

4. Monetary trends

	1973	1974	1975	1976
		End of period		
Proportion of M2 accounted for by:				
Currency in circulation	12.7	20.4	28.5	23.8
Demand deposits	42.2	33.0	30.5	31.3
Time and savings deposits	45.0	46.7	41.0	44.9

Source: Data provided by the Portuguese authorities.

The year 1976 was characterized by a reversal of postrevolutionary trends in the composition of the public's money holdings and in the process of money creation. The first two years after the revolution had seen a sharp increase in the propensity to hold currency, as a result of both reduced confidence in the banking system and income redistribution. A reflow of currency to the banking system began early in 1976 and by the end of the year, currency holdings as a proportion of M2 were slightly higher than end-1974 levels. The reflow of currency could have resulted in a sharp increase in the potential for multiple credit expansion of the banking system. However, this was largely offset by a marked decline in the rediscounting activity of the Bank of Portugal and thus in the rate of base money creation (Chart 1). The rate of domestic credit expansion nevertheless rose steadily during 1976.

	Domestic Credit Expansion During Previous 12 Months	
	In billions of escudos	As percentage of M2 at beginning of period
1973		
December	58.60	24.98
1974		
December	53.79	17.85
1975		
December	60.21	17.59
1976		
March	64.54	18.89
June	71.11	20.38
September	77.89	21.37
December	91.34	23.70

Source: Data provided by the Portuguese authorities.

In addition, a smaller proportion of domestic credit expansion (32 per cent of Esc 91 billion) was accounted for by increases in credit to the traditional public sector (as against 49 per cent of the Esc 60 billion extended in 1975), as demand for credit on the part of the traditional public sector was affected by delays in implementing capital expenditure programs (Table 3).

There is no organized money market in Portugal and interest rates continue to be administered. Real interest rates on savings deposits and bank loans have been negative throughout most of the postrevolutionary period. In July 1976, nominal lending rates were raised slightly but remained below the rate of inflation.

5. Public sector finances

The deficit of the public sector in fiscal year 1976[1] is estimated at Esc 51 billion, some 11 per cent of gross domestic product at market prices including a deficit of Esc 10 billion for the social security system (Table 4). The current deficit was Esc 26 billion. The Central Government

1/ The fiscal year differs from the calendar year in that expenditure appropriated in the budget of a given year may be undertaken during the first 45 days of the following year. Thus, expenditure appropriated in the 1975 budget could have taken place to February 14, 1976, etc.

budget, which was originally budgeted to be in deficit by Esc 35 billion in 1976, was affected by a number of decisions taken throughout 1976. Additional appropriations totaling Esc 21 billion were authorized but actual expenditures were not increased to this extent because of administrative delays.

On the revenue side, results were affected by three major developments that tended to counteract one another. In December 1975, a measure of tax relief was provided with the introduction of delayed installment payments for industrial (profits), transactions (sales), and professional (income) taxes. Secondly, collection of the complementary tax (a progressive surtax on combined income from all sources) was stepped up in 1976 in respect of amounts due on 1974 as well as 1975 income. The third factor affecting revenue was the increase in tax rates. In January 1976, the schedule of transaction tax rates was increased substantially (i.e. from 7, 12 and 20 per cent to 10, 20 and 30 per cent), and its coverage was extended. In August 1976, the rates of the major direct taxes, i.e., the complementary, professional, industrial and gift and inheritance taxes, were raised by 10 per cent. In addition, the stamp tax was increased substantially. Indirect tax revenues were affected by increases in the import surcharge which had been introduced in mid-1975 so that its full effect on revenue was not felt until 1976. As a result of these developments, total tax revenue increased by 39 per cent, with indirect tax revenue up by 47 per cent, compared with an increase in nominal GDP at factor cost of 22 per cent (Table 5).

6. Balance of payments

Portugal's balance of payments has come under heavy strain since 1974. Factors directly associated with the revolution of 1974 have had their impact on the trade account, and include: (1) the loss of export markets in the former overseas territories; (2) the supply disruptions associated with political and social change; and (3) reduced competitiveness, due to sharp increases in unit labor costs and doubts abroad about the ability of Portuguese suppliers to meet delivery dates. Additional barriers have also been imposed by other countries against Portuguese workers and exports. The trade account has also been adversely affected by the sharp rise in prices for oil and other raw materials and by the ensuing world recession.

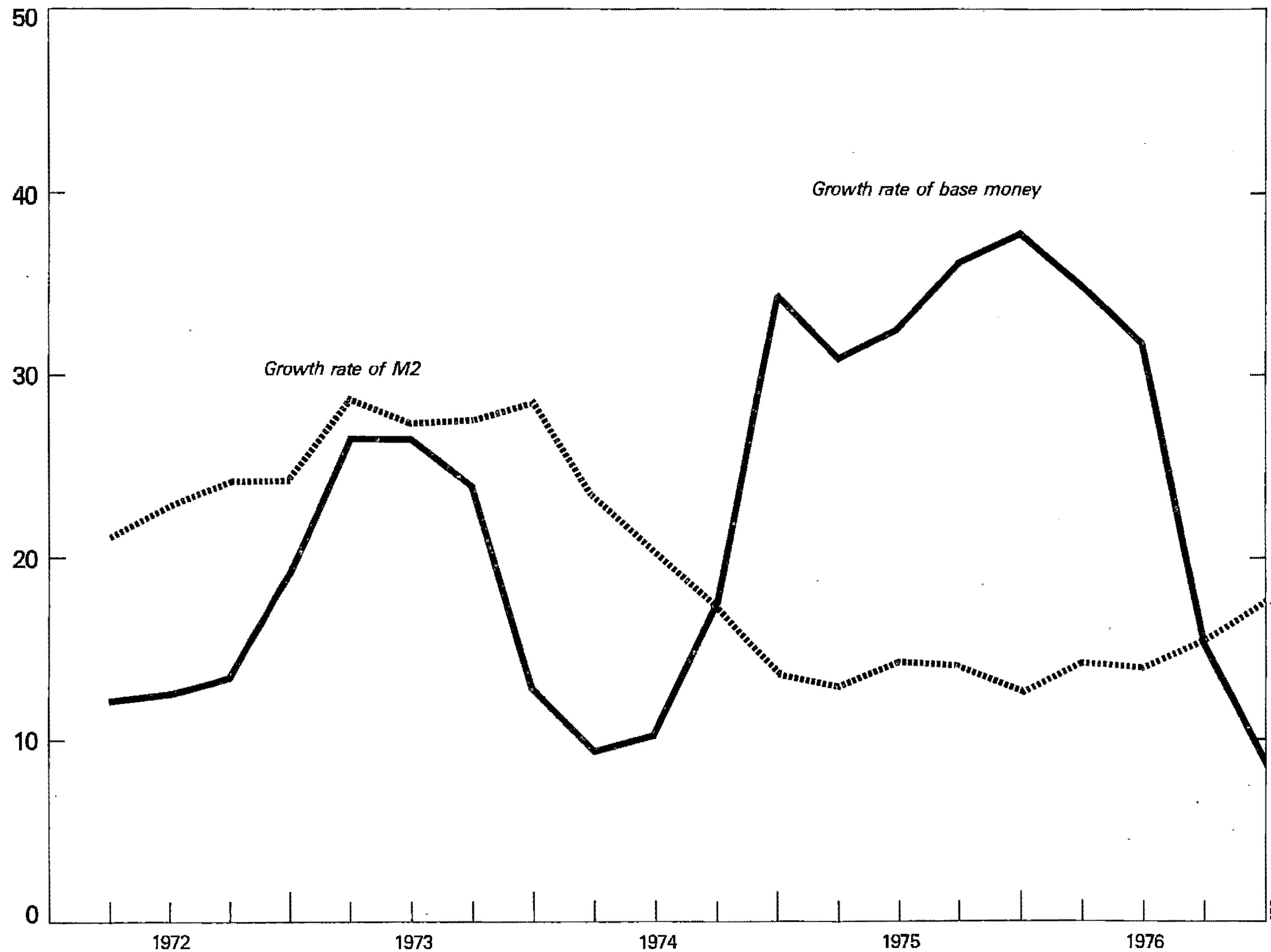
Exports declined by 16 per cent (in SDR terms) in 1975 and are estimated to have declined again in 1976 (Table 6). The fall in export receipts in 1975 was due entirely to a decline in export volume. There was an apparent increase in the volume of exports in 1976, as stockpiled products were sold at sharply reduced prices. The volume of textile exports, traditionally Portugal's most important export, declined by 6 per cent due mainly to voluntary limitations on exports to the United Kingdom and some important northern European markets. Exports to the former territories, which had diminished by 57 per cent between 1973 and 1975, declined by a further 42 per cent during 1976.

After increasing by 54 per cent (in SDR terms) in 1974, imports declined by 16 per cent in 1975 due to a variety of factors, including (1) domestic stock depletions; (2) declines in investment and industrial production; (3) difficulties in obtaining suppliers credits; and (4) the impact of the import surcharge. These trends were reflected in a decline of almost 25 per

CHART 1

PORTUGAL

GROWTH OF BASE MONEY AND M2 1972-1976 1/



Source: Data provided by the Portugese Authorities.

1/ Percentage changes from corresponding period in previous year.

cent in import volumes in 1975, following a rise of 12 per cent in 1974. Import payments increased by 14 per cent in 1976 due almost entirely to volume increases. Higher than average increases in import volumes were recorded for imports of raw materials, intermediate goods, and consumer appliances, reflecting in part the recovery in output but to a large extent speculative demand. Overall, the trade deficit, which had declined somewhat from SDR 1,650 million in 1974 to SDR 1,375 million in 1975 reached SDR 1,800 million in 1976.

The services and transfers account has also been adversely affected in recent years by economic and political developments. There was a marked decline in net tourist receipts in the years after the revolution, due to the recession abroad and unsettled domestic conditions, but some recovery occurred in the second half of 1976. A major decline in investment income, previously derived mainly from the former escudo area, and the continued rise in debt service payments abroad contributed to the deficit in the services account. Net receipts from private transfers, mainly emigrants' remittances, declined in 1975 and recovered only in the second half of 1976. The decline in emigration, cyclical developments abroad and the impact on expectations of the gradual depreciation of the escudo all affected transfer receipts in 1976. The substantial improvement in the invisibles account in the second half of 1976 was all but offset by a marked deterioration in the trade account and for the year as a whole the current account deficit is estimated at almost SDR 1,100 million (about 8 per cent of nominal GDP). This deficit is considerably higher than in 1974 and 1975 and is in marked contrast with the surpluses of earlier years.

During 1976 the capital account moved to a small net surplus. While official capital movements continued to be negative on balance, the private capital account swung sharply from a deficit of SDR 145 million in the first half of 1976 to a surplus of SDR 130 million in the second half. Moreover, the errors and omissions item was also positive. It appears that the inflow of private capital, both short-term and long-term, represented an increase in trade credits, whereas the outflow of official capital represented debt repayments. While detailed figures on external debt are not yet available, the public external debt increased from about SDR 425 million in 1973 to about SDR 640 million in 1976 (excluding official compensatory borrowing); the increase was entirely accounted for by loans for the Cabora Bassa Dam project in Mozambique, which are guaranteed by Portugal. Since 1975 the monetary authorities have undertaken compensatory borrowings totaling SDR 1.17 billion. Private external debt appears to have risen to about SDR 1.4 billion at end-1976 from a negligible and largely unrecorded amount at end-1973. Total debt service payments, excluding amortization of loans against gold collateral, are estimated at around SDR 520 million in 1977, approximately 25 per cent of receipts from exports of goods and services in 1976.

Net reserves of the banking system declined in 1976 by SDR 840 million (following a decline of an equivalent amount in 1975). Gross reserves of the Bank of Portugal declined by SDR 198 million in 1976 to SDR 1,112 million at end-December 1976. During the first two and one half months of 1977, net reserves declined by a further SDR 225 million. However, as a result of short-term borrowing, the level of gross reserves was maintained. At end-February, gross reserves stood at SDR 1,160 million. All but SDR 100 million of this was represented by gold (valued at the official price) of which 40 per cent had been pledged for compensatory borrowing.

7. Exchange and trade system

In the years before 1974, Portugal maintained a liberal exchange and trade system. Despite the deterioration of the external accounts since 1974, all bona fide payments and transfers for current international transactions have continued to be authorized, although exchange control regulations have been tightened to prevent illegal capital outflows (SM/76/188, 8/31/76). The standard travel allocation of foreign exchange has been progressively reduced from Esc 50,000 per year to Esc 7,000 per year per adult traveler, plus a maximum of Esc 1,000 in local currency (EBD/76/129, 6/22/76). Under the Foreign Investment Code of April 1976, the transfer of dividends, formerly unlimited, is guaranteed only up to 12 per cent of invested capital after taxes, or 20 per cent in the case of export firms. Amounts beyond these limits are subject to approval by the Bank of Portugal in the context of the balance of payments situation. On the basis of information available to the staff, no bona fide applications to transfer profits in excess of the limits have been refused on balance of payments grounds.

On the trade side, Portugal introduced an import surcharge in May 1975. In September, the Portuguese authorities consulted with the Fund on a number of temporary restrictive measures affecting trade and current payments, which were then under consideration in view of the deteriorating reserves position (EBM/76/141, Staff Buff 76/119). On October 9, the import surcharge due to expire on December 31, 1976, was extended to March 31, 1977, and the rates were raised from 30 per cent on 1.3 per cent of 1976 imports and 20 per cent on about 28 per cent of 1976 imports, to 60 per cent and 30 per cent respectively. At the same time, an import deposit requirement of 50 per cent of the c.i.f. value to be deposited without interest for six months was imposed on about 7.5 per cent of total 1975 imports, all within the category of imports already subject to the surcharge (EBS/76/484, 11/19/76).

On December 16, new regulations on the granting of domestic bank credit to importers were announced. In the case of equipment goods valued at more than Esc 500,000 for sale on the domestic market, importers must seek foreign financing and could receive domestic credit only up to 30 per cent of the value, to be repaid within six months. Equipment goods for the use of the importing firm were to be financed abroad to the extent of not less than 40 per cent of the f.o.b. value of light equipment goods (not to be repayable in less than two years) and 80 per cent of the f.o.b. value of heavy equipment goods (not to be repaid in less than three years). Once foreign financing had been obtained, the remaining 60 per cent or 20 per cent of the value of the equipment goods concerned could be covered by domestic bank credit, over a period not less than that of the foreign credit. The financing arrangements in such cases would be subject to the approval of the Bank of Portugal. These measures effectively add to the cost of foreign exchange. In order to encourage the required foreign borrowing, a new system of exchange risk insurance operated by a special fund was introduced in February 1977.

Also in February, new temporary measures affecting trade and current payments were announced in conjunction with the devaluation of the escudo. Quantitative restrictions in value terms were imposed on items accounting for some 6 per cent of total imports in 1976, mainly automobile parts, household appliances, coffee, and bananas. For the year 1977 the quotas for automobile parts were based on the estimated value of imports in 1975; for the other items, the base was the average of imports in the two years 1975 and 1976. The regulations provided that the quotas could be increased by the amount of addition to exports of the manufactured goods involved. It was also announced that exchange budgeting would be applied to external transactions of the Central Government and indicative exchange budgets to the expenditures of state agencies charged with imports of essential foodstuffs and raw materials. The transportation of goods exported or imported by the State was to be reserved for Portuguese vessels. A further proposal submitted to the Parliament would extend coverage of the 60 per cent import surcharge on "luxury" goods from 1.3 per cent of total 1976 imports to about 2.3 per cent.

III. The Program

The program described in the attached letter aims at reducing the deficit of the balance of payments and at laying the groundwork for the development of the economy on a sound basis. It consists of measures taken by the Portuguese Government which took office in July 1976 (some of them building on earlier measures introduced by the Sixth Provisional Government) culminating in the comprehensive package announced on February 25, 1977 (see Appendix), as well as of understandings specific to the stand-by arrangement.

The authorities' economic strategy is to reduce the balance of payments deficit by containing consumption and imports and to stimulate investment and exports. The former objective is to be achieved by limiting wage increases, by allowing prices to reflect cost developments and by fiscal policy; the latter is to be sought through stepped-up public capital expenditure and measures to improve the financial position of enterprises, particularly changes in labor legislation designed to improve productivity and to contain labor costs. The depreciation of the escudo is an essential part of the program: by raising the domestic cost of imports and restoring the competitiveness of Portuguese exports it can be expected to make a substantial contribution, in combination with the restraints placed on credit expansion, to the desired reduction in the balance of payments deficit. However, financing constraints have called for the introduction of fast-acting measures in the form of the temporary import restrictions described in the preceding section.

Staff estimates of the impact of the program on the main macroeconomic aggregates and the balance of payments are summarized in Table 7.

1. External policies

The action taken on February 25, 1977 to depreciate the escudo by 15 per cent, combined with the gradual depreciation allowed during 1976 and the first two months of 1977, lowered the effective exchange rate by 27 per cent between the beginning of 1976 and the end of February 1977 (Chart 2). Given the relative moderation in domestic wage increases during the period, this action restored the competitiveness of Portuguese industry, which had deteriorated markedly in 1974-75 (Chart 3), and it should allow exporters to recoup some of their recent losses in market shares.1/ The escudo is now pegged on a basket of currencies.2/ To the extent that this ends the uncertainty as to future exchange rate developments, it should curtail speculation, including stockpiling of imports, and reverse the unfavorable effects of a gradually sliding rate on the inflow of workers' remittances and on leads and lags.

The exchange rate action, in combination with the financial program and the wage and price policies described below, should contribute to the achievement of the authorities' balance of payments target: a reduction in the overall deficit from SDR 840 million in 1976 to SDR 550 million in 1977. The current account deficit is projected to decline by SDR 350 million to approximately SDR 700 million in 1977. The volume of exports could rise by as much as 15 per cent in 1977, for a gain in market shares of 8 percentage points. The volume of imports would decline slightly despite a continuation of the recovery of exports and investment which have a relatively high import content. Invisible receipts, particularly from tourism and emigrants' remittances, are expected to respond to the incentives offered by the depreciation of the escudo but this will be partly offset by larger interest payments on foreign borrowings. No substantial increase in net capital imports is forecast for 1977: reliance on short-term trade credits will be reduced but there should be larger inflows of long-term project aid. Total foreign commitments in 1975-76 are estimated at about SDR 400 million, but the phasing of disbursements is uncertain.

The financing of the balance of payments deficit for 1977 will not be easy. As already indicated, official reserves consist almost entirely of gold, 40 per cent of which has been pledged as collateral for compensatory borrowing. There is no doubt some of the gold that is not pledged--valued at SDR 580 million at the official price--will need to be used. Financing difficulties have made it imperative that the deficit be reduced at an early date and this has led the Portuguese authorities to introduce temporary import restrictions to supplement the stabilization measures. With only 30 per cent of imports consisting of consumer goods, of which food imports are the largest component, there was little to gain from further deflation of consumption, and there was considerable uncertainty as to the likely timing of the benefits to be derived from the exchange rate adjustment. A larger devaluation could not be expected to overcome quickly shortages of exportable goods and import substitutes. The authorities intend that the quantitative restrictions will be eliminated and the import surcharge phased out as soon as domestic production has recovered sufficiently to permit some import substitution, especially for food, and to allow a substantial expansion of exports. The import deposit requirement is to be rescinded before the end of 1977.

1/ In the absence of quarterly productivity figures for Portugal, the comparison in Chart 3 is based on wages only. A comparison of annual data on productivity developments indicates that during 1974-76 productivity in Portugal increased by at least 5 percentage points less than in its main trading partners.

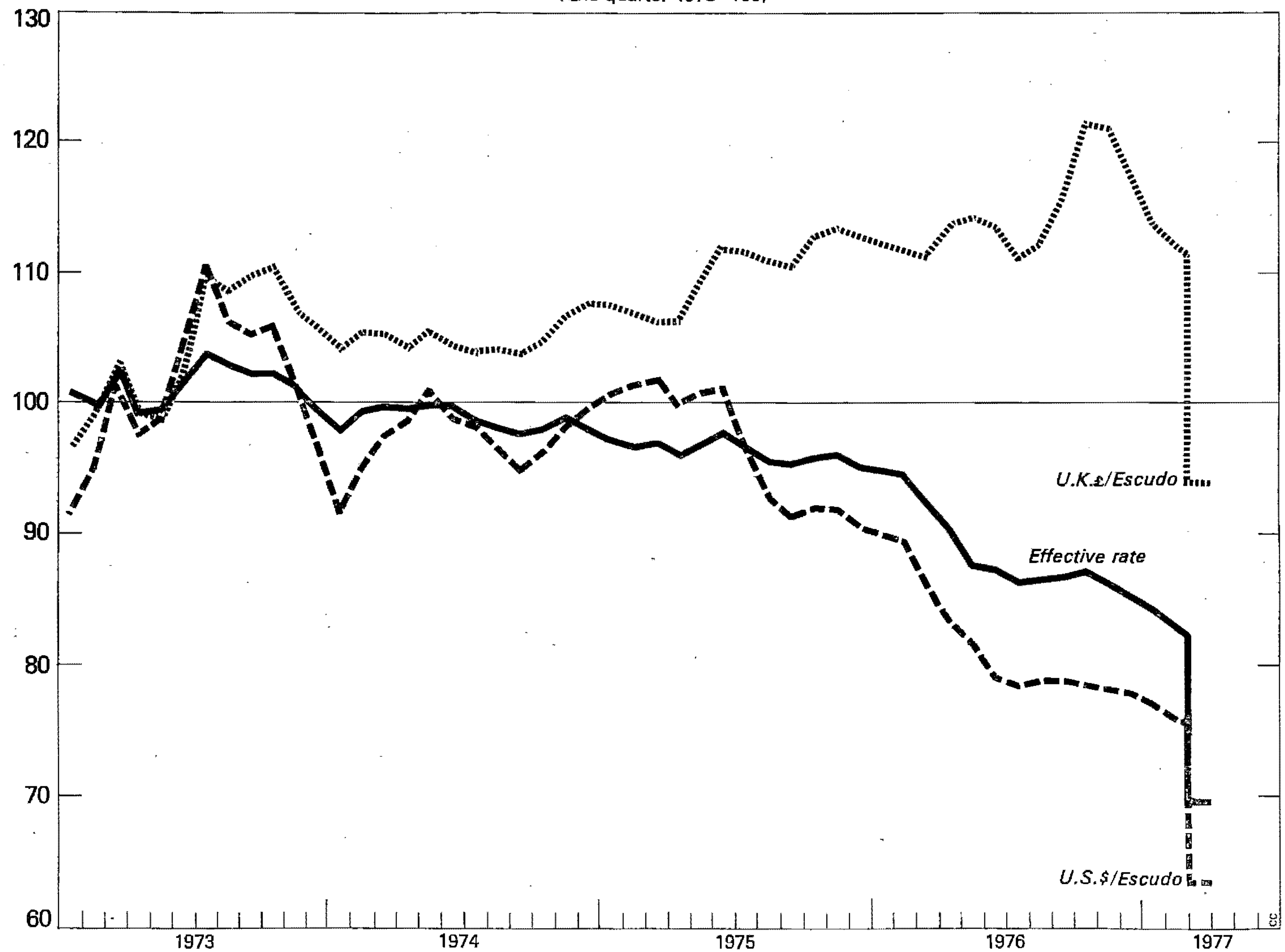
2/ The composition of the basket, which was communicated to the staff, is based on the proportion of Portugal's trade and invisible receipts accounted for by the major trading partners' currencies.

CHART 2

PORTUGAL

EXCHANGE RATE INDICES

(2nd quarter 1973=100)



Source: IMF, European Dept.

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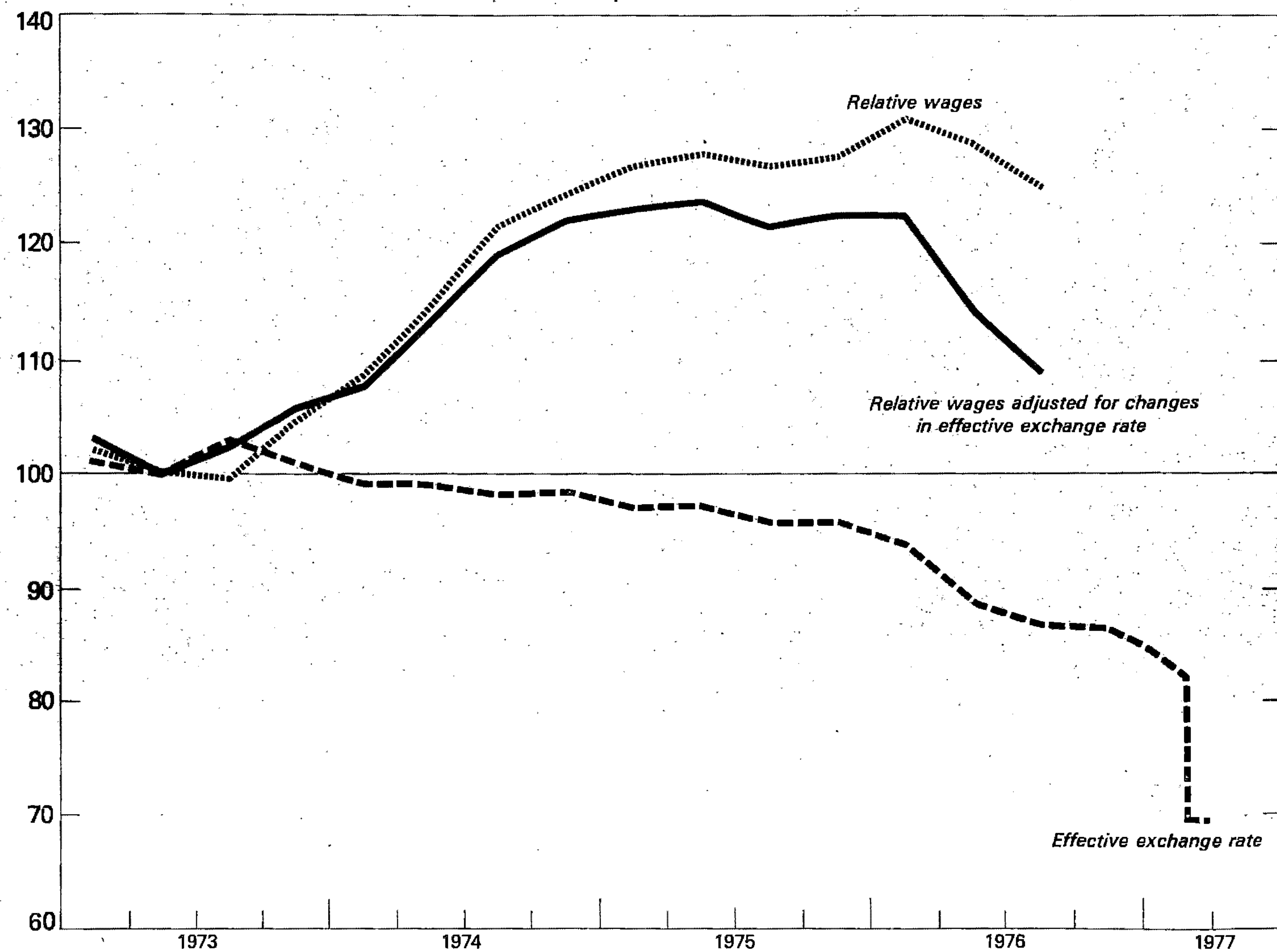
CHART 3

PORTUGAL

RELATIVE WAGES 1973-76

(2nd quarter 1973=100)



Source: Data provided by the Portugese Authorities and staff estimates.

2. Wages and prices

The measures taken by the authorities in the field of prices and incomes policy are expected to play an important role in restraining consumption and in ensuring the effectiveness of the exchange rate adjustment. They consist mainly of restraints on wages and of changes in price policy designed to reduce subsidies and to allow domestic prices to fully reflect cost increases, including changes in import prices.

At the end of 1976, legislation was passed limiting salary increases for civil servants to 15 per cent in 1977. The ceiling was subsequently extended to all dependent workers. Effective January 1, 1977 the minimum wage, which had remained unchanged since June 1975, was increased by 12.5 per cent to Esc 4,500 per month.

In line with their decision to curtail the current deficit of the public sector (see below), the authorities have raised utility rates1/ and reduced price subsidies. As part of the package of measures introduced on February 25, 1977, a basket of 16 essential staples was defined. Prices of these items were increased on average by more than 20 per cent, then frozen until the end of 1977. At the same time, the system of price controls which applied to a wide range of products and necessitated prior government approval of price increases was replaced by a system of *a posteriori* review, giving the possibility of rolling back any increase that is not justified.

The combined effect of the various measures would be, under the assumption that the wage ceiling is respected, a reduction in real wages of 9 per cent in 1977 following a decline of approximately 4 per cent in 1976. Profitability in the traded goods sector will be restored and the improvement in the financial position of enterprises sets the stage for an expansion of investment and exports.

3. Fiscal policy

The consolidated budget of the public sector for 1977 represents a substantial departure from those of the two previous years, which had been characterized by large and growing transfers, substantial subsidization of consumption, postponement of tax collections, increased public consumption and the emergence of large deficits for the social security system. The 1977 budget aims at a reduction in the current deficit of the public sector from an estimated Esc 25.7 billion in 1976 to Esc 18.6 billion in 1977 (Table 4). This is to be achieved through a return to equilibrium of the social security system, with the help of increases in premiums, and a larger surplus on account of the autonomous funds.2/ For the general Government as a whole, public consumption is to remain unchanged in real terms from last year, and the subsidization of consumption is to be reduced as a result of the increases

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1/ In January 1977, fares for public transportation were raised by 25-43 per cent, and water charges by 66 per cent. Electricity, telephone and postal rates were also increased in the first two months of 1977.

2/ The two largest funds are the unemployment fund and the supply fund. The latter is responsible for the distribution and price stabilization of essential foodstuffs (e.g., wheat, sugar). It derives most of its financial resources from excise taxes on oil products, which were raised in January 1977.

in prices and utility rates mentioned above. Although the initial budget for 1977 did not include any tax increases, public sector revenues will be strengthened by those introduced in August 1976, which will have their full impact in 1977, as well as by the collection of taxes postponed from 1976. Some taxes have also been raised since the budget was approved: in particular, the rates of the transactions tax were raised by 20 per cent as part of the stabilization package of February 25, 1977.

The initial budget for 1977 allowed an increase in the overall deficit of the public sector to Esc 57 billion, or some 9.5 per cent of GDP. The nominal increase from 1976 is more than accounted for by larger appropriations for capital expenditures. This emphasis on public sector investment appears appropriate given the present rate of unemployment and the likely delays in the recovery of private investment activity. Furthermore, the low import content of some of the projects undertaken, particularly in the construction sector, makes them attractive in the context of the balance of payments situation.

As a result of a large carryover of expenditure appropriated under the 1976 budget, but which actually took place in early 1977, the public sector borrowing requirement from the banking system is projected to rise from Esc 29 billion in 1976 to Esc 39 billion in 1977, despite increased reliance on nonbank sources of finance (if necessary through recourse to forced saving schemes). In order that the traditional overappropriation of expenditures (particularly capital expenditure) and underestimation of revenue should not result in a failure to fulfill the policies underlying the original budget, the authorities intend to refrain from using funds originally appropriated for capital expenditure to increase current outlays, to finance any new appropriatrions with new taxes,1/ to carry out their plan to borrow Esc 16 billion from the domestic nonbank sector, and not to postpone tax collections. They have also agreed on a ceiling on guarantees by the State for borrowing by public and private enterprises or entities so as to avoid a substitution of bank credit for budgetary transfers. These commitments should ensure that the increase in bank credit to the public sector will be utilized for necessary capital expenditure or will be freed for use by the productive sector.

1/ This policy has in effect already been implemented since the budget was approved.

Banking System Credit to the Public Sector

(In billions of escudos)

	1976	1977
Public sector deficit 1/	51	57
Less		
Domestic nonbank borrowing	6	16
Foreign borrowing	2	3
Plus		
Expenditure from previous year's budget undertaken early in current year	11	19
Less		
Expenditure from current year to be undertaken early in following year	19	21
Other Treasury operations	-6	3 2/
Credit obtained from the banking system	29	39

Source: Data provided by the Portuguese authorities.

1/ From Table 4.
2/ Funding provided to commercial banks experiencing financial difficulties related to winding down relations with the former territories.

4. Monetary policy

In order to prevent the apparent revival in the demand for credit, which has been observed since early 1976, from resulting in an excessive credit expansion, the authorities have established a target for the expansion of net domestic credit by the banking system of Esc 130 billion during 1977. This represents a further rise to almost 29 per cent in the ratio of domestic credit expansion to the stock of M2 at the beginning of the period. However, it must be related to the projected rates of growth of investment and exports for 1977, both of which exceed 50 per cent in nominal terms. It is also consistent with a decline in net foreign assets of the banking system (abstracting from valuation adjustments) of Esc 25 billion (or SDR 550 million) and an increase in M2 of 23 per cent, considerably below the projected growth in GDP at market prices of 28 per cent. The acceleration in prices, that will result in large part from the exchange rate action and liberalization of price controls, would tend to increase the velocity of circulation. On the other hand, the move toward financial equilibrium and expectations of a stable exchange rate should offset this increase in velocity to some extent. Therefore, the targeted increase in domestic credit should exert a restraining influence on the growth of nominal income and contribute to a reduction in the external imbalance.

Money and Credit Targets

(In billions of escudos)1/

	1975	1976 Estimate	1977 Target	1976	1977
	December 31			Changes	
Money supply (M2)	385	453	558	68 (17.7)	105 (23.0)
Net foreign assets	39	12	-13	-27	-25
Domestic credit	362	454	584	92 (25.4)	130 (28.6)
Of which:					
Credit to public sector	52	81	120	29 (55.8)	39 (48.1)
Credit to enterprises, households, and non-monetary financial institutions	310	373	464	63 (20.3)	91 (24.4)
Miscellaneous	-16	-13	-13	3	--
P.M. GDP at market prices	373	465	594	92 (24.7)	129 (27.7)

Source: Data provided by the Portuguese authorities.

1/ Figures between brackets are percentage changes.

As part of the February 25 package of measures, the Bank of Portugal's discount rate of 6.5 per cent was replaced by three rates--8, 9.5 and 12 per cent--with the rates charged increasing with the amount of discounting undertaken by individual banks. The whole interest rate structure of credit institutions was altered and rates paid on time deposits and charged for bank loans were raised by 1.5 percentage points on average. Bank lending rates now range from 10.25 per cent to 14.75 per cent and interest rates on time deposits range from 5 per cent to 13 per cent.

IV. Staff Appraisal and Recommendation

Portugal's economic problems remain massive. Their solution, and in particular the reduction of unemployment, inflation and the external disequilibrium, will take time. It will require structural reforms in a number of sectors, notably agriculture and education, improvements in organization and management in both the public and private sectors, acceptance by workers of moderation in their income claims, and continued determination by the Government to follow restrained financial policies. The program elaborated by the authorities for the current year addresses itself to the more immediate problems of economic management. It is, however, a first step toward a return to internal and external equilibrium; it is also consistent with the objective of shifting resources to the production of investment goods, exports and import substitutes.

The authorities have rightly given priority to the containment of consumption, both private and public. With this aim, they have taken steps in the field of incomes and fiscal policy which are courageous and are expected to reduce consumption in real terms at a time when the economy is expanding. At the same time the authorities have paved the way for a recovery of investment and exports through various measures to improve the financial position of enterprises, notably changes in labor legislation that should raise productivity and reduce labor costs and liberalization of price controls, as well as the exchange rate action of February 25, 1977. The latter, together with the restraints placed on overall credit expansion, is an important part of the Government's efforts to reduce the balance of payments deficit to a more manageable level.

The staff regrets that the authorities have felt it necessary to include in the measures designed to improve the balance of payments a number of restrictions on trade and payments, including quantitative restrictions. It recognizes, however, that they had no realistic alternative if the external deficit was to be reduced rapidly, which is essential in view of the financing problem. The Portuguese authorities view these measures as temporary, needed only until the effect of the exchange rate adjustment on trade volumes has been felt, and until output and investment have expanded in those sectors producing exports and import substitutes. They have agreed to review them with the staff and to eliminate the import deposit requirement before the end of 1977.

Although the favorable reception of the recent measures by the population is encouraging, the success of the program is by no means guaranteed. It depends on the unions' continued restraint and acceptance of a decline in real wages, and on the entrepreneurs' willingness and ability to take advantage of the opportunities offered. It also depends on the authorities' ability to avoid an acceleration of the rate of inflation beyond the unavoidable impact of the increases in import prices and indirect taxes and of the adjustments in regulated prices. If the sharp and largely corrective rise in the price level this year is allowed to reduce real incomes and relative cost and price distortions, Portugal could look forward to greater price stability in the years ahead. However, if the recent sharp run-ups in prices resulting from shortages and speculative stockpiling caused by the inefficiency of the distribution system and of the State trading apparatus were to persist, they would jeopardize the wage guidelines, which form an essential part of the program, and the entire stabilization effort. Nevertheless, the staff believes that the program is sound and likely to achieve the desired reduction in the balance of payments deficit, and that it represents a reasonable effort on the part of Portugal to solve its problems.

Accordingly, the following decision is submitted for consideration by the Executive Board:

1. The Government of Portugal has requested a stand-by arrangement for a period of one year from April , 1977, and for the equivalent of SDR 42.4 million. The Fund approves the stand-by arrangement attached to EBS/77/100 and grants any necessary waiver of the conditions of Article V, Section 3(a) (iii), of the Articles of Agreement.

2. The Fund approves the retention by Portugal of the multiple currency practices and restrictions on payments and transfers for current international transactions as described above until the next Article XIV consultation with Portugal.

Table 1. National Accounts Estimates--1974-76[1/]

(In billions of escudos)

	1974	1975	1976	1975	1976	1975/1974		1976/1975	
	1974 Prices			Current prices		Deflator	Volume	Deflator	Volume
						(Change in per cent)			
Private consumption	276	281	284	315	378	12	2	19	1
Public consumption	49	53	57	65	84	22	9	20	8
Investment	66	30	44	38	66	27	-54	20	45
Exports	85	67	69	72	78	7	-21	5	3
Imports	-139	-105	-112	-117	-141	11	-25	13	7
Gross national product at market prices	337	326	342	373	465	14	-4	19	5

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

1/ Figures for 1976 are preliminary estimates.

Table 2. Wages and Prices--Lisbon and Oporto [1/]

	Average Wages of Workers in Industry and Transportation Lisbon and Oporto (1970 = 100)		Average Consumer Prices Lisbon and Oporto		Index of Real Wages Lisbon and Oporto	
1971	112.0		109.9		101.9	
1972	124.3	(11.0)	121.9	(10.9)	102.0	(0.1)
1973	136.1	(9.5)	136.6	(12.1)	99.6	(-2.4)
1974	180.0	(32.2)	172.0	(25.9)	104.6	(5.0)
1975	226.7	(25.9)	200.4	(16.5)	113.1	(8.1)
1976	258.4	(14.0) [2/]	239.1	(19.3)	108.1	(-4.4)
1973						
I	128.8		130.2		98.9	
II	133.3	(3.5)	134.8	(3.5)	98.9	(--)
III	138.2	(3.7)	136.8	(1.5)	101.0	(2.1)
IV	144.1	(4.3)	144.4	(5.6)	99.8	(-1.2)
1974						
I	151.9	(5.4)	160.0	(10.8)	94.9	(-4.9)
II	170.4	(12.2)	168.9	(5.6)	100.9	(6.3)
III	192.7	(13.1)	177.6	(5.2)	108.5	(7.5)
IV	205.2	(6.5)	181.4	(2.1)	113.1	(4.2)
1975						
I	211.5	(3.1)	188.2	(3.7)	112.4	(-0.6)
II	221.8	(4.9)	198.4	(5.4)	111.8	(-0.5)
III	232.0	(4.6)	203.2	(2.4)	114.2	(2.1)
IV	241.6	(4.1)	211.8	(4.2)	114.1	(-0.1)
1976						
I	251.8	(4.2)	229.2	(8.2)	109.9	(-3.7)
II	256.2	(1.7)	224.7	(-2.0)	114.0	(3.7)
III	259.1	(2.9)	242.1	(7.7)	107.0	(-6.1)
IV	...	...	260.5	(7.6)	...	...
1977						
I [3/]	...	...	277.0	(6.4)	...	...

Source: Data provided by the Portuguese authorities.

1/ Numbers in brackets are percentage changes between succeeding periods.

2/ Annual index constructed on assumption that wage increases in fourth quarter 1976 equalled rate of increase in third quarter 1976.

3/ Price index based on increase between October-November 1976 and January-February 1977.

Table 3. Monetary Survey

(In billions of escudos)

	1973	1974	1975	1976 March	1976 June	1976 Sept.	1976 Dec. 1/
Foreign assets, net	77.85	63.34	38.83	30.25	18.17	18.74	11.60
Bank of Portugal, net	72.28	56.02	31.88	21.88	10.92	8.72	4.22
Foreign assets	(72.31)	(56.02)	(40.09)	(40.14)	(39.41)	(41.32)	(40.65)
Foreign liabilities	(-0.03)	(--)	(-8.21)	(-18.26)	(-28.49)	(-32.60)	(-36.43)
Commercial banks, net	5.57	7.32	6.95	8.37	7.25	10.02	7.38
Foreign assets	(7.73)	(10.13)	(9.54)	(12.43)	(12.75)	(16.07)	(14.58)
Foreign liabilities	(-2.16)	(-2.81)	(-2.59)	(-4.06)	(-5.50)	(-6.05)	(-7.20)
Domestic credit	248.35	302.14	362.35	374.40	394.47	415.75	453.69
Claims on government,	8.23	22.82	52.36	59.45	61.70	70.38	81.66
Claims	(34.42)	(50.62)	(83.19)	(97.03)	(97.16)	(104.81)	(135.15)
Deposits	(-26.19)	(-27.80)	(-30.83)	(-37.58)	(-35.46)	(-34.43)	(-53.49)
Claims on private sector	239.65	274.68	297.44	300.51	315.59	328.05	353.99
Claims on nonmonetary financial institutions	0.47	4.64	12.55	14.44	17.18	17.32	18.04
Assets = Liabilities	326.20	365.48	401.18	404.65	412.64	434.49	465.29
Money	165.61	182.50	227.22	216.81	222.46	228.57	249.45
Currency outside banks	38.27	69.70	109.78	100.46	103.84	101.33	107.86
Demand deposits	127.34	112.80	117.44	116.35	118.62	127.24	141.59
Quasi-money	135.72	159.79	158.22	173.23	177.61	192.28	203.34
Time and savings deposits	135.72	159.79	158.22	173.23	177.61	192.28	203.34
Capital accounts	22.86	24.16	24.66	24.68	24.89	24.88	25.02
Other items, net	2.01	-0.97	-8.92	-10.07	-12.32	-11.24	-12.52

Source: Bank of Portugal.

1/ Estimates.

Table 4. Consolidated Accounts of the Public Sector[1/]

(In billions of escudos)

	1976 Revised budget[3/]	1976 Outturn[2/]	1977 Original budget estimates
General budget of the state			
1. Current receipts	66.4	66.1	81.4
Direct taxes	17.8	18.0	22.3
Indirect taxes	44.1	44.8	53.7
Other	4.5	3.3	5.4
2. Current expenditure	94.7	85.7	109.1
Goods and services	54.9	49.4	66.7
Subsidies	4.0	4.0	5.0
Interest on public debt	5.0	4.6	11.5
Transfers	30.8	27.7	25.9
3. Current deficit of the state (1 - 2)	-28.3	-19.6	-27.7
4. Balance of autonomous funds and services and local administration	3.4	3.7	9.1
5. Balance of social security system	-10.0	-9.8	--
6. Current deficit of public sector (3 + 4 + 5)	-34.9	-25.7	-18.6
7. Capital receipts	5.8	5.9	2.3
8. Capital expenditure	33.8	31.5	40.5
Investment	19.9	17.0	25.2
Other	13.9	14.5	15.3
9. Balance of capital operations (7 - 8)	-28.0	-25.6	-38.2
Net financing requirements -(6 + 9)	62.9	51.3	56.8
Financing needs	65.8	54.2	59.9
Debt amortization	-2.9	-2.9	-3.1

Source: Data provided by the Portuguese authorities.

1/ On a national accounts basis. Some current transactions involving the sale of goods and services to private consumers are simultaneously excluded from current receipts and expenditures. Direct tax revenues derived from gift and succession duties, real estate transfers etc., are considered as capital transfers.

2/ Preliminary estimates.

3/ Based on appropriations introduced throughout the year.

Table 5. Government Budget Receipts

(In billions of escudos; figures in parentheses are percentage changes over previous year)

	1974	1975	1976 1/	1977 Budgeted
Tax revenue	42.58	46.75	65.14	78.08
	(20.9)	(9.8)	(39.3)	(19.9)
Direct taxes	16.56	16.24	20.34	24.41
	(21.0)	(-0.2)	(25.2)	(20.0)
Industrial tax	4.06	3.66	1.96	4.00
Professional tax	2.97	4.05	5.38	7.00
Real estate tax	1.61	1.71	1.98	2.30
Complementary tax	2.40	1.34	4.87	4.90
Gift and inheritance tax	0.91	0.87	0.65	0.70
Property transfer tax	2.26	1.46	1.46	1.20
Capital tax	1.63	2.10	2.66	3.10
Other	0.72	1.05	1.35	1.21
Indirect taxes	26.02	30.51	44.80	53.67
	(20.9)	(16.9)	(46.8)	(19.8)
Transaction tax	8.65	10.40	15.10	18.80
Stamp tax	4.43	4.88	7.78	9.20
Import duties	5.13	3.95	4.29	4.50
Import surcharge	--	1.64	4.71	5.00
National salvation tax	2.38	2.76	2.69	2.90
Other 2/	5.44	6.79	10.24	13.27
Other current receipts 3/	7.70	8.12	11.32	11.93
Capital receipts	1.89	3.56	1.18	9.24
Total receipts	52.17	58.29	77.64	99.25
	(15.5)	(11.7)	(33.2)	(27.8)

Sources: Ministry of Finance, General Direction of Public Accounts, and General Accounts of the State; and data provided by the Portuguese authorities.

1/ Preliminary estimates.
2/ Includes taxes on tobacco and land transportation, and on sales of automobiles.
3/ Includes fees, enterprise profits and incomes from financial assets, and earmarked receipts.

Table 6. Balance of Payments

(In millions of SDRs)1/

	1973	1974	1975	1976 2/	1975 First half	1975 Second half	1976 First half 2/	1976 Second half 2/
Exports, f.o.b.	1,546	1,903	1,594	1,571	837	757	783	788
Of which:								
Petroleum and petroleum products	7	49	29	27	...	...	...	...
Imports, f.o.b.	2,303	3,557	2,969	3,385	1,559	1,410	1,580	1,805
Of which:								
Petroleum and petroleum products	129	442	476	574	...	...	...	...
Trade balance	-757	-1,654	-1,375	-1,814	-722	-653	-797	-1,017
Services (net)	128	45	-151	-91	-82	-69	-100	9
Of which:								
Tourism (net)	268	214	83	161	56	27	38	123
Investment income (net)	72	107	-12	-115	10	-22	-45	-70
Private transfers (net)3/	920	924	854	843	450	404	334	509
Current account balance	291	-685	-672	-1,062	-354	-318	-562	-500
Private capital (net)4/	-31	295	-17	24	-9	-8	-34	58
Official capital (net)	-87	-68	-71	-14	-30	-41	-5	-9
Short-term capital and errors and omissions (net)	113	-69	-73	210	-136	63	-59	269
Capital account balance	-5	158	-161	220	-175	14	-98	318
Overall surplus or deficit (-)	286	-527	-833	-842	-529	-304	-660	-182
Financing								
Monetary and financial operations of the banking system5/	-286	527	833	842	...	...	...	...
Assets (- increase)	-290	527	577	99	...	...	...	...
Liabilities (net)	4	--	256	743	...	...	...	...
IMF position	--	--	--	174	...	...	...	...
Oil facility	--	--	--	115	...	...	...	...
Compensatory financing facility	--	--	--	59	...	...	...	...
Other	--	--	--	--	...	...	...	...
Other	4	--	256	569	...	...	...	...

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

1/ Conversion factors: 1973 - Esc/SDR 29.41, 1974 - Esc/SDR 30.55, 1975 - Esc/SDR 31.03 (first half - Esc/SDR 30.40, second half - Esc/SDR 31.60), and 1976 - Esc/SDR 34.89 (first half - Esc/SDR 33.64, second half - Esc/SDR 36.13).

2/ Estimates.

3/ In 1974, includes public transfers to the former escudo areas amounting to SDR 23 million for the full year.

4/ Includes medium-term and long-term capital only.

5/ Change in net foreign asset position of the banking system net of valuation changes.

Table 7. Quantitative Implications of the Program

	National Accounts				
	1976	1977	1977	1977/1976	
	1976 Prices		Current prices	Deflator	Volume
				Percentage change	
	In billions of escudos				
Private consumption	378	367	458	25	-3
Public consumption	84	84	97	16	--
Investment	66	86	104	21	30
Exports	78	90	119	33	15
Imports	-141	-138	-184	33	-2
Gross national product at market prices	465	489	594	22	5

	Balance of Payments			
	1974	1975	1976	1977
	In millions of SDRs			
Exports	1,903	1,594	1,571	1,920
Imports, f.o.b.	3,557	2,969	3,385	3,495
Trade balance	-1,654	-1,375	-1,814	-1,575
Services (net)	45	-151	-91	-75
Private transfers	924	854	843	950
Current account	-685	-672	-1,062	-700
Capital account	158	-161	222	150
Overall surplus or deficit (-)	-527	-833	-842	-550

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

P.M.

Change in real disposable income: -1 per cent.

Contribution of indirect tax increases and subsidy reductions to consumer prices: 4 percentage points.

Assumptions

Export market growth of 6 per cent.

Domestic wage increases: 15 per cent.

Unit labor cost increases (in local currencies):

Domestic: 10 per cent

Foreign: 5 per cent

Increase in traded goods prices: 7 per cent (in foreign currency terms).

Main Measures Taken in Conjunction with the Depreciation of the Escudo on February 25, 1977

The escudo was depreciated by 15 per cent, and pegged to a basket of currencies, weighted according to the importance of individual currencies in Portugal's receipts and payments for commodities, tourism, and private transfers.

Legislation limiting wage increases in 1977 to 15 per cent was extended to all dependent workers. (This measure was introduced on February 12, 1977.)

Legislation was introduced defining a basket of 16 essential commodities whose prices were to be frozen until the end of 1977 after being increased on average by more than 20 per cent.

The extensive system of price controls was replaced by a more liberal system of declared prices which allowed price increases to be reviewed *a posteriori* by the Government.

The rates of sales tax were increased by 20 per cent.

The Bank of Portugal's discount rate of 6 per cent was replaced by a progressive rate structure of 8, 9.5, and 12 per cent. The applicable rate will depend on the amount of discounting undertaken by individual banks.

Interest rates on bank loans and time deposits were increased by 1.5 percentage points. A surcharge of 0.5 percentage points to help finance the Exchange Risk Guarantee Fund was introduced. An additional surcharge of 2.5 percentage points was introduced on loans for consumer durables.

An Exchange Risk Guarantee Fund was established to reduce the risks associated with external borrowing.

Value quotas related to the average value of imports for 1975 and 1976 were introduced for such items as automobile parts, domestic appliances, coffee and bananas, affecting approximately 6 per cent of 1976 imports.

It was required that public bodies undertaking international trade utilize Portuguese vessels.

Plans were announced to compensate foreign owners of property that was nationalized or expropriated.

The stock exchange, which had been closed shortly after the revolution, was reopened on February 28, 1977 for trading in equities.

EBS/77/100
Corrected: 4/21/77

ATTACHMENT

Stand-by Arrangement - Portugal

1. Annexed hereto is a letter dated April 12, 1977 from the Government of Portugal, setting forth the objectives and policies which the authorities of Portugal will pursue.

2. The International Monetary Fund grants this stand-by arrangement to support these objectives and policies.

3. Portugal will remain in close consultation with the Fund during the period of the stand-by arrangement and, in particular, will consult with the Fund in accordance with paragraph 12 of the annexed letter. These consultations may include correspondence and visits of officials of the Fund to Portugal or of representatives of Portugal to Washington, D.C. For the purpose of these consultations, Portugal will keep the Fund informed of developments in the exchange, trade, credit, and fiscal situations through reports at intervals or dates requested by the Fund.

4. For a period of one year from , Portugal will have the right, after making full use of any gold tranche that it may have, to purchase from the Fund the currencies of other members in exchange for its own currency in an amount equivalent to SDR 42.4 million. The amounts available in accordance with this paragraph 4 shall be augmented by amounts equivalent to repurchases in respect of purchases under the stand-by arrangement, unless when any such repurchases are made, Portugal informs the Fund that it does not wish the stand-by arrangement to be augmented by the amount of that repurchase.

5. Portugal will pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

6. Portugal will have the right to engage in the transactions covered by this arrangement without further review by the Fund. This right can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally (under Article XIV, Section 1(a)(ii)) or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Portugal. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 6, purchases under this stand-by arrangement will be resumed only after consultation has taken place between the Fund and Portugal, and understandings have been reached regarding the circumstances in which such purchases can be resumed.

7. No later than three years after each purchase of exchange by Portugal under this arrangement Portugal shall repurchase an amount of the Fund's holdings of Portuguese escudos equivalent to the outstanding amount of the purchase. Repurchases shall be made with assets specified by the Fund at the time of the repurchase, in accordance with the Fund's policies and practices at the time of repurchase.

8. The rate of exchange at which Portugal will purchase currencies from the Fund in exchange for the currency of Portugal and at which the Fund will return the currency of Portugal in repurchase operations and made all other computations involving the currency of Portugal will be such rate as the Fund may from time to time determine under Article IV, Section 8, of the Fund agreement.

Banco de Portugal
Lisbon, Portugal

April 12, 1977

Dear Mr. Witteveen:

1. The Government of Portugal hereby authorizes the Banco de Portugal to request of the International Monetary Fund a stand-by arrangement under which the Banco de Portugal will have, for a period of one year, the right to purchase from the Fund the currencies of other members in exchange for escudos up to an amount equivalent to SDR 42.4 million. Before making purchases under this stand-by arrangement, the Banco de Portugal will consult with the Managing Director on the particular currencies to be purchased.

2. The purpose of the request is to support the policies adopted by the Government of Portugal to strengthen the balance of payments position and to create the conditions for the development of the Portuguese economy on a sound basis beyond the program period.

3. In the second half of 1974 and in 1975, Portugal experienced serious economic difficulties caused mainly by the increase in energy prices and ensuing world recession, political and social changes, the granting of independence to its overseas territories, and the barriers erected in certain countries against the admission of Portuguese workers and exports. The decline in output and the sharp increase in the labor force resulted in unemployment which, at the end of 1975, exceeded 10 per cent of the total labor force. Large increases in labor costs and in import prices contributed to inflationary pressures, and the balance of payments, which had traditionally been in surplus, recorded sizable deficits in both 1974 and 1975. Some recovery of production took place in 1976, but the current account deficit of the balance of payments increased further to over US$1 billion and inflation accelerated despite a more moderate rise in wage rates. Unemployment continued to rise, and reached 14 per cent by the end of the year. Official reserves, which represented more than 12 months of imports in 1973, are now down to little more than gold holdings, of which 40 per cent has been pledged for various compensatory borrowings.

4. On December 30, 1976 the National Assembly of the Republic approved the 1977 budget and economic plan presented by the Government. The policies described in these documents, together with the action taken on February 25, to depreciate the escudo by 15 per cent are the mainstay of the Government's program for 1977. This program aims at reducing the deficit of the balance of payments for this year from about US$1 billion to about US$650 million by curbing the growth of consumption and imports and fostering exports. At the same time, a substantial effort is to be made to expand investment on which the country's employment and capacity to export will depend in the future.

5. The budget for 1977 provides for a reduction in the current deficit of the public sector to about three quarters of its 1976 level. A major increase has been provided in budgetary appropriations for public investment designed to arrest the decline in the country's capital stock and reduce

unemployment, and any increase in the overall deficit realized by the Central Government will be due to the growth of public investment. Increases in taxes and social security premiums, decided in 1976 and early 1977, will contribute to this result and the growth of total expenditures will be slowed; salary raises for the civil service will be limited and transfers and subsidies will be reduced. Moreover, in order to contain the financial impact of the budget, the authorities intend that no new expenditure appropriations will be authorized during 1977 unless offsetting tax increases are introduced within the calendar year, no funds will be transferred from the capital budget to the current budget, and no tax collections will be postponed from 1977 to 1978. The budget provides for borrowing Esc 16 billion from the private nonbank sector in 1977. The Social Security accounts will be kept in balance for the current fiscal year, and the autonomous funds will show an overall surplus for the year. The authorities intend to limit the growth of credit from the banking system to the public sector (Central Government, Social Security, autonomous funds and services, and local authorities) in the year ending December 31, 1977, to no more than the Esc 39 billion implied by the 1977 budget. This amount may be raised by Esc 3 billion to allow for the possible introduction of fiscal incentives for investment in the export sector.

6. The growth of money and credit was moderate in 1974 and 1975 as the demand for credit by the private sector remained abnormally low; the growth of credit showed signs of accelerating during 1976. The money stock broadly defined increased by 13 per cent and 18 per cent, respectively, during 1975 and 1976 compared with a growth of nominal GDP at factor cost of 12 per cent in 1975 and nearly 25 per cent in 1976. For 1977, monetary policy will aim at contributing to the improvement in the balance of payments and the price situation while allowing for the desired expansion of investment and exports. The targeted rate of increase of the money supply will be 23 per cent, which would be below that projected for nominal income. The authorities intend, therefore, to limit the increase in total domestic credit of the banking system in the year ending December 31, 1977, to no more than Esc 130 billion, consistent with the targeted improvement in the balance of payments. Furthermore, in order to avoid an excessive utilization of credit by nonviable enterprises, it is intended that the guarantees extended by the Central Government in 1977 will not bring the total amount of guarantees above Esc 70 billion, and that most of the increase would be in support of international borrowing. The authorities have recently increased interest rates for both loans and time deposits by an average of 1.5 percentage points.

7. The recent exchange rate adjustment, added to the effective depreciation of the escudo in the course of 1976 and early 1977, is expected to restore the competitive position of Portuguese products. This improvement will encourage the necessary reallocation of resources toward the export sector and promote import substitution. Together with the intensified effort to expand investment mentioned above and the steps taken to normalize labor relations, this action will provide the foundation for economic growth in the medium term consistent with a more balanced external position. In their efforts to achieve these objectives, the authorities intend to collaborate with the Fund in accordance with the provisions of Article IV, Section 4(a).

8. Real wages declined in 1976 as price controls and food subsidies did not prevent an acceleration of inflation. For 1977, the authorities intend to allow the exchange rate adjustment to produce its desired effect on international competitiveness and domestic employment. Accordingly, the Government has decided to limit increases in salaries to 15 per cent. It is also the intention to allow increases in import prices to be fully reflected in domestic prices with the exception of a few essential products, for which subsidies will be kept within the limits set by the budget. The system of price controls has been revised to allow greater flexibility in its application. As already indicated, budgetary expenditure for price subsidies will be reduced and this reduction will not be offset by allowing a deterioration in the financial position of the Supply Fund.

9. Portugal's external public debt (direct and guaranteed; excluding compensatory borrowings) increased by about 50 per cent from US$426 million at the end of 1973 to about US$640 million at the end of 1976. Obligations of public enterprises, including enterprises brought within the framework of the public sector since 1974, and of the private sector were estimated at around US$1.4 billion at end-1976. Debt service payments in 1977 (excluding any amortization of loans against gold collateral) are estimated at around US$600 million, about 25 per cent of receipts from exports of goods and services in 1976. Much of the debt is short- and medium-term; about three quarters of total repayments are due during the next five years. With the expected improvement in the balance of payments in the period ahead, the Government intends to slow the rate of increase of the external debt and to strengthen the maturity profile by reducing reliance on financing with maturity of five years or less, insofar as availability of longer-term official development loans and conditions in international financial markets allow. The authorities will therefore monitor carefully overall external debt developments and the Treasury will coordinate borrowing by public sector entities. The contracting of supplier credits will be subject to authorization by the Banco de Portugal so as to avoid excessive increases in such borrowing and bunching of maturities. The authorities are instituting a comprehensive debt registration system to be centralized in the Banco de Portugal.

10. Despite the deterioration of the external account since 1974, all bona fide payments and transfers for current international transactions have continued to be authorized. However, the standard travel allocation of foreign exchange has been progressively reduced. Importers of capital equipment goods are now required to arrange for foreign financing in order to qualify for domestic bank credit. Foreign exchange budgets are specified for transactions of the Central Government, and indicative exchange budgets for government agencies charged with importing essential foodstuffs, fuel, and raw materials. In May 1975, Portugal introduced a temporary import surcharge on about 30 per cent of total imports. Exemptions were provided for in cases of items essential for domestic production. In October 1976, in view of the further deterioration of the balance of payments, the rates of surcharge were raised to 60 per cent on about 1.3 per cent of imports and 30 per cent on about 28 per cent. A proposal currently before the Parliament would increase the coverage of the 60 per cent surcharge to about 2.3 per cent of total imports. An import deposit requirement of 50 per cent, to be blocked without interest for six months, was applied to about 7.5 per

cent of import items within the group already subject to the surcharge. In February 1977, Portugal introduced temporary value quotas on some 6 per cent of imports, including automobile components, household appliances, coffee, and bananas. The 1977 quotas are equal to average imports for the years 1975 and 1976, but may be enlarged by the amounts of increased exports of certain of the manufactured goods involved. The Portuguese authorities intend to eliminate the import deposit requirement and to review the quantitative restrictions with the Fund before the end of 1977. The import surcharge will be phased out gradually as soon as the balance of payments position permits.

11. During the period of the proposed stand-by arrangement, the Government does not intend to introduce any multiple currency practices or impose new or intensify existing restrictions on payments and transfers for current international transactions or enter into any bilateral payments arrangements with Fund members or to introduce new or intensify existing restrictions on imports for balance of payments reasons.

12. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of the program but will take any further measures that may become appropriate for this purpose. During the period of the stand-by arrangement, Portugal will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of Portugal or whenever the Managing Director advises that consultation on the program is desirable. In any case, Portugal will consult with the Fund before the end of the program period.

Sincerely yours,

/s/

Dr. Medina Carreira
Minister of Finance

Dr. Jose da Silva Lopes
Governor
Banco de Portugal

cc: HS

MINISTÉRIO DAS FINANÇAS

GABINETE DO MINISTRO

ORIG: EURO
CC: MD
DMD
MR. DINI
LEG
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4/11/77

Dear Mr. Witteveen:

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.../...

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.../...

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.../...

The import surcharge will be phased out gradually as soon as the balance of payments position permits.

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Sincerely yours,

Lisboa, 11 de Abril de 1977

Minister of Finance

Governor
Banco de Portugal

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MR. PATRICK DE FONTENAY

CHIEF WESTERN EUROPEAN DIVISION

INTERFUND

WASHINGTONDC

I AM PLEASED TO INFORM YOU THAT THE PORTUGUESE GOVERNMENT AGREES WITH THE TERMS OF THE LETTER OF INTENT THAT I HAVE DISCUSSED WITH YOU LAST WEEK. BEST REGARDS.

JOSE DA SILVA LOPES

GOVERNOR

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Portugal | 1160

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INTERNATIONAL MONETARY FUND

Washington, D.C. 20431

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ADDRESS

~~Dr. Silva Lopes~~
Governor
Bank of Portugal
Lisbon (Portugal)

Special Instructions

This is to confirm that, as per our telephone conversation, the penultimate sentence of paragraph 6 of the letter of intent now reads as follows: "Furthermore, in order to avoid an excessive utilization of credit by nonviable enterprises, it is intended that the guarantees extended by the central government in 1977 will not bring the total amount of guarantees above Esc. 70 billion, and that most of the increase would be in support of international borrowing."

Distribution

Best regards
Patrick de Fontenay
Interfund

MESSAGE MUST END HERE

Drafted by: ~~P. de Fontenay~~
Department: ~~European~~
Date: ~~3/22/77~~

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Mr. Green

CONFIDENTIAL

The Managing Director

January 26, 1977

L. A. Whittome

Meeting with Mr. Yeo, January 25, 1977

At his request I called on Yeo yesterday afternoon. He wished to run over the situation in the United Kingdom, Italy, and Portugal and in addition to touch on France. I have listed below only the points which seem new or relatively new.

The United Kingdom

I queried the potential policy conflicts inherent in the requirements of the stand-by--to maintain a competitive exchange rate--and the sterling balances agreement--to make reasonable efforts to secure a fall in sterling balances. Obviously interest rate policy could provide one way through, but Yeo is at least partially aware of the United Kingdom's long standing reluctance ever to raise interest rates and therefore the dangers of encouraging a fall that might not prove sustainable for more than a short period.

In the end Yeo put it that the Fund had the reins in its own hands. If we thought it right to put top priority on maintenance of a competitive exchange rate, then your judgment could properly be that given the overriding importance of this consideration, the British were still making resonable efforts to reduce the sterling balances notwithstanding the fact that these balances might have risen. Obviously, such matters as the progress achieved in the sale of bonds and use of other appropriate means would also be relevant.

Yeo also was uneasy at the present euphoria in London and at the continuing tensions between Callaghan and Healey.

Italy

I said that from all that I could see the financial situation was deteriorating. Yeo seemed divided, in himself, agreeing in substance and yet desperately hoping that we could keep open all bridges and somehow achieve a breakthrough. In a subsequent talk with Dini, he told me that by Friday Andreotti hopes to have a position on the scala mobile and the fiscal prospects. Based on such consensus as he can obtain, we may well be asked at the beginning of next week to decide whether or not to visit Rome, for it has long been agreed that yet another round of consultations with the Italians which led to no result could only be harmful to all concerned.

Orig. c/U.K. /815
copy c/ Italy / 810

Portugal

As with Italy I think there is some inconsistency in the present U.S. position. They want very much to keep the Fund in the forefront and want discussions to continue and to be successful yet at the same time, they want us to insist on policy changes. I suppose that the truth is that the obvious political dangers in Italy and Portugal add to the weight of the State Department's voice which, fortunately for us, was somewhat muted during the U.K. discussions.

France

Despite signs that the Barre plan is having more success than was earlier feared Yeo very much agreed that the French situation remained tightly balanced. In particular, I fear that the results of the municipal elections (to be held next month) and doubts over the elections to the National Assembly (due next year) could precipitate a large outflow of capital.

We did not touch on such potential dangers as Spain, Greece, Turkey, and South Africa.

cc: The Deputy Managing Director
Mr. Green

Mr. Green

January 5, 1977

MEMORANDUM FOR FILES

Subject: Portugal

Mr. Dini telephoned from Lisbon yesterday evening. The Portuguese had told him of their agreement with the United States--of which we had already been told by the United States--and now under U.S. prodding have decided to ask for a second credit tranche drawing. Dini then said that this filled him with unease. He did not think that the Portuguese policymakers had either the power or the determination both to make the necessary commitments and carry them out. He therefore feared either a weak stand-by by Fund standards, in which case we would dent our reputation with the commercial banking world and the United States and Germany or else a normal stand-by which would not later be observed. These views are in line with our own and in some contrast to those of Mr. Yeo.

The staff team arriving in Lisbon today has authority to negotiate a first credit tranche stand-by. Mr. de Fontenay has been told that if in his opinion and after deliberately taking a conservative view he thinks it proper and appropriate to go further, then he should phone us. I have told him that in such a case, we might favor agreeing to a use of some part of the second credit tranche, which would only be made available some six months after the beginning of the stand-by. I have in mind first that it is going to take several years before external equilibrium is restored in Portugal and we need therefore to husband our resources. Secondly, that the point of a second credit tranche is to set performance clauses and this can be done as well with a token amount of money as with a full tranche.

L. A. Whittome

cc: The Managing Director
The Deputy Managing Director
Mr. Schmitt
Mr. Sturc
Mr. Green ✓

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The Managing Director

December 23, 1976

MEMORANDUM FOR FILES

Subject: Portugal

I asked Mr. Yeo where the United States stood in its conversations with the Portuguese. He said that according to their assessment there was no reasonable hope that the Portuguese authorities could both put in hand and carry out a program that would justify a drawing beyond the first credit tranche. Against such thinking they had come to be convinced that the difficulties facing the Portuguese were such as to necessitate direct assistance. Their plan over time was to tie in their lendings to Fund programs.

L. A. Whittome

cc: The Managing Director
The Deputy Managing Director
Mr. Pfeifer
Mr. de Fontenay
Mr. Schmitt
Mr. Green