EBS/83/196
Supplement 1

CONFIDENTIAL

October 13, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Portugal - Stand-By Arrangement

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

Att: (1)

Stand-By Arrangement - Portugal

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

September 9, 1983
Lisbon, Portugal

CONFIDENTIAL

Dear Mr. de Larosière,

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Sincerely yours,

Ernani Rodrigues Lopes
Minister of Finance and Planning

Manuel Jacinto Nunes
Governor
Bank of Portugal