

EBS/83/135

CONFIDENTIAL

June 29, 1983

To: Members of the Executive Board
From: The Secretary
Subject: Portugal - Change in the Exchange Rate

The attached paper on a change in the exchange rate of Portugal is circulated for the information of the Executive Directors.

Att: (1)

INTERNATIONAL MONETARY FUND

PORTUGAL

Change in the Exchange Rate

Prepared by the European Department

(In consultation with the Exchange and Trade
Relations Department)

Approved by L. A. Whittome

June 28, 1983

On June 22, 1983 the Portuguese authorities communicated to the Managing Director by means of the attached cable, their decision to devalue the escudo by 12 per cent in effective terms. The escudo will continue to be depreciated in effective terms at the rate of 1 per cent a month.

The recent staff report on the 1983 Article IV consultation discussions with Portugal (SM/83/88, 5/17/83), which was considered by the Executive Board on June 13, 1983, analyzed the factors responsible for the sharp deterioration in Portugal's external accounts over the last three years. These include a rate of growth of domestic demand far in excess of the OECD average, a sizable loss in the terms of trade, high interest rates abroad and significant capital outflows through the current account. As a result, the current account balance shifted from near equilibrium in 1979 to a deficit equivalent to over 13 per cent of GDP in 1982. During the same period external debt rose from US\$ 7.3 billion to US\$13.5 billion (66 per cent of GDP) and the debt service ratio reached 27 per cent of foreign exchange earnings (Table 1).

Throughout this period the exchange rate continued to be depreciated against a basket of partner countries' currencies at a preannounced monthly rate. However, the rate of crawl particularly since 1981 was not adequate to offset the inflation differential between Portugal and its main trading partners, and the competitive position deteriorated significantly through mid-1982. Following a 9.4 per cent devaluation in June 1982, the competitive position was nearly restored to its previous peak (Table 2) but a further erosion took place subsequently as the rate of monthly depreciation was maintained at 0.75 per cent, or below the inflation differential. The monthly rate of depreciation was increased to 1 per cent in March 1983, when the escudo was also depreciated by 2 per cent in effective terms, at the time of the EMS realignment. The recent exchange rate move took place against the background of considerable pressure on foreign exchange reserves, which are currently equivalent to about two weeks of imports. In reflection of continued weakness in the current account and of delays in the conclusion of some external

loan arrangements the Portuguese authorities have had to resort in recent months to two short-term credits from the BIS secured on the collateral of gold, in the amount of about US\$700 million.

The 12 per cent effective devaluation places the competitive position at a level significantly above its previous peak in 1979 (Table 2). As indicated in the staff report for the 1983 Article IV consultation, the staff believes that an improvement in the real exchange rate beyond the previous peak was called for by the structural changes that have affected the balance of payments of Portugal over the last few years and are likely to continue to affect it in the future. These changes include the impact of the oil price increases in 1979-80, the downward trend in emigrants' remittances, and the sharply rising external debt service burden. A full assessment of the adequacy of the exchange rate move cannot, however, be made in the absence of more precise information on the new Government's intentions in other areas of economic policy.

Preliminary indications received by the staff so far suggest that the authorities intend to support the exchange rate action with a tightening of financial and budgetary policies and with efforts to secure wage moderation. The staff expects to be in close contact with Portuguese authorities over the next few weeks and to assist in the design of a detailed economic program of adjustment which may form the basis of an arrangement with the Fund.

Table 1. Portugal: Summary of the Balance of Payments, 1979-83

(In millions of U.S. dollars)

	1979	1980	1981	1982 ^{1/}
Exports, f.o.b.	3,550	4,575	4,089	4,119
Imports, f.o.b.	6,182	8,781	9,251	8,972
Merchandise trade balance	<u>-2,632</u>	<u>-4,206</u>	<u>-5,162</u>	<u>-4,853</u>
Services, net	104	-45	-441	-1,047
Of which:				
Tourism, net	695	859	778	611
Investment income, net	-437	-612	-960	-1,223
Transfers, net	2,476	3,000	2,893	2,661
Of which:				
Emigrants' remittances	2,455	2,931	2,839	2,599
Current balance	<u>-52</u>	<u>-1,251</u>	<u>-2,710</u>	<u>-3,239</u>
As per cent of GDP	(0.2)	(5.2)	(11.5)	(13.2)
Medium- and long-term capital	813	718	1,282	2,192
Short-term capital ^{2/}	617	1,391	1,268	1,137
Overall balance	1,378	858	-160	90
Change in net foreign assets of commercial banks ^{3/}	-995	-498	48	18
Change in official net foreign assets ^{3/}	-383	-360	112	-108
External debt outstanding	7,267	8,978	11,015	13,501
Of which: Short term	1,651	2,397	3,289	3,971
Total official reserves ^{4/}	1,951	14,698	9,852	10,282
Of which: Foreign exchange	930	751	477	393
<u>Memorandum items: (percentage change)</u>				
Effective exchange rate	-14.7	-3.0	-3.6	-13.9
U.S. dollar/escudo rate	-10.5	-2.0	-18.7	-22.6
Exports, f.o.b., unit value (in escudos) ^{5/}	28.0	21.6	13.1	17.4
Exports, f.o.b., volume ^{5/}	29.2	8.2	-2.0	7.8
Imports, c.i.f., unit value (in escudos) ^{5/}	35.2	27.9	21.3	16.6
Imports, c.i.f., volume ^{5/}	6.7	12.0	5.2	5.6
Ratio of debt to GDP (level)	36.4	39.5	49.7	66.2
Ratio of debt service to foreign exchange earnings (level)	16.8	14.6	22.5	27.3

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

^{1/} Provisional estimates.

^{2/} Includes errors and omissions and SDR allocation.

^{3/} Negative sign denotes an increase.

^{4/} With gold valued at SDR 35 per ounce until December 31, 1979 and at the quarterly average London market price thereafter.

^{5/} Merchandise trade, customs basis.

Table 2. Portugal: Exchange Rate Developments, 1977-82 ^{1/}

(1979 = 100)

	Escudo/ Dollar Rate	Nominal Effective Exchange Rate	Portuguese Consumer Prices	Portuguese Consumer Prices in Relation to Partners	Real Effective Exchange Rate ^{2/}
1977	78.2	66.8	65.9	75.6	113.4
1978	89.8	85.3	80.8	87.2	102.5
1979	100.0	100.0	100.0	100.0	100.0
1980	102.3	103.0	116.6	105.4	102.3
1981	125.8	106.8	140.0	115.0	107.7
1982	162.4	124.0	171.8	130.7	105.8
1979					
March	98.1	97.2	93.1	95.9	98.6
June	101.2	99.4	99.3	99.9	100.6
Sept.	100.7	102.4	105.1	103.1	100.7
Dec.	101.8	104.8	109.6	105.3	100.4
1980					
March	101.5	99.8	113.9	105.8	106.0
June	100.1	102.9	115.9	105.0	102.0
Sept.	101.8	104.2	118.4	105.1	100.9
Dec.	108.9	104.2	123.9	107.7	103.4
1981					
March	115.7	104.5	131.0	110.6	105.9
June	128.5	105.6	136.3	112.5	106.6
Sept.	132.9	108.4	146.5	118.0	108.9
Dec.	133.2	111.7	154.9	122.9	110.1
1982					
March	143.1	113.7	166.5	129.6	113.9
June	162.1	124.0	171.6	130.4	105.2
Sept.	178.0	131.7	176.8	132.6	100.7
Dec.	183.3	136.4	184.1	136.6	100.2
1983					
Jan.	183.7	138.2	191.6	141.2	102.2
Feb.	188.3	139.6	195.7	143.9	103.1
Mar.	193.1	141.9	200.3	146.3	103.1
Apr. ^{3/}	199.5	145.4	204.9	148.5	102.1
May ^{3/}	202.2	146.6	204.5	147.1	100.3
June (end of period) ^{4/}	239.2 ^{5/}	165.7	...	147.1	88.8

Sources: Bank of Portugal; and IMF, International Financial Statistics.

^{1/} Based on average 1979-80 export and import weights.

^{2/} A decline in the index indicates a depreciation.

^{3/} Estimates based on provisional data.

^{4/} End-of-period estimates based on the assumption that exchange rate depreciated in effective terms by 13 per cent through the month and that the relationship between Portuguese consumer prices and those of its main trade partners remained unchanged from that prevailing in May.

^{5/} As of June 23, 1983.

Communication Received by the Managing Director from
the Portuguese Authorities on June 22, 1983

Mr. Jacques de Larosiere
Managing Director and Chairman
of the Executive Board
INTERFUND
Washington, D.C.

Following Portuguese Government decision, the Portuguese escudo has been devalued in effective terms by 12 per cent effective June 22, 1983. The exchange market will be closed on same date.

It was also announced that immediate action is being taken as follows:

(1) A thorough revision of the investment programs for the public sector including public enterprises.

(2) Issuance of regulations governing the extraordinary tax on some corporate expenditures viz entertainment such as receptions, luncheons, traveling, gifts and the like. This tax was created under the budget for 1983. Approved on February 28.

(3) Issuance of regulations governing the extraordinary tax on corporate profits, also created under the budget for 1983.

Best regards,

Manuel Jacinto Nunes
Bank of Portugal