FOR AGENDA

EBS/83/196

CONFIDENTIAL

September 9, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Portugal - Request for Stand-By Arrangement

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

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

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

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Portugal--Request for Stand-by Arrangement

Prepared by the European and Exchange and Trade Relations Departments

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

Approved by L. A. Whittome and Subimal Mookerjee

September 9, 1983

I. Introduction

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

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

II. Background

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

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

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

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

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

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

III. The Program

1. The overall strategy

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

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

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

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

2. Fiscal policy

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

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

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

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

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

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

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

3. Monetary policy

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

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

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

4. External policies

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

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

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

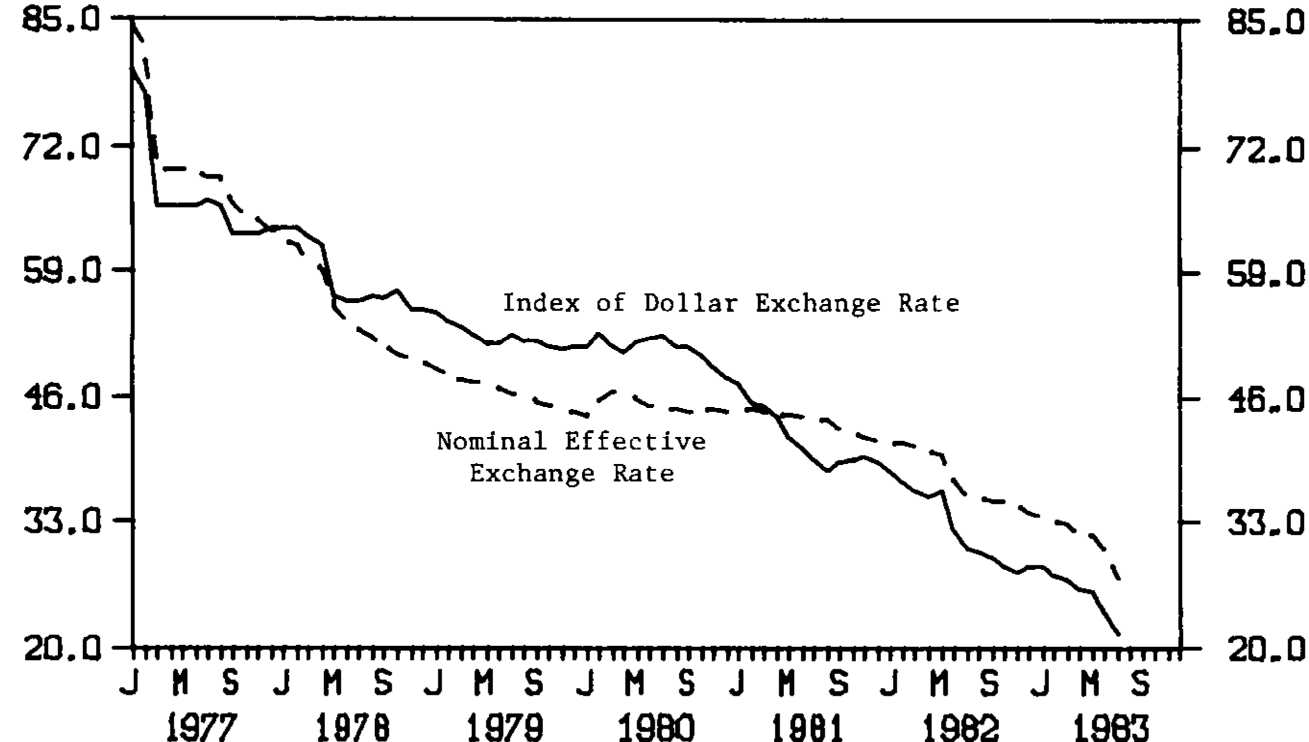
The authorities are also committed to the maintenance of an exchange system free of restrictions on payments and transfers for current international transactions. They will refrain from introducing new restrictions on trade and from intensifying existing ones for balance of payments reasons, and will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

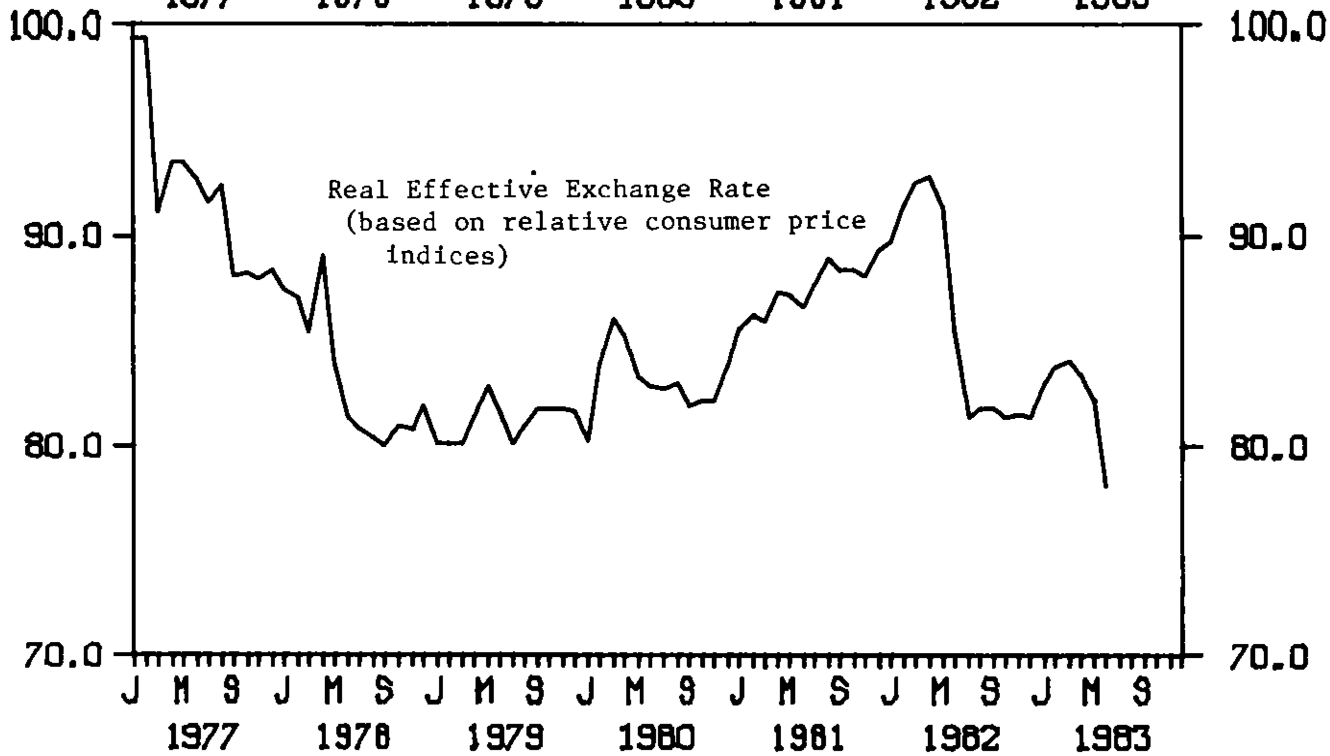
The Portuguese authorities recognize that a more effective control over resort to external borrowing is essential to ensure a reduction in the debt service burden to a level sustainable over the medium term and to containing total financing to the economy to levels consistent with the targeted improvement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

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

Chart 1. Portugal: Exchange Rate Indices

(1975 = 100)





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

5. Prospects

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

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

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

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

6. Performance criteria

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

IV. Staff Appraisal

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

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

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

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

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

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

V. Proposed Decision

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

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

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

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

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

(In millions of U.S. dollars)

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

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

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

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

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

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

Sources: Bank of Portugal; and staff estimates.

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

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

3/ Excluding amortizations of short-term debt.

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

(In billions of escudos)

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

Source: Data provided by the Portuguese authorities.

1/ Estimates.

2/ Preliminary forecast.

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

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

5/ Including Treasury operations.

Table 4. Portugal: Monetary Survey, 1982-84

(In billions of escudos; end of period)

	1982	1983	1984	1983	1984
				Percent change	
Change in net foreign assets of the banking system	569.5	624.5	624.5		
Total domestic credit	2,148.9	2,786.5 1/	3,416.5 2/	27.5 3/	21.3 3/
Of which:					
To the public sector	462.3	629.3 1/	779.0 2/	26.5 3/	18.8 3/
To enterprises and households	1,633.9	2,100.2	2,577.5	28.5	22.7
To nonmonetary financial institutions	52.8	57.0	60.0		
Total assets	2,718.4	3,411.0	4,041.0	24.0 2/	17.6 2/
M1	599.9	660.0	726.0	10.0	10.0
Time deposits of residents	1,066.3	1,337.0	1,635.0	25.4	22.3
M2	1,666.2	1,997.0	2,361.0	19.9	18.2
Emigrants' deposits	488.8	667.0	895.0	36.5	34.2
Nonmonetary financial institutions	23.1	18.0	15.0		
M2*	2,178.1	2,682.0	3,271.0	23.1	22.0
Nonmonetary liabilities	122.1	192.0	233.0		
Exchange rate valuation	231.2	347.0	347.0		
Other items, net	187.1	190.0	190.0		
Memorandum items:					
Percent change in total domestic and external credit 4/	29.8	23.1	19.6		
Percent change in velocity of M2* 5/	-3.0	0.8	-1.0		
Interest rate on six-month deposits 6/	21.5	28.0	...		

Source: Data provided by the Portuguese authorities.

1/ Performance clauses.

2/ Indicative targets.

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

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

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

6/ End of period.

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

(Annual percentage change)

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

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

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

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

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

Sources: Bank of Portugal; and staff estimates.

Table 7. Portugal: Quantitative Performance Criteria

	Ceilings for December 31, 1983	Indicative Ceilings for December 31, 1984
Credit ceilings		
Total domestic credit extended by the banking system 1/	Esc 2,786.5 billion	Esc 3,416.5 billion
Domestic bank credit to the public sector 1/	Esc 629.3 billion	Esc 779.0 billion
External debt ceilings		
Total disbursed external debt to the nonmonetary sector 2/	US$13,800 million	US$15,000 million
Short-term disbursed external debt 3/	US$3,600 million	US$4,000 million
Net foreign asset test		
Cumulative loss in net foreign assets of the banking system since the beginning of 1983	US$1.6 billion 4/	...

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

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

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

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

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

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

(In millions of SDRs)

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

Source: International Monetary Fund.

Fund Relations with Portugal

(As at end-July 1983)

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

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

I. Targets

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

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

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

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

II. Assumptions

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

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

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

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

III. Main Elements of the Program

1. Public sector policies

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

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

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

2. Money and credit

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

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

3. Prices and wages

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

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

4. External policies

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

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

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

5. Review

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

Stand-By Arrangement - Portugal

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

September 9, 1983
Lisbon, Portugal

CONFIDENTIAL

Dear Mr. de Larosière,

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Sincerely yours,

Ernani Rodrigues Lopes
Minister of Finance and Planning

Manuel Jacinto Nunes
Governor
Bank of Portugal