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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/116

10:00 a.m., July 30, 1984

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	A. Koné, Temporary
	S. Kolb, Temporary
B. de Maulde	
	M. Teijeiro
	D. C. Templeman, Temporary
	T. Alhaimus
H. Fujino	T. Yamashita
	I. R. Panday, Temporary
R. K. Joyce	
	H. A. Arias, Temporary
G. Laske	G. Grosche
G. Lovato	N. Coumbis
R. N. Malhotra	
	J. E. Suraisry
J. J. Polak	
A. R. G. Prowse	
	O. Kabbaj
	E. I. M. Mtei
M. A. Senior	
J. Tvedt	A. Lindø
N. Wicks	T. A. Clark
	Wang E.

J. W. Lang, Jr., Acting Secretary
R. S. Franklin, Assistant

Also Present

European Department: P. B. de Fontenay, Deputy Director; T. Catsambas, A. M. Mansoor, K. A. Swiderski, T. M. Ter-Minassian, M. Xafa. Exchange and Trade Relations Department: M. Guitián, Deputy Director; S. Mookerjee, Deputy Director; S. J. Anjaria, E. R. J. Kalter. Legal Department: J. K. Oh. Research Department: N. M. Kaibni, E. A. Milne, T. K. Morrison. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. El-Khouri, L. Ionescu, W. Moerke, G. E. L. Nguyen, D. I. S. Shaw, A. Steinberg, A. Vasudevan. Assistants to Executive Directors: I. Angeloni, R. L. Bernardo, J. Bulloch, M. Camara, M. B. Chatah, D. Hammann, H. Kobayashi, K. Murakami, E. Olsen, G. W. K. Pickering, E. Portas, J. Reddy, D. J. Robinson, J. E. Rodríguez, A. A. Scholten, Shao Z., A. J. Tregilgas, Wang C. Y.

1. EXECUTIVE DIRECTOR

The Chairman welcomed to the Executive Board Mr. Hirotake Fujino, Executive Director for Japan.

2. PORTUGAL - 1984 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT; AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

Executive Directors considered the staff report for the 1984 Article IV consultation with Portugal and a review under the stand-by arrangement (EBS/84/143, 7/2/84) together with a request by Portugal for a purchase equivalent to SDR 54.6 million under the compensatory financing facility (EBS/84/148, 7/11/84; and Sup. 1, 7/27/84). They also had before them a report on recent economic developments in Portugal (SM/84/170, 7/16/84).

Mr. Lovato made the following statement:

My Portuguese authorities wish to express their deep appreciation for the steady and effective support provided by the staff during the preparation and the implementation of the stand-by program. They generally concur with the staff's assessment of Portugal's current economic situation and of the key policy priorities, and wish to reaffirm their willingness to continue to collaborate with the Fund in their effort toward financial and structural adjustment.

The coalition Government which took power in June 1983 has made a serious effort to correct the major imbalances in the economy and has achieved substantial results. Clear evidence of this is already apparent in all major aspects of the economy, including the external accounts, public sector finances, monetary and credit conditions, and incomes and pricing policies.

In particular, the current account deficit of the balance of payments decreased from the equivalent of $3.2 billion (more than 13 percent of GDP) in 1982 to about $1.7 billion (8 percent of GDP) in 1983. The overall deficit was contained below $900 million in 1983, despite a sharp decline in foreign capital inflows. This outcome, which was significantly more favorable than the program targets for 1983, was mainly the result of a sharp reduction of domestic demand at a time when the country's main trading partners were beginning a phase of economic recovery, but it also reflected a substantial improvement in competitiveness.

The General Government's financing requirement was reduced to the equivalent of 9 percent of GDP in 1983 from nearly 12 percent in 1982. The borrowing requirements of the public

enterprises declined in the same period from 10.4 percent of GDP to 6.2 percent. This amounted to a reduction in the borrowing requirement of the enlarged public sector--the fiscal aggregate on which the authorities have now decided to focus attention--of over 7 percent of GDP in one year. These developments resulted in a fall in the growth rate of total financing to the enlarged public sector of 12 percentage points to below 22 percent, and of total financing to the economy of 10.5 percentage points to 18.2 percent, in both instances implying substantial declines in real terms.

The tightening of financial policies was accompanied by a moderation in personal incomes, particularly wages, which declined sharply in real terms, and by substantial adjustments in administered prices of subsidized commodities and of public sector services, which were designed to restore realistic market signals and to improve the financial situation of a number of public enterprises. The moderation in labor costs contributed to the containment of unemployment to a level somewhat lower than originally expected.

Unfortunately, despite the tightened financial stance and the moderation in the growth of incomes, the performance on the inflation front was disappointing. This was partly the inevitable consequence of the process of price liberalization, and partly the result of the sharp exchange rate depreciation of mid-1983. Although some effects of the recent increase in administered prices should continue to affect price developments in the near future, the authorities are convinced that the current policies will reduce the pressure on prices in the coming months, and expect the 12-month inflation rate at the end of 1984 to be some 10 percentage points below the 34 percent level of December 1983.

The sizable progress on the external front and in the public finances was achieved at the cost of sharp reductions in domestic demand (over 7 percent) and in the standard of living. It is fair to emphasize in this context that the Portuguese authorities undertook a severe and controversial adjustment effort even before the Board's approval of the stand-by arrangement in order to avoid a worsening of the situation, and that they have carried it out with a determination that is remarkable in the light of the political and institutional conditions of the country.

Concerning prospects for the current year, the policies outlined in the letter of intent are aimed at securing both a consolidation of the results already achieved and significant further progress.

The current account deficit should decline by at least 2 percentage points of GDP to 6 percent, and the overall balance of payments is expected to be in equilibrium for the year as a whole. Preliminary data for the first months of 1984 indicate once again that progress on the external front is greater than targeted. The current account deficit for the first quarter remained below $300 million, compared with $766 million in the same period of 1983. The enlarged public sector deficit should decline by about 1 percentage point, to below 14 1/2 percent of GDP. Despite the measures already taken, and although further cuts are being planned in some public enterprises' investment programs, a more substantial improvement in the finances of the enlarged public sector is made difficult this year by the greater than expected depth of the current recession and by the fact that a number of tax measures taken last year were of an exceptional, temporary nature. In both the public and private sectors, wage moderation is expected to continue as in 1983. The credit ceilings of the program imply a further reduction of total as well as domestic financing in real terms, and are aimed at arresting the reduction in the share of the private sector in domestic credit expansion. Finally, exchange rate policy will continue to be flexible with a view to avoiding substantial changes in competitiveness. The firm implementation of this overall policy stance will, in my authorities' view, be instrumental in securing the targeted adjustment on both the external and the inflation fronts, in the absence of unforeseen external shocks.

My Portuguese authorities have just presented a three-year program that provides the framework for macroeconomic management beyond the current stand-by period and delineates the priorities and the broad lines of government action in the medium term. The program is based on the recognition that the economy continues to be beset by structural and institutional rigidities in many areas and that the current financial adjustment effort needs to be supplemented by actions aimed at removing these rigidities, with a view particularly to preparing the economy for a successful integration into the European Communities.

In the medium-term program, the authorities have clearly rejected any substantial easing of financial policies, recognizing the inevitable costs of a new stop-go cycle. Instead, they intend to gear policies in 1985 to promoting a further reduction of the current account deficit of the balance of payments in relation to GDP and a continued deceleration of inflation. These targets should be consistent with a gradual recovery of demand and output, led by exports and investment. Private consumption is expected to stagnate in real terms in 1985 and to rise moderately in the following years. The authorities recognize the importance, in this respect, of continued moderation in the growth of nominal incomes in the next few years.

Over the period covered by the economic recovery program, however, the crucial challenge facing the Portuguese economy is the implementation of a number of structural reforms in both the public and the private sectors. The government program echoes in this respect many of the undertakings outlined in the letter of intent. As regards the public sector, the main priority areas are fiscal reform and a comprehensive restructuring of the major public enterprises. The main aspects of the tax reform will be the introduction of a value-added tax--to replace the transaction tax currently in force--already planned for 1985, and the restructuring of income taxation over the next two to three years. The public enterprises will gradually be reorganized according to market criteria regarding their investment plans, labor management and pricing policies, as well as in their relations with the capital markets. The authorities fully recognize the importance of a revitalization of this sector. In order to address properly this problem, however, it is necessary that steps be taken to improve the quality of the managerial environment, with more emphasis being placed on technical competence and performance records. The World Bank has stressed this point in a recent report on the Portuguese public enterprises.

Another area in which the authorities intend to concentrate efforts is the development of capital markets through a broadening of the range of financial institutions and instruments. Progress in this respect will enhance the scope for nonmonetary financing of both the public and the private sectors and pave the way for greater reliance on market instruments in the conduct of monetary policy, rather than on administrative controls through credit ceilings.

In the private productive sector, the major area of structural weakness is agriculture. With its low productivity levels and heavy dependence on weather conditions, the sector would greatly benefit from a modernization of production techniques, better extension services, and from improvements in the transportation system, in the road network, and in other infrastructures. Portugal's participation in the European Communities can be particularly traumatic for the country's primary sector unless producers manage to raise their productivity to levels more comparable with those of their European competitors. Moreover, Portugal's strong and rigid dependency on foreign energy sources can be alleviated in the medium term only if public and private investments are carefully oriented toward energy-saving.

The present difficulties and the long-standing weaknesses mentioned above will require a consistent and sustained policy effort in the years ahead, as well as the support of the international community. The performance of the Portuguese economy in the face of the many challenges of the last ten years gives cause for some optimism concerning the future. The young Portuguese

democracy has given adequate demonstration of readiness to take difficult but necessary steps to adjust to the realities of the world economy and to collaborate fruitfully with this institution. At present, both the Portuguese authorities and many foreign observers are increasingly convinced that the measures designed to deal with the emergency financial situation cannot produce long-lasting effects unless they are complemented by a comprehensive program of structural amelioration. The latest OECD economic survey of Portugal stresses this point, and concludes by saying that "short-term corrective measures should be continued, but the results already achieved cannot be consolidated other than by implementation of the second part of the Government's economic policy consisting of a set of structural measures of an economic, financial, and social nature." Sharing the same belief, and convinced that my authorities are committed to a sustained collaboration with the Fund in the future, I ask my colleagues in the Board to continue their support for Portugal's economic program by approving both the decisions related to the present stand-by arrangement and the proposed purchase under the compensatory financing facility.

Mr. Teijeiro said that it was encouraging to see the determination of the authorities in implementing necessary adjustment measures and carrying out a medium-term program aimed at resolving the structural problems and rigidities of the economy. Progress thus far had been satisfactory; for the future, an extended arrangement with the Fund might be the appropriate framework within which the efforts of the authorities could be continued.

When the stand-by program had been launched in 1983, the external account objectives--particularly the target for the current account deficit--had not appeared sufficiently strong, given the very high level of external indebtedness, Mr. Teijeiro continued. However, performance under the program had been better than expected. The current account deficit for the first quarter of 1984 had been only one third the deficit registered in the same period in 1983, and the prospect was for a current account deficit that was significantly lower than the target of 6 percent of GDP. If that prospect were to be realized, it would provide a good opportunity for making the medium-term objectives for the current account more ambitious and more compatible with the high level of external indebtedness.

An appropriate exchange rate policy was crucial to continued good performance, Mr. Teijeiro considered. Following the June 1983 devaluation, the competitive position of the Portuguese economy had reached a record high and had been a major factor in the turnaround in the external accounts. However, he had had some reservations about the exchange rate policy pursued following the devaluation. The 1 percent monthly devaluation had allowed an effective appreciation of the currency, not only in terms of domestic prices--through the once-for-all adjustment in administered prices--but also in terms of labor costs. Wage increases on the

order of 20 percent were too high for the chosen rate of devaluation, and it was clear that improvements in the current account must be consolidated and that steps to liberalize the import system must be implemented before the exchange rate was allowed to appreciate. One way of preventing the escudo from appreciating further was to ensure lower wage guidelines for 1985, which would also aid progress on the inflationary front. Accelerating the rate of devaluation was only a second-best alternative, although it might be unavoidable if wage guidelines were not reduced.

On the fiscal front, Mr. Teijeiro observed that the program included a target for the total borrowing requirement of the public sector. Since the public enterprises were a major component of Portugal's fiscal problem, aiming at a comprehensive definition of the public sector was a first step in the right direction. Of course, monitoring could be difficult, at least initially, and efforts to improve the financial control of public enterprises should therefore continue.

The reduction in the total public sector borrowing requirement had been equivalent to 7 percent of GDP in the period 1982 to 1983, Mr. Teijeiro remarked. Progress in 1984 had been considerably slower, with a reduction equivalent to less than 1 percent of GDP, although that pattern could be corrected by the behavior of domestic arrears. Such a correction could indicate that the improvement in the fiscal situation had been lower in 1983 and would be greater in 1984. The problem of domestic arrears of the public sector appeared to be difficult to tackle. The public sector targets did not include any possible change in domestic arrears; however, given past experience, it might be useful to incorporate that item when monitoring the behavior of the public sector deficit. In any case, a fiscal deficit of 14 percent of GDP was still quite high, and further improvements for 1985 and beyond were imperative. Taking into account the continued increase in the Government's share in GDP, it seemed that most of the reduction in the deficit should be achieved through expenditure cuts. It was not clear from the staff papers whether or to what extent there was room for further increases in public sector prices.

In the area of monetary policy, the credit ceilings should be sufficient to secure a substantial decline in the inflation rate, particularly if interest rates were not reduced in anticipation of the fall, Mr. Teijeiro commented. The present level of interest rates should not be altered until greater progress on the inflation front had been achieved and consolidated.

The results of the program had been satisfactory and continued implementation of current policies might serve to secure further improvements in the short run, particularly with respect to inflation and the current account balance, Mr. Teijeiro considered. It was essential that the adjustment effort be maintained and that the focus remain on exchange rate policy and the fiscal deficit. In addition, the authorities should begin to face the structural problems in the economy. It was encouraging to note that, in the three-year program, priority was being given to tax reform and to a comprehensive restructuring of the major public enterprises, two areas where progress could have a major effect. However, greater attention

should also be paid to the possibility of deregulating the economy in a way that would allow for significant increases in incentives for private domestic and foreign investment. Setting the appropriate climate for private investment could yield much greater and faster results in terms of the growth of the economy than efforts to make the public sector more efficient.

Commenting on two technical matters, Mr. Teijeiro observed, first, that the performance criteria included in the Portuguese program differed from those in other programs, particularly with respect to the definition of credit targets. In the Portuguese case, a limit was established for the growth of credit in absolute terms, while in other programs the limit was set for domestic assets net of changes in foreign assets. The difference between the two approaches was striking. For example, an unexpected private capital inflow under the Portuguese program would have to be sterilized to avoid increases in total credit beyond the absolute credit ceiling; on the other hand, a program working with a net domestic assets definition would automatically allow an increase in credit to the private sector equivalent to the capital inflow. The definition used in the Portuguese program was thus more restrictive and, while that might be justified at the beginning of a program when the reduction in inflation was a priority matter, a net domestic assets definition could be more appropriate in the later stages. Certainly the question would be an interesting topic for the forthcoming discussions on the design of Fund programs.

His second point was related to the definition of public sector deficits, Mr. Teijeiro said. He had noted that different definitions were being used in different staff reports: for some countries, like Israel and Brazil, the operational deficit definition was used; for most other countries, the total borrowing requirement of the public sector was employed. The application of those two definitions might lead to two very different results, and not only when the country involved was experiencing high inflation or hyperinflation. For example, when the operational deficit definition was applied in the case of Portugal--with its rate of inflation and an outstanding domestic debt of the total public sector greater than 40 percent of GDP--the monetary correction required would be about 10 percent of GDP. Taking a closer look at public finances from different perspectives might help to reconcile the existence of a public sector deficit that, in the case of Portugal under the traditional definition, would be equivalent to 14 percent of GDP with a current account deficit that, in 1984, might be reduced to a level of 4 percent of GDP. He hoped that an opportunity would be provided in future for discussing that matter; in the meantime, it would be helpful if public sector figures in the staff papers could at least distinguish between domestic and foreign interest payments. In conclusion, he recorded his support for the proposed decisions.

Mr. de Maulde remarked that, in his opening statement, Mr. Lovato had convincingly said nearly all that he himself had wished to say on the Portuguese economy. All targets under the current program had been met,

the current account had improved beyond expectations, and appropriate monetary, fiscal, and incomes policies had been followed. In the circumstances, he could do little more than encourage the authorities not to relax their policy stance.

The weaknesses in the Portuguese economy were in two areas: the management of the public enterprises, and the rate of inflation, Mr. de Maulde continued. With regard to the former, the World Bank was providing some technical assistance designed to improve the management of the public enterprises; and the French authorities had also responded to Portugal's request for technical advice. As for the latter, since the appropriate policies were in place, the current rate of inflation should fall markedly in the near future. Moreover, for those who remained concerned about the current level, it should be noted that the persistence of a high inflation rate in the first phase of an adjustment program was not necessarily a bad thing, since it helped the adjustment process in a number of ways.

For the medium term, Mr. de Maulde considered that it was urgent to carry out the long-awaited tax reform. The present archaic tax system seriously hampered the authorities' efforts to conduct a modern economic policy. The decision to introduce a value-added tax in 1985 was to be welcomed, but much remained to be done in other areas, including income taxes.

Agriculture also required emphasis in the medium term, Mr. de Maulde remarked. The agricultural sector still employed 25 percent of the labor force in Portugal, and that percentage would have to fall sharply in future. According to Mr. Lovato, because of Portugal's low productivity levels and heavy dependence on weather conditions, the agricultural sector would benefit greatly from a modernization of production techniques, better extension services, and improvements in the transportation system and other infrastructures. Portugal's induction into the European Communities would be particularly traumatic for the agricultural sector unless producers managed to raise their productivity to levels more comparable with those of their European competitors. That view seemed to suggest that agriculture in Western Europe, as fashioned by the Common Agricultural Policy, was an extremely competitive and productive business and not at all a haven for the irresponsible, as some of the critics of that policy had suggested. In conclusion, he could support Portugal's compensatory financing request, which met all the requirements for a purchase, especially since the proposed purchase was far smaller than the calculated shortfall.

Mr. Laske indicated that he was in broad agreement with the staff appraisal and could support the proposed decisions. Portugal had made good progress under the stand-by arrangement, with all performance criteria having been observed. The adjustment of the economy had benefited from tightened financial policies, a decline in real wages, some rehabilitation of the public enterprises, and a flexible exchange rate policy. As a consequence, the current account of the balance of payments

had improved beyond expectations. However, the economy continued to suffer from serious structural deficiencies which, if left uncorrected, could increase the external vulnerability of the economy and impair the authorities' efforts to re-establish a viable balance of payments position over the medium term. In that respect, the program supported by the stand-by arrangement was an important step toward achieving lasting improvements in Portugal's economic structure.

Success achieved thus far had been mainly through appropriate exchange rate, monetary, and fiscal policies, Mr. Laske continued. Consolidation of that success would require a continuation of those policies, together with greater vigor in the area of structural adjustment. The positive contribution that the tightening of monetary policy had made to the containment of inflation could not be overstated, although the conduct of monetary policy continued to be hampered by relatively rigid institutional arrangements and by narrow financial markets. The authorities favored an approach under which quantitative controls on domestic bank credit were the main instruments of monetary policy. With the recent introduction of a "pivot" rate for short-term time deposits, the authorities had taken an important step forward in liberalizing the financial markets. He wondered, in passing, what preliminary reaction, if any, the markets had shown to the authorities' action. For the future, timely adjustments in the pivot rate, which should take account of shifts in the demand for monetary assets, would be important. In that context, it might be interesting to learn what role was accorded to the Central Bank's own lending rate in relation to the pivot rate. Also, he would suggest consideration of some deregulation for lending rates which, according to SM/84/170, were tightly administered by the Central Bank.

On the matter of credit controls, experience seemed to suggest that a different way of directing the flow of credit might produce a more efficient allocation of resources and greater flexibility in the economy, Mr. Laske continued. For example, the Central Bank might do better in seeking to control the volume and cost of money that it provided to the banking system. He viewed the new pivot rate as a first, cautious step toward such a policy, and he encouraged the authorities to be bolder than they appeared to be at present in moving toward that end.

Despite the progress recorded in 1983, the public sector finances were likely to remain an area of serious weakness in both the short and medium term, Mr. Laske remarked. That view was underlined by the indication of the staff that a steady reduction in the public sector's claims on financial resources would be essential for a sustained recovery of productive investment, which was particularly important for export-oriented industries. The recent reduction in the public sector budget deficit was welcome, but it should not be overlooked that, to a certain extent, the reduction in the deficit had been owing to temporary factors. In the circumstances, the authorities must persevere in their effort to compress the absorption of resources by the public sector in more than one field if the public borrowing needs were to be prevented from increasing once again and absorbing an excessive proportion of domestic savings or requiring unsustainable amounts of foreign reserves.

Another important element of fiscal policy was the reform of the tax system and the consequent broadening of the revenue base, Mr. Laske considered. Such reform could help to distribute the burden of adjustment more equitably over the Portuguese population. The introduction of a value-added tax in 1985 should make possible the replacement of the present complex system of indirect taxation, while other reforms should aim at improving the existing structure of incentives. He welcomed the intended thoroughgoing review of existing fiscal incentives and tax exemptions that, in recent years, appeared to have led to a contraction of the tax base.

Exchange rate policy would play an important role in the eventual restoration of a viable balance of payments position, Mr. Laske commented. The devaluation of the escudo in 1983 had helped the Portuguese economy to regain competitiveness and to register impressive export increases; with a continued adjustment of the exchange rate, the gains made thus far would be preserved. The set of policies to which the authorities had committed themselves was designed to allow a further reduction in the rate of inflation, which was projected to fall to 23 percent by the end of 1984. That rate would still be rather high, however, and a further decrease must remain a primary objective of economic policy. The staff had indicated that monthly depreciations of 1 percentage point were consistent with the inflation objective in the program; however, he would be grateful for some further elaboration on that matter, with some focus on any uncertainty that might be inherent in the inflation target. In that context, he had been interested in the remarks of Mr. Teijeiro on the relationship between the depreciation schedule and the development of real wages.

Viewing the balance of payments statistics, he had been struck by the precipitous decline in the trade deficit, from $4.8 billion to $2.5 billion in 1984, Mr. Laske said. Approximately 60 percent of that reduction had apparently been due to a decline in imports, the largest part of which had already occurred in 1983. Indeed, 1983 imports had been considerably lower than projected in the program. The strong decline in investment, both fixed investment and inventories, in combination with nearly stagnant private consumption, had obviously been the driving force behind the shrinkage in imports. Still, the further reduction projected for 1984 raised questions about how long such a drastic reduction in the availability of imported goods could be sustained without impairing the growth potential of the economy.

According to the data, Portugal carried a relatively heavy external debt burden, Mr. Laske noted. The three scenarios developed by the staff left little doubt that only a consistently pursued policy of demand restraint, together with a maintenance of international competitiveness and vigorous structural adjustment, could keep the debt situation manageable. In that connection, it would be regrettable if Portugal were to resort to the "stop-go" policies of the past, an approach that could lead to an untenable foreign debt situation and, at least as important, could undermine the progress thus far achieved.

With regard to Portugal's request for a purchase under the compensatory financing facility, Mr. Laske indicated that he was prepared to go along with the proposed decision, mainly because the amount requested was considerably smaller than the calculated shortfall. Nonetheless, his authorities were not fully convinced by the judgmental element in the determination of the shortfall. There could be no doubt that Portugal met two of the requirements for a purchase under the facility: it clearly had a balance of payments need, and its collaboration with the Fund had been exemplary. However, one would not normally think of Portugal as falling into the category of those countries experiencing a shortall in the literal sense of the term. He realized, of course, that the text of the relevant decision could be understood to treat a shortfall not only as a drop in the absolute level of export earnings but also as a slowdown in the growth rate of those earnings. In Portugal's case, a real decline would occur only with respect to workers' remittances, which were projected to shrink by about 15 percent by comparison with the 12-month period ended March 1983. However, as the staff paper showed, it was unlikely that workers' remittances would ever again reach the levels achieved in 1982 and 1983, which suggested that the decline might not be temporary. That very point had been raised by his chair on the occasion of the previous compensatory financing facility discussion.

A different problem arose with respect to the shortfall calculated for receipts from tourism, Mr. Laske remarked. While the recession in Europe had caused a rather steep decline in vacation travel from European countries to Portugal, an even more decisive reason for the shortfall in tourism receipts might well have been the steep rise in Portuguese prices that, for the foreign tourist, had not been offset by a timely exchange rate adjustment. The shortfall calculated for the 12-month period ended March 1984 was strongly influenced by the rather generous growth projections for tourism in the two postshortfall years. If past tourist behavior served as an appropriate indicator for the future, he could not but be concerned that the projections for 1985 and 1986 might be overly optimistic and not, in the event, realized. Indeed, that was precisely what had happened with respect to the shortfall calculations on which the previous compensatory financing purchase had been based. Footnote 3 on page 4 of EBS/84/148 indicated that the earlier shortfall "was somewhat less than half of the amount purchased at that time." Did that mean that overcompensation had occurred and would ordinarily have called for an early repurchase if the overcompensation had not been submerged in the shortfall established in the latest request? Also, he had noted in the same footnote that the current shortfall would have been smaller than the requested purchase if the growth of earnings had been projected on the basis of less generous assumptions. On balance, despite his doubts regarding the size of the shortfall, he was willing to support the draft decision.

Mr. Polak considered that the stand-by arrangement with Portugal had been basically successful, with economy having proved susceptible to the strong demand management that had been exercised over the period of the arrangement. In 1983, the enlarged public sector borrowing requirement had been reduced to 15 percent of GDP, from 22 percent in 1982; during the

same time, external competitiveness had been much improved by the 10 percent real depreciation of the exchange rate, as measured in unit labor costs. Those adjustment measures had produced an impressive switch in resources to the external sector.

While domestic demand in 1983 had declined by 7 percent in real terms, real GDP had remained nearly constant, and the current account deficit had been considerably reduced, Mr. Polak continued. He therefore agreed with Mr. Lovato that the program had been carried out with a determination that was remarkable, in light of the political and institutional conditions in Portugal. It was clear, however, that the demand management effort would need to be sustained and that the structural reform would need to be completed.

He had no particular concerns with respect to monetary or exchange rate policies, Mr. Polak noted. However, he was troubled that the impressive improvement in the fiscal balance and in the current account in 1983 seemed to have given rise to a feeling that a slowdown in the pace of adjustment would not be harmful. He was happy to note that statistics were currently available on the enlarged public sector borrowing requirement and that a target had been established, but he was worried that the targeted reduction was so small, at less than 1 percent of GDP. The assumption seemed to be either that fiscal adjustment would be intensified in 1985, following the completion of the stand-by arrangement, or that the overall level of the public sector borrowing requirement of 14-15 percent of GDP was acceptable. In his view, a further and more rapid reduction was essential. In that connection, he was concerned about the possibility that the performance criteria for bank credit to the official sector might be met in part through increases in domestic arrears. Domestic arrears were a pervasive phenomenon in Portugal, extending even to normal wage payments; and, as noted in SM/84/170, the information on those arrears was far from complete.

On the target for the balance of payments, Mr. Polak noted from the staff report that extensive discussions of the medium-term balance of payments scenario had taken place between the staff and the authorities. However, the report seemed to focus mainly on what the staff had said and very little on the authorities' response; he would appreciate hearing the views of the authorities on the desirable course of external borrowing and whether the staff considered continued net reliance on foreign borrowing to be feasible.

Commenting on the need for structural reform, Mr. Polak observed from the staff paper and from the recent OECD survey on Portugal that the authorities would need to deal with a number of structural problems before sustained growth was possible. Among the structural reforms required were the restructuring of public enterprises, improvements in agricultural productivity, and a loosening of regulations covering labor. He was encouraged that the authorities had begun to tackle those problems.

The financial system of Portugal was another area in which structural reform was necessary, Mr. Polak considered. In its report, the staff had suggested that the banks suffered from reduced profitability; yet there were extremely wide margins between the effective lending rates, which were currently at 37 percent, and the deposit rates, which were at 26 percent. It was impossible, in his view, for a healthy savings and investment situation to exist if the financial intermediator absorbed as much as 10 percent of savings and investment flows each year. He would welcome comment from the staff on the reasons for the wide gap between lending and deposit rates and he would be interested in hearing whether a move toward a more market-oriented monetary system could be expected. While on the matter of interest rates, he noted that the large government deficits entailed rising interest payments for the Government; like Mr. Teijeiro, he would appreciate some comment on the increase in interest payments, which amounted at present to 8.3 percent of GDP and which reinforced the idea that further deficit reduction was crucial, even if reliance in part had to be placed on increased tax revenues. There was clearly a need for structural change in the tax system and, in that regard, he welcomed the expected introduction of the value-added tax. In sum, while the authorities had made considerable progress, the road ahead was a long and arduous one. Still, in view of the potential of the Portuguese economy, the task of the authorities was not insurmountable.

Portugal's request for a purchase under the compensatory financing facility met all the relevant requirements, and he could support the proposed decision, Mr. Polak commented. Although the latest projections for the two postshortfall years seemed plausible, it was clear that the projections supporting the previous year's request had not been correct. By comparison with what had been projected in 1983, the actual shortfall--on the basis of the latest data--was likely to equal only one third the original estimate, with the difference largely due to different results for tourism and workers' remittances. In its next review of experience with shortfall estimates, the staff should pay particular attention to the question whether it was more difficult to make projections for workers' remittances and tourism than for commodities exports.

Mr. Suraisry stated that he was in broad agreement with the staff appraisal and could support the proposed decisions, including the decision on Portugal's request for a purchase under the compensatory financing facility, which met all the relevant requirements. The staff had taken the opportunity in its report to remind Directors of the economic imbalances that had reached their peak in the Portuguese economy in 1982--due to a combination of domestic and external factors--and of the far-reaching measures adopted by the authorities under the stand-by arrangement to counteract those imbalances. Improvement had been registered in several areas, particularly the balance of payments and the structure of external debt, and should encourage the authorities to continue with their adjustment efforts.

Notwithstanding the successes he had mentioned, performance in other areas--particularly the growth rate, inflation, and employment--were worrying, Mr. Suraisry continued. Obviously, much more needed to be done if a sustainable balance of payments position was to be achieved over the medium term. In recognition of that fact, the authorities were determined to continue working toward improving the current account, reducing crowding out of the private sector, maintaining a strong competitive position, and correcting the structural weaknesses of the economy. Those changes were essential if Portugal was to benefit from its membership in the European Communities.

Commenting on economic policies, Mr. Suraisry welcomed the emphasis given in the program to reducing the still high rate of inflation in Portugal. Without such a reduction, a sustained adjustment effort would be increasingly difficult, and the pressure for relaxing some of the adjustment measures would mount. On the fiscal side, he agreed with the authorities that the public sector finances were structurally weak and in need of more attention, not only in the short run but also over the medium term. Also, the shortfalls in revenue that had occurred in 1983--and were expected to recur in 1984--were not helpful to the authorities' goal of reducing the overall deficit of the Government. Hence, he welcomed the ongoing effort to reform the tax system through improvements in tax administration and a widening of the tax base. Also welcome were the steps being taken to strengthen expenditure control. He noted the difficulty that had been experienced in the attempt to reduce substantially the public sector borrowing requirement in 1984, and he commended the authorities for their commitment to take additional measures in 1984 to improve the public sector financing.

In the area of structural reform, the authorities' plan for restructuring ailing companies and their stated intention to strengthen the management of the public enterprises so as to increase efficiency were positive signs, Mr. Suraisry considered. If their efforts were successful, the authorities would have taken a major step toward achieving lasting improvements in the public enterprise sector. In passing, he welcomed the World Bank's involvement in the effort to improve the public sector finances.

With regard to external policies, Mr. Suraisry observed that Portugal's strong competitive position had been responsible for the impressive performance of exports, which had lessened the impact of the adjustment on economic activity. The authorities' intention to maintain that competitive position was welcome, as was the action they had taken to roll back the import surcharge from 30 percent to 10 percent. Particularly at the present stage of the adjustment effort, Portugal needed a strong export performance; consequently, it was important for the authorities to maintain a liberal trading system so as to avoid any possibility of counterreaction from others, which could discourage exports. Finally, noting that the debt service ratio--expected to reach 36 percent of foreign exchange earnings in 1984--was relatively high, he pointed to the need for continuing the adjustment process. The economic recovery in

Portugal's main trading partners should shorten the time necessary for correcting economic weaknesses; the pickup in demand for imports in those countries as a result of the recovery would enhance the adjusting countries' exports--provided that the competitive position was maintained--and would consequently help in improving the balance of payments.

Mr. Arias remarked that performance under the 1983 stand-by arrangement had been satisfactory and that the Portuguese authorities had fulfilled all performance criteria by comfortable margins. The current account deficit of the balance of payments had shrunk by 5.2 percentage points--to 8 percent of GDP--as net workers' remittances had been more than offset by reduced imports. Both government and public enterprise borrowing requirements had declined significantly in 1983, the former showing an outturn far better than originally projected. Inflation, on average, had turned out about as expected, while GDP had declined less than initially projected.

For 1984, the staff was assuming a 1.5 percent decline in GDP, which was somewhat better than the 2 percent decline forecast by the OECD, Mr. Arias continued. The staff had concluded that "the room for sustained growth...is likely to remain narrow in the next several years." Consideration must therefore be given to the fact that Portugal's entry into the European Communities, while in the country's long-term interest, would clearly create difficult adjustment problems over the next few years, particularly in the agricultural sector. In that regard, it was a most welcome development that the authorities had adopted a medium-term structural adjustment program designed to address the major problems of the public sector through fiscal reform, restructuring of the public enterprises, development of capital markets, and an increase in the productivity of agriculture.

An increase in investment was not foreseen during the period of the stand-by arrangement, Mr. Arias noted. Indeed, the staff had originally projected an 8 percent decline in gross fixed investment for 1984 but had revised its estimates and was currently projecting a decline of 13 percent, above and beyond the 7.5 percent decline in 1983 that had been owing in part to restrictive economic policies that had resulted in a sharp drop in public investment. In that regard, he was concerned about the recent behavior of savings. Although total private sector savings forecasts were not available for 1984, he had noted a further reduction in the household savings rate, beyond the decline of 3.4 percentage points registered in 1983. That decline, while expected because of the level of unemployment and the fall in real income, was nonetheless disappointing at a time when real interest rates had begun to turn positive, the crowding out of the private market had decreased dramatically, and the authorities had adopted several policy measures to increase financial savings and facilitate the flow of funds. In conclusion, the further improvements foreseen for 1984 in the fiscal and balance of payments variables seemed reasonable, and he could support the proposed decisions, including that for a purchase under the compensatory financing facility, for which all conditions had been met.

Mr. Wicks considered that the efforts of the Portuguese authorities were yielding encouraging results: the current account deficit of the balance of payments had been reduced; the public sector borrowing requirement had also been reduced; and the recent seven-year Eurocredit was evidence of the capital markets' renewed international confidence in Portugal's progress toward recovery. However, much remained to be done in 1984 and beyond. In that respect, he had been heartened to hear from Mr. Lovato that "in the medium-term program, the authorities have clearly rejected any substantial easing of financial policies, recognizing the inevitable costs of a new stop-go cycle." It would be a tragedy if the success of the initial stabilization effort lulled the Portuguese authorities into relaxing economic policies.

He welcomed the authorities' recognition that the public sector finances would require a sustained corrective effort in the short and medium term, Mr. Wicks commented. The planned containment of the borrowing requirement of the enlarged public sector to 14.4 percent of GDP in 1984 was a step in the right direction, although the borrowing requirement would still be very high. He therefore hoped that the authorities would do all they could to ensure that the borrowing requirements of both the Government and the public enterprises were kept below the program figures shown in Table 3 of the staff report. The establishment of the Interministerial Committee to monitor government and parastatal borrowing was welcome, as was the indication that the Committee would look into the problem of extrabudgetary operations with a view to eliminating them in the medium term. He encouraged the authorities to press ahead with the general program of restructuring the public enterprises and, in that regard, he could support the intention of the authorities to make a determined effort to identify fully arrears and to proceed to settle them in an orderly fashion. Reform of the public sector enterprises was important because Portugal's economic recovery depended heavily on the performance of export-oriented industries, many of which were publicly owned. In that regard, he wondered whether any thought had been given to some limited privatization of enterprises.

On the revenue side, the moves to rationalize indirect taxes and to make progress toward reforming the tax system--with a view, in particular, to reducing tax evasion and income tax rigidities--were welcome, Mr. Wicks said. Also, the authorities deserved to be congratulated for the efforts they had made to produce the statistics that enabled Executive Directors to review the consolidated deficit of the enlarged public sector.

With regard to monetary policy, Mr. Wicks supported the authorities' plan to gear money growth toward securing a decline in inflation to 23 percent by the end of 1984. He also supported the commitment of the authorities to a more flexible management of interest rates.

Commenting on the external position, Mr. Wicks noted that the sensitivity projections for the medium term had been particularly helpful. Like Mr. Polak, he would be interested in the authorities' own views on some of the implications stemming from those projections. On other

matters, he welcomed the fact that performance with respect to the current account had been better than programmed in 1983; and progress in the first quarter of 1984 had been encouraging. As Mr. Lovato had observed, the current account deficit remained below $300 million, which suggested that the authorities might be able once again to reach or exceed their goal of reducing the deficit to $1.25 billion. Much would of course depend on the maintenance of Portugal's international competitiveness through a realistic exchange rate policy and continued wage moderation.

The decline in the short-term component of external debt during 1983 was a positive sign, Mr. Wicks continued; but it was worrying that the ratio of debt to GDP and that of debt service to foreign exchange earnings had both turned out to be higher than programmed. The staff's medium-term scenarios underlined the need for the authorities urgently to consider significant economic reforms aimed mainly at restructuring the public sector finances, increasing flexibility in the labor and capital markets, and revitalizing the agricultural and energy sectors. In that connection, he had been interested in Mr. Lovato's description of the authorities' new three-year program, which he was certain the staff would touch upon in the next round of discussions with the authorities on progress under the present stand-by arrangement and on plans for the following year's budget.

While he had no inside knowledge about what the Portuguese authorities might have in mind for a follow-on program once the current stand-by arrangement was concluded, he understood from Mr. Lovato's statement that a proposal for an extended arrangement with the Fund might be in prospect, Mr. Wicks commented. It was clear Portugal had gone some way toward stabilizing the economy and reducing the main imbalances, although much remained to be done, and there appeared to be a case for continued Fund involvement. As for the form of that involvement, it was relevant to note the extent to which Portugal's medium-term problems reflected deficiencies in economic structure, which should be one consideration in looking at the possibility of an extended arrangement. However, as with all extended arrangements, there would be questions about how much additional financial support from the Fund was needed, the extent to which stabilization had been securely established, the political commitment to undertake the necessary measures, and the likelihood that any medium-term commitment would secure long-term balance of payments viability.

Finally, with regard to Portugal's request for a purchase under the compensatory financing facility, Mr. Wicks observed that the only requirement that gave him pause was that concerning the temporariness of the shortfall, particularly with respect to the decline in workers' remittances. Factors mentioned in SM/84/170 suggested that those remittances might be in a general and long-term decline. Of course, he recognized the difficulties involved in disentangling cyclical from structural causes for that decline, and he could therefore support the proposed decision, especially because the proposed purchase amounted to only 27 percent of the estimated shortfall.

Mr. Templeman remarked that, while it was unfortunate that the review of the stand-by arrangement could not have been completed by the original end-March deadline, the expansion of the coverage of the ceiling on credit to the public sector to include public enterprises--the main cause for the delay--was a worthy goal. Moreover, the Portuguese authorities should be commended for having continued their adjustment effort in the interim, guided by the original indicative targets.

He had been favorably impressed by the larger than expected adjustment in the external account, the particularly strong growth of exports, the evident improvement in Portugal's international competitiveness and creditworthiness, and the relatively small amount of import compression, Mr. Templeman continued. However, Portugal would continue to face external constraints on economic growth, which was a sobering prospect, considering that growth had been low or negative for the past three years and was expected to be slightly negative again in 1984. He could well understand why the authorities might be anxious for a return to positive real growth rates and why they had been encouraged by prospects for a modest upturn later in 1984; however, the sources of growth must shift from recent patterns in order to be sustainable. The growth of public consumption had been relatively high, and gross fixed investment had been low or negative. Export growth had improved but needed to continue to do so; and, in order for that to happen and for the decline in the household savings rate to reverse itself, further reductions in the public sector deficit, more flexible interest rate and exchange rate policies, wage restraint, and structural reforms in the markets for capital and labor would all be necessary.

A further reduction in the public sector deficit was the key to the containment of domestic demand in the coming years, Mr. Templeman considered. It was important in that regard to limit inflationary pressures while still allowing for sufficient expansion of credit to the private sector in order to stimulate investment and export growth. Equally important over the longer term was the planned comprehensive restructuring of the public enterprises in the industrial and transport sectors, possibly with the help of a loan from the World Bank. Such restructuring was required not only to reduce the fiscal deficit but also to introduce a greater element of economic efficiency in the economy so that the public sector enterprises could compete at home and abroad without artificial props. Reductions in the still high budget deficit of the Government would also depend importantly on improved expenditure controls--which should be possible with the monthly reviews of the new Interministerial Committee--implementation of the planned review of tax incentives and exemptions as part of the 1985 budget process, the introduction of a value-added tax in 1985, and improved collections of taxes and social security contributions. In that regard, the authorities appeared to be aware of the dangers of creating disincentives to household savings; but he remained concerned about the planned rise in the tax ratio to GDP.

On the expenditure side, the temporary hiring freeze and the emergence of a surplus in the Supply Fund, which financed subsidies of foodstuffs and fuel oil out of gasoline tax proceeds, were positive signs, Mr. Templeman continued. It was, however, questionable whether such subsidies, in principle, were desirable, especially given their effects on the consumption/savings balance and on the balance of payments. The 1984 planned reduction of less than 1 percentage point in the ratio of the public enterprises' deficit to GDP was disappointing, although he understood that the sharp drop in the figure in 1983--due to such temporary factors as the rundown in stocks and the accumulation of domestic payments arrears--had created an artificially low base.

Commenting on monetary developments, Mr. Templeman expressed the hope that the improved financial situation of the public enterprises would help to avoid the pre-empting of credit that would otherwise be available for the private sector, a problem that had occurred in 1983. The adoption of a new "pivot" interest rate at 28 percent for six-month deposits should make an important contribution to creating a real positive interest rate incentive to household savings and to a more flexible system for interest rate determination. On the other hand, he shared the doubts of the staff about continued use of direct controls over bank credit and hoped that the authorities would move promptly to avoid the distortions created by such measures through the development of a wide array of financial instruments and institutions.

On the balance of payments front, the restoration of Portugal's competitiveness through the 1983 devaluation and crawling peg seemed to have paid some dividends already, with the volume of exports up substantially in absolute terms and with an increase in Portugal's market share, Mr. Templeman observed. However, the recent rapid increase in inflationary pressures highlighted the need to continue to manage the exchange rate flexibly so as to keep merchandise exports competitive and to generate inflows of workers' remittances and tourism receipts. The staff had correctly emphasized the importance of export growth over the medium term, along with the attraction of direct foreign investment and a reduction in import dependency, as the keys to relaxing the external constraints on real economic growth.

As suggested in the three medium-term debt scenarios, projected import growth of 4-5 percent in volume terms would support only a rather low rate of economic growth and would still leave Portugal with a debt service ratio in 1990 in the range of 27-32 percent, Mr. Templeman noted. A faster rate of export growth than the 7 percent assumed in those scenarios would help considerably to improve growth prospects and could also alleviate the debt service burden and even the ratio of debt to GDP. Continued improvement in economic performance would reverse the pattern of sharply declining medium-term capital inflows and large short-term capital outflows, which had occurred in 1983; it would also improve the prospects for debt and nondebt capital inflows in the coming years. It was worth noting that the debt/GDP ratio at end-1983 had reached a very high level, at 83 percent, even without much access by the private sector

to foreign capital markets. On the other hand, continued prudence in financial management, coupled with the necessary structural reforms in the fiscal area and in the financial and labor markets, should go a long way toward alleviating that problem.

Noting Portugal's continued close cooperation with the Fund, he could support the request for a purchase under the compensatory financing facility, Mr. Templeman commented. However, he shared some of the concerns raised by other Directors regarding the relationship between the latest request and the request of the previous year. He also had some reservations about the "temporariness" of the shortfall and the extent to which it was beyond the control of the authorities. In particular, given the structural changes in the labor market that were currently occurring in Europe, and Portugal's high current inflation rate, there had not for some time been a reliable real interest rate incentive for Portuguese workers in Europe to send savings home; moreover, Portugal's monthly exchange rate adjustment did not appear adequate to offset the recent rate of inflation, and workers might be anticipating a larger devaluation at some point in the future, a factor that might also have a negative effect on tourism. He would be interested in staff comment on those issues.

Mr. Senior stated that, like others, he could support the proposed decisions, including Portugal's request for a purchase under the compensatory financing facility, which clearly met all the relevant requirements. He also joined other speakers in commending the authorities for the success achieved thus far under the stand-by arrangement; they had made a valiant effort to arrest the trends that had characterized the working of the Portuguese economy before the inception of the program.

It was essential that the gains secured through the adjustment effort over the past year should not be reversed through an abrupt easing of policies in the year immediately ahead, Mr. Senior considered. To that end, the macroeconomic actions envisaged by the authorities for the remainder of 1984 should directed toward ensuring further progress toward a stable economy. Of course, the attainment of the desired equilibrium in the medium term would also require the implementation of structural reforms. In the past, Portugal's economy had been characterized by quick shifts in the major economic equilibria, but with improvements vanishing rapidly because of structural rigidities. In order to correct those rigidities, the process of modernization and capital accumulation should be maintained, while fiscal and monetary policies should be geared to meeting the needs of small and medium-sized enterprises, which formed the backbone of the Portuguese industry and were particularly vulnerable to a restrictive monetary policy.

At the same time, Mr. Senior continued, nontraditional exports should be promoted in order to lessen the country's dependence on imported energy. Moreover, the financial infrastructure should be further developed and the efficiency and income elasticity of the tax system should be increased. Unless those structural changes were made, restoration of external equilibrium would be short-lived. The authorities apparently

recognized the need for structural reforms in the areas he had mentioned, and he hoped they would work toward achieving them, perhaps within the context of an extended arrangement with the Fund.

Mr. Tvedt observed from the staff report that the stand-by arrangement with the Fund had begun to produce positive results: the current account deficit and the public borrowing requirement had been reduced, and the inflation rate had begun to abate. In the circumstances, the policies adopted by the authorities seemed broadly appropriate; however, as noted by the staff, an easing of policies in 1985 and beyond might be premature, in light of the external debt situation expected for the remainder of the decade. The maintenance of a realistic exchange rate policy was of the utmost importance. However, he remained uneasy about the present system of preannouncing exchange rate changes. The crawling peg system, which aimed at bridging the gap between price developments at home and abroad, had contributed to a widening of that gap because of Portugal's heavy dependence on imports.

In addition to firm macroeconomic policies, structural action would be needed to deal with the deep-rooted imbalances and rigidities in the Portuguese economy, Mr. Tvedt considered. Hence, he welcomed the economic recovery program, which identified many of the problems facing the authorities and suggested different lines of action for dealing with them. In particular, an effort should be made to reduce Portugal's heavy dependence on external supply sources through a more realistic pricing of imported goods. It was important that the many reforms the authorities had announced with regard to agriculture, the public enterprise sector, and the financial markets should be implemented as soon as possible. Success in those areas would make Portugal's integration into the European Communities that much smoother. In conclusion, he could support the proposed decisions, including that on Portugal's request for a purchase under the compensatory financing facility, which seemed to meet all of the necessary requirements for a purchase.

Mr. Joyce, noting that Portugal had turned in a strong performance thus far under the stand-by program, remarked that the authorities had been particularly successful in three main areas: reducing the current account deficit, improving the implementation of fiscal policy, and constraining the expansion of public sector borrowing. As a result, international confidence in the Portuguese economy was being restored. The economic and social costs of the adjustment effort--in terms of lost employment and output--had admittedly been high, but there was really no alternative to adjustment. Indeed, the restrictive stance of policy should not be relaxed until the latest progress had been consolidated. In general, the measures outlined by the authorities in the most recent letter of intent should permit further progress toward external adjustment.

The better than anticipated fiscal performance in 1983 was welcome, although fiscal restraint must continue to play an important role in 1984 and, indeed, over the medium term if the adjustment program was to be successful, Mr. Joyce said. Of special note, in that regard, was the

decision of the authorities to include state enterprises with the Central Government in the setting of credit ceilings for the public sector. It was to be hoped that such a move would lead to increased control over the overall public sector deficit, although he noted that the enlarged public sector borrowing requirement was projected to remain relatively high, at 14.4 percent of GDP. Like Mr. Polak and others, he was concerned that the authorities might not be inclined to take more difficult action even if warranted. Indeed, he had the impression that the fiscal targets under the program were on the "easy" side; his own view was that the authorities should consider the achievement of the 14.4 percent target for the public sector borrowing requirement as a minimum goal.

Clearly, further fiscal improvement must emphasize both expenditure control and improved revenue performance, Mr. Joyce continued. On the expenditure side, the burden of interest payments--which at present amounted to about 22 percent of current expenditures--implied that control over discretionary elements in the budget, such as public sector employment and consumer subsidies, must be firm. On the revenue side, he welcomed the authorities' decision to proceed with tax reform, and he encouraged them to accelerate the reform process generally.

On monetary policy, Mr. Joyce observed that the measures taken to increase the attractiveness of savings deposits and to improve the flexibility of interest rates should help to liberalize capital markets; however, much remained to be done, particularly in terms of broadening the range of financial instruments and institutions in Portugal to assist in a more efficient mobilization and allocation of domestic savings. The weaknesses in the current financial system were reflected in the poor capitalization of the corporate sector, which was characterized by a relatively high level of short-term debt. It was to be hoped that the execution of a program to revitalize the capital market would go some way toward correcting that situation.

The flexible exchange rate policy being pursued by the authorities was an important companion to the domestic adjustment efforts under way, Mr. Joyce considered. However, the high level of external debt remained a serious weakness and, in order to ease the high debt servicing burden, resort to foreign borrowing would need to be quite circumscribed in the coming years. The medium-term scenarios discussed in the staff paper clearly indicated that a strong adjustment effort would be required through the medium term if even a fairly modest improvement in the debt service ratio was to be achieved and a modest import growth was to be financed.

Commenting on other concerns about the program, Mr. Joyce observed that only modest steps toward reducing inflation through the program period were envisaged. The staff had clearly explained why inflation was likely to fall from 34 percent at end-1983 to 23 percent by end-1984. While such a decline would be a considerable achievement, it would reflect mainly adjustments in administered prices and in energy prices, reductions in subsidies, and increased cost of public services. Hence, stronger

efforts on the inflation front were particularly important if Portugal was to maintain its competitiveness, especially as the economy began to face the full effects of integration into the European Communities. In addition to the continued need for wage restraint, it would be crucial to correct upward pressures on labor costs by reforming current restrictive labor legislation. More generally, however, better performance on the fiscal and monetary targets would contribute to improved performance on the inflation front.

The staff's emphasis on the need for medium-term structural improvements in the Portuguese economy was appropriate, Mr. Joyce commented. In the agricultural sector, for example, quick and determined implementation of measures to increase productivity and competitiveness must be undertaken, particularly given the size of the trade deficit with respect to farm products and the further difficulties anticipated in the agricultural area upon Portugal's entry into the European Communities. It was regrettable that the staff report was not specific in its recommendations for structural improvements in agriculture, and he would appreciate further comment from the staff. While decontrol of both consumer and producer prices was desirable, enhanced performance in the agricultural sector also called for stepped-up efforts to reform the ownership system as well for a more extensive integration of producers into larger productive units, modernization of equipment, and improved marketing procedures. In the industrial sector, incentives might be needed to help channel profits into productive investments and to encourage modernization and capacity-enlarging investment. The recent policy of opening up areas previously nationalized--such as banking and insurance--to more extensive private involvement was a step in the right direction.

In sum, Mr. Joyce remarked, it appeared that the current stand-by arrangement could help to lay the basis for a sustained recovery of the Portuguese economy. However, the adjustments made thus far were only a first step toward that end, and the difficulties faced by the economy called for a consistent and sustained policy effort. The newly won confidence of the international financial community could be quickly lost if the momentum toward improvement was not maintained. Hence, the authorities would have to continue to exercise financial discipline and to implement measures to redress structural constraints in the productive sectors of the economy. Of course, such actions might be politically difficult: they would require both determination by the Government and public understanding of the problems facing Portugal so that a social and political consensus in support of the required measures could be developed. Finally, while he shared some of the reservations put forward by Mr. Wicks and Mr. Laske regarding the outlook for workers' remittances, he had no difficulty supporting the fairly modest request for a purchase under the compensatory financing facility. He could also support the proposed decisions concluding the Article XIV consultation and the review of the stand-by arrangement.

Mr. Kabbaj considered that Portugal's economic performance since the inauguration of a new Government one year previously and the adoption of strong austerity measures under a Fund-supported program had, to a great extent, been satisfactory. The targets for 1983 had been fulfilled, generally by a commendable margin, and prospects for 1984 pointed to a continued correction of domestic and external imbalances. The performance thus far compared quite favorably with the record of the Portuguese economy after 1979, when inadequate domestic policies--including financial and monetary policies that were too accommodating--and continued postponement of meaningful adjustment efforts had exacerbated the adverse impact of international economic conditions and had accelerated the deterioration of Portugal's domestic and external positions. Those domestic policies had also affected external confidence in the Portuguese economy, as recourse to international capital markets had become more difficult and more costly, and as balance of payments financing had forced a sharp drawdown in the country's gold reserves.

Despite progress achieved over the past 12 months, imbalances remained at unsustainably high levels, Mr. Kabbaj continued. Obviously, both the Fund and the authorities had viewed the program as only a first step in the process of economic adjustment. In that context, the good performance reported in the stand-by review paper (EBS/84/143), although facilitated somewhat by the improved international economic environment, clearly indicated that the program was on the right track, while the magnitude of remaining imbalances called for a continuation of the cautious policies implemented over the past year. Hence, he welcomed the authorities' decision to resist pressures for a relaxation of adjustment policies as a way of relieving the costs in terms of growth and unemployment. The overall strategy for 1984 was consistent with the program's original targets, particularly with respect to the curtailment of the enlarged public sector borrowing requirement and the reduction in the current account deficit of the balance of payments. On the other hand, inflation in 1984 was expected to remain above the 1983 level, reflecting mainly further reductions in the amount of subsidies and the price and tariff adjustments aimed at strengthening the public sector finances in 1984.

With regard to monetary policy, credit ceilings and other quantitative controls would apparently remain an essential part of the authorities' strategy, Mr. Kabbaj added. However, more weight would gradually be shifted to financial instruments and a more flexible interest rate policy would be employed. In that context, the announced liberalization of the structure of the rates on bank deposits, through the so-called pivot rate, and the small reduction in short-term lending rates were indicative of the authorities' commitment to such a policy. Attainment of the 1984 monetary target, however, would depend mainly on Portugal's success in reducing the public sector borrowing requirement to prevent a crowding out of demand for credit by the private sector.

On fiscal policy, Mr. Kabbaj indicated his agreement with the staff's analysis with regard to the urgent need to tackle the public sector finances, which had been allowed to deteriorate over the years as a result of inappropriate investment policy and a large accumulation of external debt. It was encouraging to note that the authorities were aware of the magnitude of the problem and had, in fact, taken a number of steps to strengthen the financial position of the public enterprises through cutbacks in their investment programs and increases in charges for public services. However, there should not be an excessive reliance on increased charges in dealing with public enterprises; less inflationary remedies should be sought, particularly in the areas of productivity, expenditure control, and restructuring.

Commenting on external policies, Mr. Kabbaj observed that a more adequate exchange rate policy had restored the competitive position of the Portuguese economy and had resulted in an impressive export performance, while imports had recorded a significant decline. However, although the prospects for achieving the program's external targets for 1984 were good, the various medium-term scenarios developed by the staff were a clear indication that the Portuguese authorities had little room for maneuver.

Apparently, time constraints had made it difficult for the staff, in its projections, to take into account Portugal's announced entry into the European Communities (EC) by 1986, Mr. Kabbaj commented. The prospect of Portugal's entry into the EC further highlighted the need for concentrating economic priorities on the continued improvement of Portugal's competitive position through the maintenance and strengthening of present wage and exchange rate policies. It also pleaded for the acceleration of structural reforms to prepare the economy for a healthy integration into the EC. In future, perhaps on the occasion of the 1985 Article IV consultations with Portugal and Spain, the staff might usefully look into the regional effects of the expected accession of the two countries into the EC.

Finally, with respect to Portugal's request for a purchase under the compensatory financing facility, Mr. Kabbaj noted that the proposed purchase was equivalent to only about one quarter of the estimated shortfall in aggregate earnings and that all the requirements of the compensatory financing facility decision had clearly been met. In the circumstances, he had no difficulty agreeing to Portugal's request. He could also support the proposed decisions on the 1984 consultation and the review under the stand-by arrangement with Portugal.

Mr. Prowse agreed with the appraisal of the Portuguese economy in the report for the 1984 Article IV consultation and indicated his support for the proposed decisions. As others had observed, results under the program to date had been encouraging, although there were some areas that were worrying. Inflation was still too high, the external debt remained serious--at 70 percent of GDP--and the public sector finances were not yet viable. Moreover, for the authorities to consolidate what successes had been achieved, massive structural adjustment measures would be required in agriculture and industry as well as in the financial and social structure

of the economy. For the very short term, it would be essential for the authorities at least to maintain restrictive financial and monetary policies. In that respect, he had found interesting the staff's analysis of the consequences of any "stop-go" policy by the authorities over the medium term. It seemed clear from that analysis that the adverse effects on the external account of a stop-go policy would be far greater than if a steady policy was maintained, even if the cumulative deficit were to be the same under both approaches.

A number of Directors had welcomed the steps taken by the authorities to moderate the borrowing requirement of the public sector, and particularly the public sector enterprises, Mr. Prowse recalled. However, a greater effort by the public sector enterprises was in his view required. In 1983, public enterprise borrowing had been 6.2 percent of GDP while, in 1984, it was projected to be 5.7 percent of GDP. The enlarged public sector requirement in 1983 had been 15.2 percent of GDP; in 1984, it was 14.4 percent. The improvement was limited, however, and no provision had been made for adverse developments. Of course, to be fair, 1983 had registered a large improvement over developments in 1982, when public enterprise borrowing had been at 10 percent of GDP and the enlarged public sector had borrowed the equivalent of 22.2 percent of GDP. Nonetheless, he was concerned about the financial position of public enterprises and did not feel that the 1984 borrowing requirement targets were sufficiently stern.

He noted with pleasure that a public enterprise restructuring loan had been arranged with the World Bank, Mr. Prowse continued. The restructuring of the public enterprises would be improved through better accounting operations in the extrabudgetary field that would fully integrate the complex and numerous funds outside the Treasury into the Treasury accounting. In particular, he welcomed the innovation of performance criteria affecting public credit to the public enterprise sector. There were two other elements relating to the public enterprises that were deserving of note. First, the setting up of the Interministerial Committee to review borrowing requirements was welcome; however, he wondered whether that Committee might not have its mandate extended to consider the overall resource and efficiency performance of the public enterprises. Second, he hoped that there would be a conscious and deliberate opening up of private enterprises--both Portuguese and foreign--in the large sectors of industry that had been nationalized over the previous decade. It seemed that such "privatization" was necessary for Portugal's membership in the European Communities to be useful.

Another sector of note in Portugal was the agricultural sector, where performance of late had been quite weak, Mr. Prowse remarked. Twenty-five percent of the labor force was employed in agriculture, which contributed only 12 percent to GDP; moreover, the export-import ratio had fallen from its level in earlier years to 0.5 percent, a decline that was discouraging in a country where the potential for agricultural production was quite strong. Of course, the agricultural sector in Portugal had suffered from government intervention over the years, which had led to serious

distortions in farm resource use. In particular, since export prices were higher than in the European Communities generally, the prospects for Portuguese agriculture on Portugal's entry into the European Communities had rightly been described by Mr. Lovato as "traumatic." That was not to suggest that agriculture in the European Communities was particuilarly efficient; the statement was simply a measure of the inefficiency of agriculture in Portugal. In that regard, he noted that the ownership arrangements for rural land in Portugal might have had something to do with the problems of productivity in the agricultural sector.

On another matter, Mr. Prowse recalled that, during the previous Article IV consultation discussion, one of his colleagues had raised the question of whether the Portuguese authorities should attempt to ameliorate the external position through the sale of gold. The staff itself had observed that the sale of gold would "contribute to a significant moderation in the external debt and its service, but would have little impact on the permissible rate of growth of imports." According to the staff, Portugal had about 20 million ounces of gold in reserve; conservatively valued at $300 per ounce, the gold was worth approximately $6 billion. If invested at 13 percent interest, the yield would be about $800 million a year, which was equivalent to 10 percent of programmed imports in 1984. Hence, even if only half the gold reserves were invested, the yield would allow an additional 5 percent import growth annually. That was not a small matter, particularly in view of the amount of Fund assistance to Portugal that was currently being provided. He wondered in that regard how it was possible that sales of gold and investment of the proceeds would contribute to a reduction in debt service but would have little impact on the permissible rate of growth of imports, as suggested by the staff. Was it that the gain in command of foreign exchange would be used to reduce external debt? If so, that was an objective that he could support, although some allocation to imports might encourage a decision at the policy level. Finally, he could fully support Portugal's request for a purchase under the compensatory financing facility.

The staff representative from the European Department agreed that the target for the current account for 1984 suggested a degree of adjustment that was not particularly strong when compared with the actual outturn for 1983. Of course, when the target had first been negotiated, the comparison had been with the target for 1983, and the gap had implied a reasonable degree of adjustment. It was her impression--based on the outturn thus far for the balance of payments and on very preliminary indications for trade and invisible movements--that, barring unforeseen external developments, the current account target for 1984 would also be undershot, although it was difficult to say by how much. It was in any event clear that such a development would leave debt service and external debt at relatively high levels, which would require further adjustment in the external accounts beyond 1984.

Some elaboration on the medium-term targets outlined by the authorities in the recovery program for 1985-87 might be helpful, the staff representative noted. Those targets envisaged that the current account

deficit projected for 1984 would be maintained in 1985 and 1986 and that a small reduction would occur in 1987. Having reviewed the projections for the external debt scenarios with the different current account target, she noted that there would be little difference in the projections for both the debt outstanding and the debt service ratio from what had been shown in Scenario B. However, the change did allow room for a significant growth in imports in real terms--around 3.5-4 percent in 1985--which would not be possible under Scenario B, where growth was limited to about 1.5 percent. Of course, the current account deficit for 1984 might well be below the $1.25 billion target, which would provide a base for an altogether lower level for the current account throughout the decade, with the same increase in imports that was contemplated by the authorities. On the whole, the objectives for the current account appeared to be on the "easy" side, and the staff considered that a stronger adjustment would be necessary in order to reduce the debt service ratio to a more sustainable level over the medium term. For that reason, the staff was inclined more toward the pattern of adjustment outlined in Scenario C.

In response to Mr. Prowse's question on the effects of sales of gold, the staff representative observed that the scenarios had been based in part on the hypothesis of a small loss in foreign exchange reserves to pay for the gold. Of course, it was possible to envisage a strategy whereby the conversion of gold into liquid reserves was larger. The more of the debt that was repaid up front, the more room would be created for a reduction in interest payments--for a given current account deficit--to increase imports. Of course, it was unclear what effects such a large sale of gold might have on confidence in the markets as well as on the price of gold, especially given that Portugal was the seventh largest holder of gold reserves in the world. In any event, the staff's simulations had been intended mainly to provoke discussion rather than to provide any conclusive answers to the question raised by Mr. Prowse. What the staff had not done--although it might have been interesting--was to simulate the strategy referred to by Mr. Prowse of using the proceeds of the sale of gold to reinvest in securities rather than using them to repay external debts.

Turning to questions on the role of the exchange rate policy in securing medium-term external adjustment, the staff representative remarked that it was clear from the chart on page 10a of the staff report that the devaluation in the middle of 1983 had represented an "overshoot." Such overshooting had been necessary, mainly for confidence reasons. Although the competitive position had improved from 1982--with a small deterioration in the course of the first half of 1983--the market had simply not believed that the exchange rate had been adequate, as evidenced by the continued flight of capital through remittances, travel, and underinvoicing of investments. In the circumstances, the authorities had decided to go beyond what the numbers suggested was required. Indeed, the low of the real exchange rate following the 12 percent devaluation in mid-1983 had been several percentage points below the previous historical low in 1979, a year in which the current account had been in equilibrium. Of course, since that time, a number of structural factors--including the

increase in oil prices--had made the comparison somewhat questionable. The fact that the exchange rate had been strong was evidenced by the remarkable performance of exports since mid-1983, a performance which appeared to be continuing. The question was whether an adequate competitive position could be maintained. The answer to that question was clearly negative if one measured competitiveness on the basis of relative consumer prices; if, however, emphasis was placed more on relative unit labor costs, then the exchange rate would act mainly to improve profitability in the export industries. For 1984, on average, there had been an improvement in competitiveness as measured by unit labor costs. More specifically, the exchange rate in dollar terms was expected to depreciate by about 27-29 percent on average; partner countries' unit labor costs were expected to fall in dollar terms by 3 percent; and unit labor costs in Portugal were projected to rise by about 18-20 percent. In those circumstances, and assuming that wages would continue to rise below 20 percent, there was no reason to expect any significant deterioration in competitiveness as measured by relative unit labor costs.

There was scope for reducing tariff and nontariff protections in Portugal, the staff representative noted, although the emphasis should be more on the nontariff barriers rather than the tariff barriers. For a number of years, Portugal had been associated through trade agreements with both the European Communities and the European Free Trade Association, and trade barriers in the form of tariff protection had been fairly low. Although there remained a 10 percent import surcharge, it applied only to a subset of imports; and, in any case, that protection had been significantly reduced in 1984 with the rollback of the import surcharge, which would be reduced even further if a follow-on program with the Fund were to be negotiated. On the other hand, nontariff barriers--particularly in terms of the administration practices of the import permit system--had been rather high, and those would need to be dismantled as Portugal became integrated into the European Communities. Portugal's accession to the EC was likely to create some problems in trading with certain countries toward which the import system had been administered in a rather restrictive manner.

Commenting on inflation performance in Portugal and the role of pricing policies in establishing the inflation target, the staff representative observed that, even if the latest target for a reduction in the rate of inflation--23 percent by year-end--was achieved, the rate of inflation would still be very high, and further improvements would be necessary. It was thus encouraging to see as part of the medium-term recovery program an indication by the authorities of their intention to continue to gear policies toward a significant deceleration of inflation throughout the period, with the goal of eventually reaching the average inflation rate of countries in the European Communities.

The inflation performance in 1983 had been strongly affected by administered price adjustments, the staff representative continued. For example, some calculations showed that the composite index of administered prices had risen on average in 1983 by 32.5 percent, as compared with an

overall increase in the consumer price index of 25.5 percent; it was thus clear that the component of administered prices was an important determinant of inflation performance. Also to be taken into account was the fact that the consumer price index in Portugal was sensitive to changes in food prices--which accounted for more than 50 percent of the basket of consumer prices--and, hence, to the vagaries of the weather as well as to problems relating to productivity in agriculture. One element that made her hopeful that the inflation objective for the end of the year would be realized was the continued moderation of wage increases. According to preliminary indicators for the first quarter of 1984, wage increases in all sectors of the economy had been below 18 percent, with far lower increases registered in some areas like the depressed construction sector. It was remarkable that, as in previous stabilization programs, the brunt of the adjustment had been borne by real wages, which had fallen in 1983 by more than 10 percent and were certain to fall in 1984 by at least 4-5 percent.

On the scope for using pricing policies more aggressively to correct the public sector deficit, the staff representative considered that true prices for public sector services and utilities were essential, and the authorities were making an effort to ensure that such prices accurately reflected costs. Increases in the past 18 months, for example, had been high; and, even with respect to subsidies for foodstuffs, price increases as high as 50 percent had been registered in a relatively short period. Energy prices, too, were up; the price of gasoline in Portugal was the highest in Europe--with the exception of Italy--at $2.66 per gallon. Diesel prices were comparably higher than the average, and the price of fuel oil had been increased sharply over the past 18 months, so that it was once again the highest in Europe. Reflecting those increases, the energy sector in 1984 would make a net contribution to the budget of about $65 billion.

In response to those who felt that improvements in the area of public finances had been minimal, the staff representative considered that any improvement should be viewed over an 18-month period. Over only a 12-month period, say, between 1983 and 1984, the improvement appeared to have been minimal; over the entire program period, however, it had been remarkable. Of course, she agreed that the projected deficit for 1984--at 14.5 percent of GDP--was still too high and that further measures should be taken to reduce it.

A number of factors had made it difficult to obtain a better performance with regard to the deficit in 1984, the staff representative continued. The first was the effect of the recession, which had been substantially deeper than earlier expected, particularly with respect to domestic demand and investment, both of which negatively affected tax receipts. For 1984, the tax ratio was expected to remain more or less unchanged from the level of 1983, but that had to be seen against the background of the recession in the economy and, in particular, the fact that the 1983 revenues had been boosted by an extraordinary tax package accounting for about 10 percent of direct tax receipts. Another point to be remembered was that a large proportion of the deficit of the enlarged

public sector was accounted for by interest payments. Indeed, for the Government alone in 1984, an increase equivalent to 2 percentage points of GDP had been projected, but that figure would be substantially larger if interest payments of the public enterprises were to be included.

Two further elements should be taken into account in assessing the objectives for the public sector deficit in 1984, the staff representative commented. First, there was a need to begin some repayment of domestic arrears. The staff was projecting a reduction of about Esc 13 billion in domestic arrears of public enterprises to their suppliers. At the same time, the arrears of private customers to the electricity company--despite actions recently adopted by the Government--were expected to increase by about Esc 4.5 billion in 1984, which would add to the borrowing requirement of the electricity company. Also, the public sector was making a contribution to the targeted external adjustment; indeed, much of the projected improvement in the current account would be due to the reduction in the borrowing requirements of the public sector, with the rest being contributed by the private sector.

Replying to questions on the propensity of the private sector to save, the staff representative noted that household savings had fallen in 1983, although that decline must be seen against the background of a 10 percent fall in real wages and a 5 percent drop in real disposable income. It was not surprising that the first reaction of households would be to cushion the impact of the reduction in real disposable income. Still, fiscal targets for 1984 should be seen as the minimum to be accomplished, and the authorities must make every effort to exceed them. It was also evident that structural improvements in the public finances would be necessary beyond 1984. Both Mr. Lovato and the staff had outlined the policies that the authorities were committed to following in that respect. Those included tax reform, better expenditure control, reductions in subsidies through pricing and other policies, and the restructuring of the public enterprises.

The restructuring of public enterprises was crucial, the staff representative considered. The results of a restructuring effort would not be immediately visible, in part because the problems involved were not amenable to quick solutions. Inappropriate investment decisions had been taken by some enterprises in the past; and the country was presently faced with the choice of whether or not to eliminate some marginal enterprises or lines of production. Of course, the external debt that had been incurred by those enterprises to finance their investments would still need to be serviced; and the State would have to take over the servicing of the debt of any of those enterprises that were eliminated. In some other cases, a restructuring would be possible simply through cuts in capacity, which would make the position of a given enterprise more viable over the medium term; such an approach had already been adopted for the chemical company. In any event, it was important that the Portuguese authorities receive appropriate technical--and, if possible, financial--support from the World Bank in their efforts. In that regard, the negotiations for the proposed public enterprise restructuring loan were

scheduled to take place in early autumn, immediately following the Annual Meetings. The proposed program focused on three areas, one of which was institutional reform. The intention was to eliminate the current double total system and to establish an Interministerial Committee charged with coordinating the borrowing requirements of individual public enterprises and of the Government and of allocating credit according to global macroeconomic policy.

The staff agreed with those Directors who felt that it was necessary to create conditions for a more flexible management of monetary policy, whereby less reliance would be placed on credit ceilings and a broader and more varied set of financial instruments would be used, the staff representative said. In that regard, creation of a "pivot" rate was only a first step, and further liberalization would be required and a number of other modifications in the institutional system would need to be taken. In particular, a change would be needed in the attitude of the Treasury toward issuing more bonds for financing, either directly by the commercial banks or by the nonbank public. Of course, it would be necessary to deal with the conflict between the desire to keep down the budgetary costs of interest and the desire to expand the scope for nonmonetary financing.

In response to a question by Mr. Polak, the staff representative observed that the large spread between deposit and lending rates could be explained in part by inefficiency of the banks; however, a more important factor was that a large portion of the banks' resources was basically frozen because of credit ceilings. In the circumstances, the banks had a great deal of free liquidity, which was invested in the interbank bond market at rates that were lower than those necessary to secure an adequate profit position. The average cost of resources to the bank was about 28 percent, and the banks were receiving less than 25 percent in the interbank bond market. Hence, a form of crowding out was occurring, as the private sector was required to pay through high lending rates for the pre-emption of financial resources by the budget deficit. Finally, in response to comments by a number of Directors, the staff would attempt in future reports to expand on the economic effects of accession to the European Communities. The staff would also try to provide further details on the agricultural sector, perhaps by updating some of the studies that had been conducted by the World Bank.

The Deputy Director of the Exchange and Trade Relations Department recalled that Mr. Teijeiro had referred to the form of the credit ceilings that had been used in the stand-by arrangement for Portugal and had noted that it was different from the form of some of the ceilings used for Western Hemisphere countries, where the ceiling was on the net domestic assets of the Central Bank defined as currency minus net foreign assets. The domestic credit ceiling in the Portuguese case covered domestic credit extended by the entire banking system to the economy as a whole, net of public sector time deposits. That way of formulating the ceiling was not at all uncommon; indeed, it had been used extensively over the years for many countries in different areas. It was a comprehensive ceiling and was employed when the objective was to control the total volume of credit,

irrespective of capital flows. It should be noted that, in the Portuguese case, there was some automatic adjustment; the ceilings could be adjusted upward or downward depending upon the deviation from the targeted amount of external credit to the Government. On another matter raised by Mr. Teijeiro, he observed that the staff in the Fiscal Affairs Department had been studying the issue of fiscal deficits and inflation correction and expected to issue a paper on its findings in the near future.

The staff representative from the Research Department noted that most of the questions that had been raised on Portugal's request for a purchase under the compensatory financing facility concerned the fact that Portugal had requested drawings in both 1983 and 1984 in respect of two consecutive shortfall years. To some extent, the two requests were related; indeed, the latest request was a reflection of the fact that the projections for the previous year's request had turned out to be optimistic. That did not necessarily mean that, taking the two requests together, a case of overcompensation had arisen. If Portugal had not requested a purchase in 1983, or if the compensation granted in that year had been lower, Portugal would have qualified in 1984 for an even larger purchase than was being requested, because the maximum entitlement would have been larger in 1984.

According to the latest data--which covered 9 out of 24 months of the two postshortfall years--the staff was presuming that Portugal had been overcompensated in its drawing in 1983, the staff representative continued. However, that type of overcompensation was not to be confused with the sort that demanded an expectation of early repurchase; the latter was related to those cases in which part of the shortfall year was based on estimates but where a subsequent calculation based on actual data for the entire shortfall year indicated that the member had been overcompensated. In fact, Portugal's drawing in 1983 had been based on the early drawing provision, but the subsequent final calculation of the shortfall, which the staff had reported to the Board early in 1984, showed that there had been no overcompensation. Over time, the staff monitored, ex post, calculations of shortfalls, a process that was more relevant for longer-term reviews of the adequacy of the method that had been applied in calculating shortfalls. Perhaps in a future review of the compensatory financing facility the method involving the projection of exports for two years could be examined; certainly, it would be useful to look at Mr. Polak's question of whether it was more difficult to project workers' remittances than merchandise exports. In the specific case of Portugal, projecting workers' remittances had proved to be a difficult exercise for the staff, largely because the projections hinged crucially on developments in one host country--France--which accounted for 63 percent of total remittances. And the staff's assessment of the economic situation in France had proved to be optimistic.

Mr. Lovato considered that the review of the stand-by arrangement for Portugal had been useful, both because of the technical assistance provided and because of the role that the staff mission had played in helping the Portuguese authorities accept the need for new harsh measures during a time of social and political difficulty. A few times during the

negotiations, the staff had had to return to headquarters without an agreement because the mission had not been satisfied with the public sector figures provided, particularly the estimates for the borrowing requirement of the nonfinancial public sector enterprises. It was for that reason that the review had not been completed in the spring as scheduled. Initially, the Minister of Finance had been upset at the request for what he had considered too many details of the sort that his aides had been unable to provide. However, with the help of the Fund staff, it had eventually been possible to fill in many of the statistical gaps and to overcome the difficulties of supplying reliable estimates; and his Portuguese authorities were now convinced that the additional work had been necessary and they were grateful for the technical assistance they had received.

As for the support given to the austerity measures, Mr. Lovato noted that the review had taken place in a period of some social and political turmoil. From the beginning of 1984, opposition parties, unions, and economists in Portugal had begun to point out that the cost of adjustment in both economic and social terms had been too severe and that some policy relaxation was necessary. During that period of mounting pressure, the staff mission had helped to strengthen the conviction of his Portuguese authorities that the country could not afford to relax the measures that had been adopted. With that resolve, the Prime Minister had insisted that the path toward further demand restraint be resumed. He had also insisted on further cuts in subsidies and had refused to bend under the pressure to reduce interest rates.

It appeared from the discussion that a number of Directors felt that the improvements targeted for 1984 in the public sector deficit and the borrowing requirement were not sufficiently ambitious and that the authorities should continue their efforts to reduce the public sector budget deficit, Mr. Lovato commented. He agreed with his authorities that the 1984 program would not achieve the same impressive results achieved in 1983 in the two areas he had mentioned. Through end-May 1984, the increase in revenues had been quite good, although the disappearance of some temporary factors that had contributed to the improvement in 1983, together with the negative effects of the deep recession, suggested that the early positive trend would not continue. Still, some improvement might be engendered by the effort to fight income tax evasion and through the implementation of the value-added tax. On the expenditure side, excluding the interest rate payments on the public debt, a remarkable reduction had occurred in real terms. Nevertheless, the authorities would be continuing their restrictive fiscal policy and would take further steps to reduce the actual rate of spending and to increase public utility rates.

Generally speaking, the Prime Minister would prefer to restore the public sector finances to a sound condition as soon as possible so as to lay the groundwork for a stable recovery of the economy, Mr. Lovato said. On the other hand, given the consequences thus far of adjustment on the unemployment rate and on purchasing power, he was concerned that too rapid and too harsh an adjustment might impair the social and political

stability of Portugal and, consequently, the feasibility of the program. In that regard, it might be of interest to Directors to hear that the Government had decided to close some state-owned enterprises, reduce investment, and cut down on the number of employees in some overmanned enterprises. With that decision, terrorism had appeared in Portugal for the first time in history. Still, while worrisome, that unpleasant phenomenon had not stopped the authorities from continuing with their adjustment program; they were convinced that, without further action, a worsening of the economic situation could break down social cohesion and exacerbate the problems.

It was apparently agreed by all parties concerned that a further improvement in the public sector would represent an important contribution to the needed adjustment in two main areas, namely, the balance of payments and inflation, Mr. Lovato commented. In order to deal with the balance of payments problem, the Portuguese authorities were interested in continuing their relationship with the Fund, perhaps in the form of an extended arrangement. As for inflation, they were convinced that, while demand management policy was necessary, there was a limit to what it could do to reduce the rate of inflation substantially. Thus far, the anti-inflationary fight had been hindered by measures aimed at reducing domestic demand, cutting subsidies, increasing administered prices, and managing the exchange rate flexibly. Moreover, the presently available instruments for fighting inflation were not adequate to Portugal's needs. In the conduct of monetary policy, for example, rigid institutional factors and the narrow financial market represented limitations; and the same could be said for the fiscal system. Still, during 1984, despite some adverse developments in certain agricultural prices, the overall increase in the consumer price index had slowed, and his authorities were confident that the pursuit of domestic demand restraint would continue to bring about success. There was no intention to relax current policies or to move toward "stop-go" policies of the sort that had been adopted in 1979.

It was also necessary for the authorities to tackle a wide range of problems of a more structural nature, Mr. Lovato remarked. The Minister of Finance had indicated his intention to do so, but it must be recognized that success would be difficult because of various social and political constraints. As mentioned by a number of Directors, agricultural yields had been quite low: in northern Portugal, poor soil and the small size of the productive units had hindered production; to the south, legal uncertainties and social tensions deriving from the expropriation of land following the 1974 revolution had contributed to the problem. Portugal was very much dependent on the agricultural sector for growth and must therefore improve productivity and competitiveness; to do so it must introduce modern equipment into highly fragmented areas and settle the ownership status of the vast estates earlier expropriated or illegally seized and reorganize the farms to ensure that they became more productive.

Another area of weakness was in the financial and banking system, Mr. Lovato considered. After the revolution, the banks had been nationalized; and, with an overlarge increase in employees, they had become

inefficient. The authorities had begun to demonstrate both imagination and determination in dealing with the problem. According to the Constitution, the banks could not be denationalized; but the Government had proposed--and Parliament had approved the idea--that private banks could be created and that foreign banks could open branches in Portugal. Moreover, the Government was working toward permitting private investors to participate in the capital increase of the state-owned banks in order to improve their management and efficiency. Through similar forms of "privatization," efforts were being undertaken to improve the productivity of some export-oriented enterprises.

The authorities wanted very much to resolve the structural problems in a way that would avoid social disruptions, Mr. Lovato noted. Given the economic policies adopted thus far, the results achieved in the context of the adjustment program, and the commitments made in the letter of intent, Portugal deserved both understanding and confidence. He was therefore saddened by the doubts expressed by some about the adequacy of the adjustment for 1984. Two recent articles in the Financial Times suggested that the Portuguese authorities had demonstrated determination in implementing the adjustment program in spite of social and political constraints. Moreover, foreign investors and foreign banks had proved their confidence in the actions of the authorities. For example, direct investment for the first part of 1984 had already increased substantially by comparison with that in 1983; and the foreign banks had recently produced new loans of $400 million--which was $100 million more than expected--with an interest rate of only three quarters of a percentage point over LIBOR for the first three years, seven eighths of a percentage point over LIBOR for the next four years, and a grace period of four years. Those terms reflected the confidence of the international market in the adjustment efforts of Portugal.

The Chairman, responding to a point raised by Mr. Teijeiro, agreed that the definition of credit targets in the case of Portugal was different from that employed in some other cases. In principle, if one had an absolute ceiling, capital inflows, for example, were not taken into account; when the credit limit was set for domestic assets net of changes in foreign assets, capital inflows were taken into account by definition. However, in the case of Portugal, there were other criteria employed. Since indebtedness was limited by specific criteria, and since capital inflows in Portugal's case took the form of indebtedness, they could be dealt with through the external indebtedness criteria.

The Chairman made the following summing up:

> Directors were in broad agreement with the staff appraisal in the report for the Article IV consultation with Portugal. They commended the Portuguese authorities on the determined progress made so far in reducing the current account deficit of the balance of payments and in re-establishing the confidence of international capital markets in Portugal's economic management. Directors noted that all the performance criteria of the stand-by

arrangement had been observed and that the balance of payments outcome had been more favorable than targeted in the program. They also noted that the improvement in the external accounts in 1983 was the result not only of a tightening of the stance of fiscal and financial policies, but also of wage moderation and a significant strengthening of the competitive position as a result of the June 1983 devaluation. Those policies were instrumental in securing a marked decline in imports from their record 1982 levels and a strong recovery of exports.

Directors stressed, however, that the present and prospective burden of servicing Portugal's external debt remains high and makes it essential to secure further progress in the external accounts in 1984 and beyond. The economic policy strategy in support of the objectives set by the authorities for 1984 includes the maintenance of a firm stance of monetary and credit policies, with ceilings on total domestic and external financing that imply a reduction in real terms, a further decline in the borrowing requirement of the enlarged public sector in relation to GDP, continued wage moderation, and an exchange rate policy aimed at the maintenance of a favorable competitive position. Directors welcomed the authorities' intention to increase flexibility in their management of interest rates, a first step toward which was taken with the recent liberalization of rates on bank deposits.

Directors welcomed the extension of the ceiling on domestic credit to the public sector to include the public enterprises, a move that would ensure better control over public sector finances. However, they noted with some concern that the reduction targeted for the enlarged public sector borrowing requirement in 1984 was a modest one, following substantial progress in 1983. Directors stressed that the public sector deficit--over 14 percent of GDP--remained very high and that its financing pre-empted a large share of available financial resources. It was felt that further significant reductions in the public sector borrowing requirement in relation to GDP will be needed if continued progress is to be made in external adjustment in future years while creating room for a sustained recovery of private investment. The magnitude of the domestic arrears of the public sector was noted as a cause for concern.

Directors welcomed indications that the authorities intend to maintain beyond 1984 a stance of financial and other macroeconomic policies that would allow further progress in reducing inflation and the external imbalance, while carrying out a comprehensive program of structural reforms aimed at correcting existing rigidities in the economy and at preparing it for successful integration into the European Communities. In particular, Directors urged the Portuguese authorities to implement with determination the necessary policies in the Government's

medium-term recovery program. Among those policies, high priority should be attached to fiscal reform, to a tightening of controls over spending by peripheral public entities, to the restructuring of ailing public enterprises, to the continuation of a flexible exchange rate policy--underlined as a key element by a number of Directors--to the modernization of agriculture, to the development and broadening of capital markets, and to the achievement of greater flexibility in labor markets and legislation. Directors welcomed the Portuguese authorities' intention to cooperate with the World Bank in the design and implementation of the public enterprises' restructuring program.

In sum, the Board urged the authorities to consolidate and intensify the adjustment effort and stressed that any substantial easing of financial policies would be unwarranted in view of the high debt service burden of the country, the remaining imbalances, and the inflationary situation. Furthermore, Directors encouraged the authorities to press on with the necessary structural reforms.

It is expected that the next Article IV consultation with Portugal will take place on the standard 12-month cycle.

The Executive Board then adopted the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Portugal, in the light of the 1984 Article IV consultation with Portugal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Portugal maintains a system virtually free of restrictions on current payments and transfers for current international transactions, and welcomes the authorities' commitment to the maintenance of this system.

Decision No. 7768-(84/116), adopted
July 30, 1984

Review Under Stand-By Arrangement

1. Portugal has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Portugal (EBS/83/196, Sup. 1, 10/7/83), and the letter of the Minister of Finance and Planning and the Governor of the Bank of Portugal, annexed to the stand-by arrangement, dated September 9, 1983, in order to reach understandings with the Fund regarding policies and measures which Portugal will pursue through February 15, 1985.

2. The letter of the Minister of Finance and Planning and the Governor of the Bank of Portugal, dated June 20, 1984, shall be attached to the stand-by arrangement for Portugal, and the letter of September 9, 1983 shall be read as supplemented by the letter of June 20, 1984.

3. Portugal will not make purchases under the 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 that currency resulting from purchases of borrowed resources beyond 12 1/2 percent of quota during any period in which the data at the end of the preceding period indicate that:

(i) the ceilings on total domestic bank credit at end-July 1984, end-September 1984, and end-December 1984; or

(ii) the ceilings on net domestic bank credit to the enlarged public sector at end-July 1984, end-September 1984, or end-December 1984; or

(iii) the ceilings on increases in the total disbursed external debt of the nonmonetary sector at end-July 1984, end-September 1984, or end-December 1984; or

(iv) the ceilings on increases in the short-term external debt of the nonmonetary sector at end-July 1984, end-September 1984, or end-December 1984; or

(v) the ceilings on the cumulative loss in net foreign assets of the banking system since the beginning of 1984 at end-July 1984, end-September 1984, or end-December 1984.

specified in paragraphs 7 and 8 of the letter of June 20, 1984 have not been observed.

4. Paragraph 4(e) of the stand-by arrangement for Portugal (EBS/83/196, Sup. 1), shall be amended to read as follows:

(e) during the entire period of the stand-by arrangement, while Portugal has any overdue financial obligation to the Fund, or if Portugal....

5. Purchases under the stand-by arrangement for Portugal (EBS/83/196, Sup. 1), which amounted to SDR 166.4 million on July 30, 1984, shall not, without the consent of the Fund, exceed the equivalent of SDR 166.4 million until September 15, 1984; SDR 259.3 million until November 15, 1984; and SDR 359.3 million until February 15, 1985.

Decision No. 7769-(84/116), adopted
July 30, 1984

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request by the Government of Portugal for a purchase of SDR 54.6 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979, as amended).

2. The Fund notes the representations of Portugal and approves the purchase in accordance with the request.

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

Decision No. 7770-(84/116), adopted
July 30, 1984

3. EXECUTIVE DIRECTOR

The Chairman informed Executive Directors that Mr. Sangare was expected to return to Washington, D.C., on August 1, following his recent enforced absence. (EBM/84/107, 7/16/84)

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/115 (7/27/84) and EBM/84/116 (7/30/84).

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/84/104, Supplement 1 (7/26/84) is approved.

APPROVED: April 30, 1985

JOSEPH W. LANG, JR.
Acting Secretary