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May 18, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Portugal - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Portugal. A draft decision appears on page 15. It is proposed to bring this subject to the agenda for discussion on Monday, June 13, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. D. N. Lachman, ext. 60886.

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INTERNATIONAL MONETARY FUND

PORTUGAL

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives
for the 1983 Consultation with Portugal

Approved by L. A. Whittome and Subimal Mookerjee

May 17, 1983

I. Introduction

A staff team consisting of Mrs. T. Ter-Minassian, Messrs. D. Lachman, E. Spitaeller, T. Catsambas, and, as secretary, Miss C. Strayer (all EUR), visited Lisbon from March 8 to 22, 1983 to conduct Article IV consultation discussions. The mission met with the Minister of Finance and Planning, the Governor and Deputy Governors of the Bank of Portugal, and with officials in the Ministries of Finance and Planning, of Industry, Energy and Exports and in the Bank of Portugal. The previous consultation discussions had taken place on March 1 to 12, 1982 and the Staff Report was considered by the Executive Board on May 28, 1982.

Portugal continues to avail itself of the transitional arrangements under Article XIV.

II. Report on the Discussions

1. Recent economic developments

Following a successful stabilization effort in 1977-79, the performance of the Portuguese economy has deteriorated markedly over the last few years. In particular the external position has worsened and the deficit is now at a level that is clearly unsustainable over the medium term. The current account of the balance of payments shifted from near equilibrium in 1979 to deficits equivalent to 5 per cent of GDP in 1980, to over 11 per cent of GDP in 1981 and to an estimated 14.5 per cent in 1982 (Table 1). After declining to about 16 per cent in 1980, the rate of consumer price inflation rose to 20 per cent in 1981 and to over 22 per cent in 1982 (Table 2), albeit decelerating somewhat in the course of the year.

An important role in the deterioration of the external accounts was played by external factors, including a cumulative 10 1/2 per cent deterioration in the terms of trade between 1979 and 1982, the international recession and high interest rates abroad, and adverse weather conditions which necessitated a sharp increase in energy and agricultural imports. However, there is little doubt that the main responsibility lies in the stance of financial policies which accommodated a rate of growth of domestic demand 15 percentage points in excess of the OECD average over the period 1980-82 and which failed to provide appropriate incentives for the holding of escudo-denominated financial assets (Chart 1).

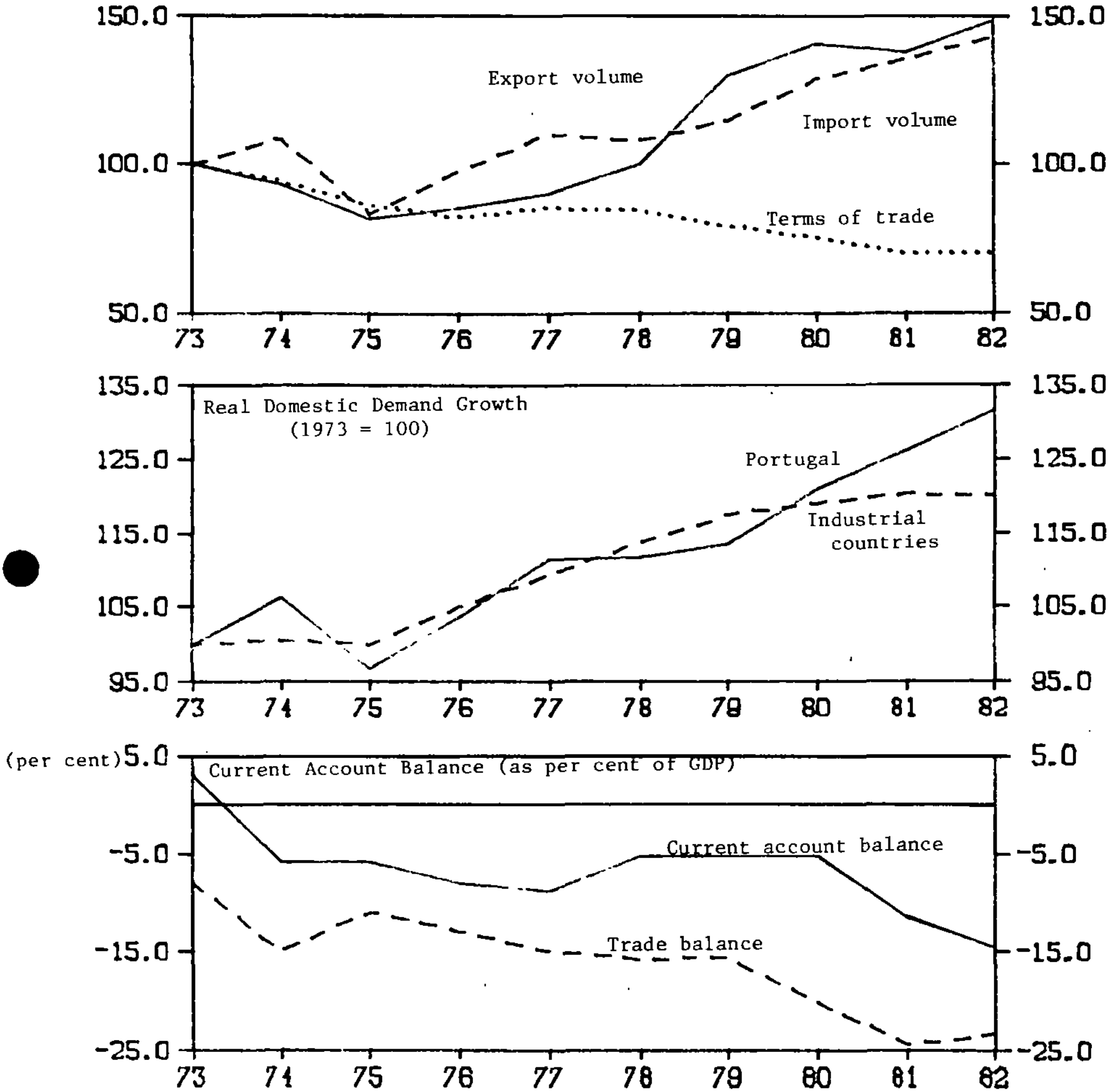
The public sector finances have represented a major area of weakness in economic management over the last several years. Not only has the deficit of the General Government remained in excess of 10 per cent of GDP for a few years but large deficits not fully reflected in the accounts of the General Government have also been recorded in the operations of various autonomous funds, notably the Supply Fund which subsidizes the prices of essential commodities. Moreover, the financial position of several major public enterprises has deteriorated sharply, in reflection of inadequate pricing policies, failure to effectively check the rise in labor costs and, in some instances, inappropriate investment decisions (Table 3).

In 1982 the general government deficit on a national accounts basis declined significantly in relation to GDP to below 10 per cent, reflecting a strong increase in revenues and a relative moderation in current expenditure. The latter was mainly attributable to a deceleration in public consumption and to a sizable decline of subsidies in real terms. Capital spending was, however, boosted by a sharp increase in transfers to peripheral public entities, such as some autonomous funds which are not included in the General Government, and to public enterprises. In addition, the overall cash deficit was raised to the equivalent of 10.7 per cent of GDP by Treasury operations, mainly reflecting cash advances to various public entities and to public enterprises. This deficit was financed entirely through resort to domestic bank credit and to foreign borrowing (Table 3).

An improvement was registered in the operations of the Supply Fund, which in 1981 had recorded a deficit equivalent to over 3 1/2 per cent of GDP in the form of a buildup of arrears toward suppliers (mainly the public enterprises which import oil products and subsidized foodstuffs). On the basis of preliminary data, the deficit of the Supply Fund is estimated to have declined to the equivalent of about 1.2 per cent of GDP in 1982 partly reflecting a moderation in import prices of subsidized commodities. However, the improvement was also due to a shifting to the Fund for Guarantee of Foreign Exchange Risks, administered by the Bank of Portugal, of the exchange losses on the short-term external debt incurred to finance the imports of subsidized commodities. The limited information available at present on developments in the position of nonfinancial public enterprises in 1982 suggests that there was a further significant deterioration and that their total borrowing requirements approached 12 per cent of GDP (Table 3). While domestic bank credit to these enterprises continued to rise less rapidly than total domestic credit to the private sector (Table 4), their external indebtedness rose by almost 30 per cent in dollar terms, to nearly 60 per cent of total external debt outstanding (Table 5).

Chart 1. Selected Indicators of Trade Performance

(1973 = 100)



Financial policies remained largely accommodating in 1982, with the rate of growth of total domestic bank credit showing only a small deceleration compared with 1981 (Table 4). In particular, the rate of growth of credit to the private sector, after decelerating from a peak of 30 per cent in mid-1981 to about 21.5 per cent in mid-1982, reaccelerated thereafter to over 25 per cent (4.5 per cent in real terms) by year-end. Large excesses were recorded over the permissible ceilings for bank credit expansion, reflecting the persistence of a strong demand for credit and the fact that penalties for the excesses did not represent an effective deterrent. The maintenance of a strong demand for domestic credit was fostered by the fact that, despite a small upward adjustment in April 1982, lending rates remained barely positive in real terms. Moreover, the effective cost of credit continued to be further moderated by the existence of a pervasive system of interest subsidies (on agriculture, exports, housing and investment) which have grown very rapidly in recent years. Rates on financial assets (including time deposits) were kept negative in real terms and significantly below comparable rates abroad. There is indirect evidence that these policies significantly contributed to promoting disguised capital outflows through the trade and invisibles account of the balance of payments.

The lack of effective restraint on domestic credit was accompanied by an accommodating stance with respect to external borrowing, especially by public enterprises. In fact, the latter continued to be encouraged to borrow abroad to finance not only investment projects but also imports of essential commodities, especially oil and cereals, leading to a further sizable increase in short-term external debt to around US$4 billion by the end of 1982. On the basis of preliminary estimates, which are likely to prove downward biased, total external indebtedness rose by the equivalent of US$2.5 billion to US$13.5 billion at the end of 1982 (66 per cent of GDP), contributing to an increase in total financing to the economy, from domestic and external sources, of almost 29 per cent.

The expansionary stance of financial policies was reflected in a renewed strong increase in domestic demand (4.3 per cent) coming on the heels of increases of 6.7 per cent in 1980 and of 4.3 per cent in 1981. The main contribution to the growth in domestic demand came from stockbuilding (Table 2), spurred by the accommodating stance of credit policy, by adverse exchange rate expectations and by the need to rebuild stocks of oil and agricultural products which had been run down in 1981. Private and public consumption also continued to grow at sustained rates, albeit apparently decelerating in the course of the year. Private consumption was sustained by a positive growth in real disposable income and by a further fall in the savings ratio, probably related to a significant deceleration in the growth of emigrants' remittances and to the maintenance of negative real rates of interest on most domestic financial assets. The growth of investment, albeit decelerating markedly from the high rates of the previous two years, remained significantly positive in real terms, reflecting the relative ease of credit conditions and the lack of effective control by the Government over the investment plans of several major public enterprises.

The rate of increase in wage rates accelerated in 1982, as wage demands were adjusted to reflect the spurt in inflation in the second half of 1981 and in the first few months of 1982. Preliminary estimates suggest that real wages were virtually stagnant on average for the year, albeit recovering in the second half as inflation decelerated. The rate of consumer price increases, which had been running at over 25 per cent toward the end of 1981 and in the first quarter of 1982, declined thereafter to below 19 per cent by November 1982, in reflection of a moderation of food prices, of delays in some administered price adjustments and of a three-month wage and price freeze following a 9.5 per cent discrete devaluation in June 1982. By year-end and during the first quarter of 1983, however, the rate of inflation picked up again, partly reflecting increases in administered prices.

The external accounts recorded a further sharp deterioration in 1982, with the current account deficit reaching an estimated US$3.3 billion (14.5 per cent of GDP). A strong growth of exports in volume, partly related to the coming on stream of a major petrochemical plant, was largely offset by a continued rapid increase in imports (5.6 per cent in volume). The trade deficit narrowed only slightly from the record level of 1981 as the terms of trade registered only a small improvement, despite the substantial moderation in prices of imported commodities. The fact that export prices in escudos rose by significantly less than those in partner countries, adjusted for exchange rate changes, provides an indirect evidence of possible underinvoicing of export receipts. A sharp deterioration was recorded in the invisibles account. Exports of nonfactor services fell sharply in dollar terms. The decline in tourism receipts, against the background of a significant increase in the number of nights spent by foreigners in Portugal, provides a further indirect evidence of disguised capital outflows. The growth of remittances was adversely affected by the depreciation of the exchange rate of the French franc vis-à-vis the U.S. dollar (France being the country with largest share of Portuguese emigrants) and by unfavorable interest rate differentials with abroad and exchange rate expectations. The invisibles account was further negatively affected by the sharp increase in interest payments on the external debt, which in 1982 reached 16 per cent of foreign exchange earnings. The overall debt service ratio (excluding rollover of the short-term debt) exceeded 27 per cent of foreign exchange earnings (Table 5).

The current account deficit was financed largely through borrowing, both medium- and long-term and short-term, resulting in a small overall surplus (Table 1). The net foreign assets position of commercial banks showed little change for the year as a whole, while the Bank of Portugal continued to reduce its foreign indebtedness. Official foreign exchange reserves stood at just under US$400 million (less than 2.5 weeks of f.o.b. imports) at the end of 1982. Gold reserves, as of the same date, amounted to about 22.1 million ounces (equivalent to about US$9 billion at current market prices). Commercial bank holdings of foreign exchange amounted to about US$1.2 billion.

2. Economic policies

The consultation discussions took place against the background of greater than usual political uncertainty, as anticipated national elections have been called for April 25, 1983. Consequently, the authorities did not feel in a position to fully articulate the policy stance for 1983 and beyond. They recognized that, in order to ensure a more sustainable external position, fundamental changes would be needed in a number of policy areas but they felt severely limited in their scope for immediate action by the caretaker nature of the present Government. Thus, the discussions focussed primarily on the policy stance already in place and on the nature of the steps that would be required to secure a sustained improvement in the economic performance, particularly in the external accounts.

a. Fiscal policy

The 1983 budget was shaped by the objective of achieving a substantial reduction in the deficit of the General Government in relation to GDP (Table 3). This objective is predicated on a combination of revenue-raising measures, which are projected to raise the ratio of taxes to GDP by 1 1/2 percentage points to about 31 per cent, and of steps to contain expenditures. The main tax measures consist of surcharges on selected direct taxes and of increases in the rates of some indirect taxes, including the import surcharge, which was raised from 10 per cent to 30 per cent in January 1983. The Portuguese representatives expressed concern that the delay in the approval of the budget entailed by the political crisis at the beginning of this year, may cause a shortfall of revenue from indirect taxes with respect to the budgetary projections. While underlining that the tax measures included in the 1983 budget were necessary in the short run to moderate the financing requirements of the General Government, the Portuguese representatives recognized that over the longer run the effort in the areas of taxation should be focussed on a reform of the structure of taxation which remains overly complex, relatively income-inelastic and leading to distortions in the distribution of the tax burden and in the allocation of resources and savings. In this respect they noted that a considerable effort had gone into preparations for the introduction, possibly by 1984, of the value-added tax. As for the reform of direct taxation, it was felt that the progress made over the past two years in strengthening the administrative infrastructure in the area of tax collection provided a basis for proceeding soon with the design and implementation of this reform.

The effort to contain expenditure is to be articulated on several fronts. Wage increases for civil servants have been set at 17 per cent, and steps have also been taken to strengthen the control of the Central Government over various autonomous funds. Also, subsidies and capital transfers to public enterprises have been frozen at the same nominal level as in the initial 1982 budget. The Portuguese representatives recognized, however, that slippages could occur in a number of areas, notably in expenditures on health, education and housing. The Supply

Fund is projected to shift into a small surplus, reflecting the decline in oil prices and expected moderation in agricultural commodity prices. The projected surplus, which would be used to begin repaying the arrears of the Fund toward its suppliers is, however, predicated on the assumption that significant further increases will be made later in the year in the prices of some subsidized commodities, in particular milk, cereals, vegetable oils and fertilizers.

The finances of public enterprises remain an area of serious concern which, in the absence of prompt and strong corrective measures, is likely to continue to lead to budgetary overruns and to excessive resort to domestic or external credit. At the time of the consultation discussions the authorities were engaged in a comprehensive review of the position of individual public enterprises, discussing with the companies' management the investment program and overall financial prospects for 1983. Sources of particular concern were the finances of some of the chemical enterprises, burdened with the consequences of inappropriate investment decisions in the past, and of some transport companies, notably the railways and the national airline, which would necessitate substantial cost-cutting measures, as well as price increases. The Portuguese representatives underlined that the public sector investment program for 1983 would be largely concentrated on the continuation of projects already underway, with the exception of investment in the energy field, and that in particular a very large project on expansion of capacity in the steel company would remain blocked. They recognized however that, to ensure the desired restraint in spending by some public enterprises, a more effective control would be necessary over their resort to external and domestic financing.

b. Monetary policy

The main instrument of monetary policy in Portugal continues to be ceilings on domestic bank credit to the private sector, including the public enterprises. These ceilings are set on a monthly basis, in accordance with a monetary program which is prepared at the beginning of each year but is subsequently revised in the light of changing conditions in the economy. In the last few years the monetary program has been generally designed to accomodate a rapid growth in nominal income, in reflection of the authorities' belief that a tightening of the monetary policy stance would have a greater impact on real output than on inflation. Besides "moral suasion", the enforcement of the credit ceilings has relied on penalty reserve requirements for excesses over the ceilings. These penalties have, however, generally been set at levels too low to provide an effective deterrent and even those levels have not always been applied in practice. Thus sizable excesses over the already relatively permissive ceilings have often been recorded. These excesses have frequently been accommodated in subsequent revisions of the monetary program. The maintenance of a sustained rate of growth of domestic credit to the private sector has also been fostered by the existence of widespread interest rate subsidies and by the relative inflexibility of interest rate policy, which resulted in a decline in the real cost of credit as inflation accelerated after 1980.

The reluctance of the authorities to raising interest rates on financial assets has also been partly responsible for the rapid growth of monetary financing to the General Government. Historically the proportion of the public sector deficit financed by the nonbank public has been very small, in reflection of the narrowness of capital markets and of the lack of a wide spectrum of government securities with diversified maturities and attractive returns. This type of financing of the public deficit declined further in 1981 and 1982 (Table 3). The share of the deficit financed through sales of government securities by the Bank of Portugal in the interbank bond market declined as well in the last two years, as the rates on these securities remained relatively low. Thus a very large proportion of the deficit was financed through recourse to the Bank of Portugal and to external credit.

The Portuguese representatives recognized that the levels of lending rates and even more of deposit rates prevailing at the time of the consultation discussions were too low and, given the inflation differential between Portugal and its main partners and related exchange rate expectations, had fostered open and disguised capital outflows. On March 24, the authorities announced increases ranging from 4 to 5 percentage points in most rates on bank deposits and loans. These increases appear to have eliminated the real interest rate differential with the United States, on the assumption of no further acceleration of inflation (Chart 2).

The initial monetary projections for 1983 were based on the assumption that the recent increase in interest rates would promote a recovery in the demand for domestic financial assets, notably time and emigrants' deposits. Thus broad money was projected to grow by around 28 per cent, or at a rate significantly in excess of the rate of growth of nominal GDP (estimated at around 24 per cent). On the assumptions of a small improvement in the net foreign assets position of the banking system and of a significant decline in the rate of growth of credit to the public sector (from over 30 per cent in 1982 to around 25 per cent in 1983) in reflection of the tighter stance of the 1983 budget, credit to the private sector was projected to rise by about 25 per cent in the course of the year. The Portuguese representatives recognized that such a monetary program, if implemented, would imply the maintenance of a broadly accommodating policy stance but felt that the scope for reducing inflation below the projected 22 per cent in 1983 was very limited, especially in the light of the recent and prospective increases in administered prices that were required to secure an improvement in the public sector finances and of the need to maintain a flexible exchange rate policy. They stressed, however, that the projections were preliminary and would be adjusted in the course of the year as required by circumstances, with particular regard to the evolution of the overall balance of payments. They also felt that there was a margin for tightening the ceilings on credit to the private sector, if it proved impossible to contain the borrowing requirements of the public sector within the targeted limit. With respect to the enforcement of the ceilings, they indicated that consideration was being given to raising the penalties for excesses. They felt that the recent increase in interest rates (including those in the interbank bond market) should help moderate both the demand for credit and the incentive for banks to exceed the ceilings.

c. External policies

For several years exchange rate policy has been operated in Portugal on the basis of a preannounced monthly depreciation vis-à-vis a weighted average of partner countries' currencies. The rate of monthly depreciation has been changed repeatedly, in response to cost and price developments and to the varying priority attached over time to the maintenance of a given competitive position. Since 1980, in particular, the rate of crawl has generally not been adequate to offset inflation differentials (Chart 3), and periodic discrete adjustments in the exchange rate have been required to offset the erosion of competitiveness. In June 1982, the authorities took advantage of the EMS realignment to devalue the exchange rate in effective terms by 9 1/2 per cent. On the basis of available indicators of competitiveness, it appears that this adjustment broadly restored the competitive position to its peak level of end-1979. However, the rate of monthly crawl was kept at 0.75 per cent, which was inadequate to compensate for the inflation differential, leading to a loss of competitiveness estimated at about 5 percentage points between July 1982 and March 1983. On March 24, 1983, again following an EMS realignment, the authorities announced, simultaneously with the interest rate measures, the stepping up of the rate of monthly depreciation to 1 per cent and an effective devaluation of 2 per cent. The Portuguese representatives recognized that this package would not be sufficient to restore the competitive position to its past peak and that it would not even secure the full maintenance of the present level of competitiveness, given the prospective inflation differential in 1983. However, they felt that, in the light of the strong performance of export volumes in 1982, competitiveness could be regarded as broadly adequate at the present time and that exchange rate policy could be reviewed later in the year after the elections, in the context of the definition of the overall policy stance for the second half of 1983 and for 1984.

The management of the external debt in recent years has been largely shaped by the need to finance a rapidly growing current account deficit of the balance of payments, in the face of a low level of liquid international reserves. Medium- and long-term borrowing was undertaken mainly by the public sector (General Government and public enterprises) in connection with the financing of the budget deficit and of investment projects. Until recently Portuguese borrowers in international markets received terms broadly comparable to those of major industrial countries. This was in part a reflection of the high level of gold reserves and of the careful management by the monetary authorities of the access of Portuguese borrowers to capital markets, through appropriate queueing

Chart 2

Portugal: Interest Rate Differentials with the U.S.

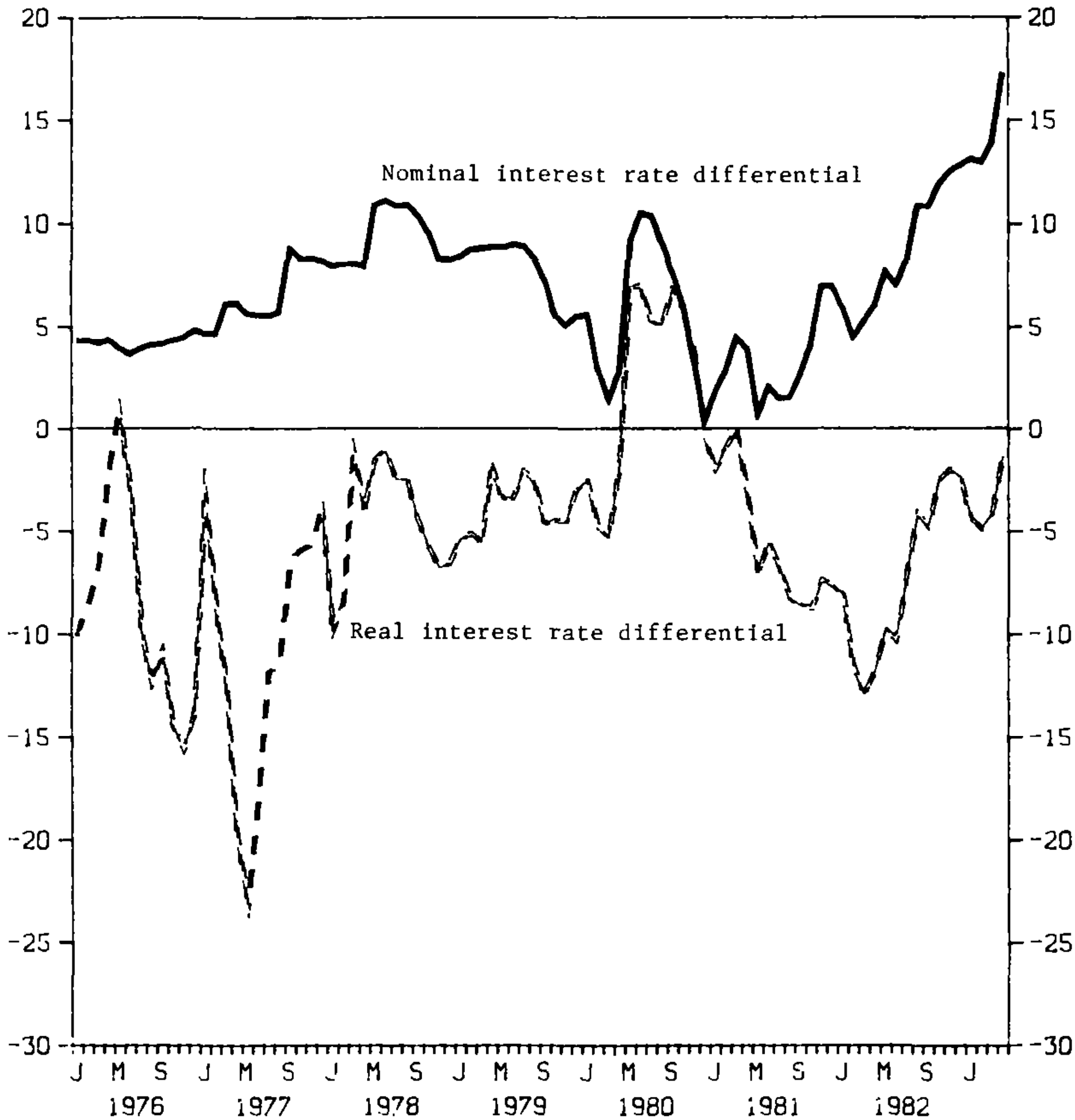
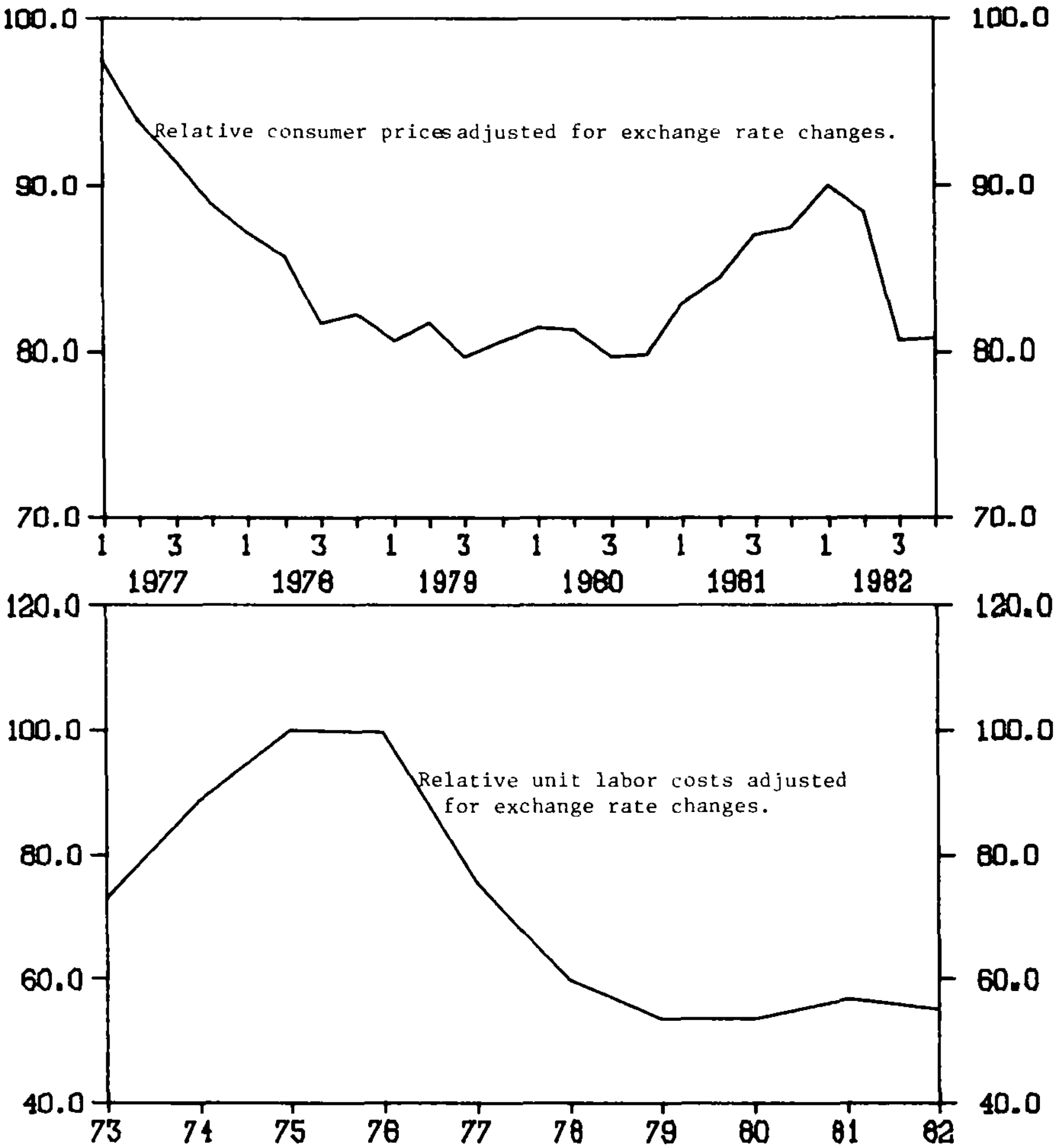


CHART 3
PORTUGAL: REAL EFFECTIVE EXCHANGE RATE INDICES
(1975=100)



procedures and diversification of sources of financing. There has been a significant increase in spreads since the beginning of this year but, on the whole, terms remain more favorable than for most developing countries. The portion of the external financing requirements not covered by medium- and long-term borrowing was met through a rapid increase in short-term debt, mainly contracted by public enterprises in connection with imports of essential commodities (oil and foodstuffs). The Portuguese authorities have been conscious of the risks inherent in the accumulation of short-term liabilities. Since 1981 they have endeavored to secure some consolidation of this portion of the external debt, but progress has been limited by the size of the external borrowing requirements.

The Portuguese representatives recognized that the pace of accumulation of external debt in recent years could clearly not be sustained in the future. Illustrative staff projections suggest that, for the debt service ratio (excluding the amortization of short-term debt) to broadly stabilize at the relatively high level of 30 per cent during the rest of the 1980s, the current account deficit of the balance of payments would have to be reduced to around 7 1/2 per cent of GDP in 1983 and to below 5 per cent on average in the following years. These projections are based on the possibly optimistic assumptions that foreign exchange earnings would be rising at an average annual rate of over 12 per cent in dollar terms during the period 1983-90, and that the average cost of foreign borrowing for Portugal would decline to around 3 per cent in real terms. These projections highlight the acute need for a comprehensive adjustment effort to secure a substantial reduction in the external financing requirements. An important element of this adjustment would be a more effective control over external borrowing especially by public entities. The Portuguese authorities agreed with the staff that, in this respect, it would be desirable to ensure a closer coordination of the external debt management policy with domestic credit policy, with the public investment program and with other policies, including administered pricing and budgetary support, regarding the public enterprises. They indicated that steps were being taken in this direction in the definition of the public enterprises' investment program for 1983 and that a significant reduction in medium- and long-term borrowing by public enterprises was foreseen for this year, compared with the trend of the last few years. On the other hand, an increase was expected in external borrowing by the State and, in contrast to the trend in recent years, by the Bank of Portugal.

d. Incomes policies

Wage policy, which during the stabilization period of 1977-79 relied on the setting of mandatory ceilings, has been conducted in the last two years primarily through guidelines, which have been set in line with the official targets for inflation of 17 per cent and 19 per cent in 1981 and 1982, respectively. The Government has also tried to influence wage negotiations in the private sector by limiting increases in civil servants' salaries to rates below the general guidelines. Available information on wage developments in the last two years suggests that the guidelines were significantly exceeded (Table 2), as wage demands were boosted by inflation rates well above the official targets. On the whole, real wage rates are estimated to have remained broadly stable in 1981-82, following a sizable increase in 1980.

For 1983 the Government has set a 17 per cent limit on wage increases for purposes of authorizing increases in prices subject to various regimes of administrative control, which cover a large number of products (see SM/82/87, 4/30/83). In addition, it is envisaged that wage increases in excess of the 17 per cent limit would be subject to a surcharge in the rate of social security contributions, at the rate of 30 per cent for the employer and 30 per cent for the employee. This surcharge would not apply if the wage increase in excess of the target was paid in the form of a nonnegotiable Treasury bond with five-year maturity. Preliminary indications on wage negotiations in major public enterprises, however, suggest that the Government may have considerable difficulties in enforcing the wage guideline, which would imply a sizable cut in real wages in 1983. Industrial unrest, especially in the public utilities, has escalated in recent months. The authorities ascribed it partly to political motives and indicated their resolve to resist it.

3. Prospects

The outlook for 1983 is affected by the greater than usual uncertainties regarding the policy stance for the rest of the year. The staff forecast, presented in Tables 1 and 2, is based largely on the present policy stance, albeit assuming some tightening in the second half of the year. In particular, the forecast assumes that there would be a small decline in the budget deficit in relation to GDP from the 1982 outturn and a modest deceleration in the growth of monetary and credit aggregates. It also presupposes that the financing required for the current account deficit of the balance of payments would be forthcoming. The very high level of this deficit clearly indicates the need for stronger and more timely adjustment measures.

The rate of inflation in 1983 is likely to be boosted to over 22 per cent by, inter alia, administered price adjustments and by the depreciation of the escudo. On the assumption that excesses in actual wage settlements over the official 17 per cent guideline will remain moderate, real wages are likely to show some decline. This, in conjunction with the tax measures introduced with the 1983 budget, should lead to a small decline in real disposable income and, barring a sharp fall in the savings ratio from an already historically low level, to a virtual stagnation in consumption. A deceleration is also expected in the growth of public consumption, in reflection of the effort envisaged in the budget. Private fixed investment is likely to be affected negatively by the political and economic uncertainties, as well as by the recent interest rate increases, and investment in the public sector, including the public enterprises, is also expected to show a decline in reflection of the effort to curb resort by these enterprises to external credit. Investment in inventories should decline from the high level of 1982, in the face of a significant increase in the cost of credit and of some tightening of credit policy in the second half of the year. Real domestic demand is projected to decline by 0.7 per cent and GDP to remain flat, reflecting an improvement in the real trade balance.

Imports are expected to decelerate markedly in volume, in line with demand, while exports are expected to grow less rapidly than in 1982, despite a pickup in external demand, because of the loss of competitiveness implicit in the present exchange rate policy. The terms of trade are projected to show a significant gain, as a result of a 14 per cent decline in oil prices which should contribute about US$300 million to the reduction in the trade deficit. A recovery is expected in receipts from tourism and emigrants' remittances from the depressed levels of 1982. The recent increase in interest rates should help in this respect, although its impact is likely to be partly offset by the continued political uncertainties and by exchange rate expectations at least through the first several months of this year. Portugal is also expected to benefit from the decline in international interest rates, which, however, would be largely offset by the increase in the size of its external debt. On the whole, the current account deficit is expected to show a modest decline from the record level of 1982 but to remain very high (about 12 per cent) in relation to GDP. The financing of such a deficit, together with the US$1.2 billion amortization on medium- and long-term debt, would require a gross borrowing of nearly US$4 billion in addition to the rollover of the outstanding short-term debt.

III. Staff Appraisal

The performance of the Portuguese economy in 1982, and its prospects for 1983 in the absence of adequate adjustments in policy, give cause for serious concern. The current account deficit of the balance of payments in 1982 reached the equivalent of 14.5 per cent of GDP, a level which is the highest among OECD countries and clearly unsustainable. Being superimposed on deficits in excess of 5 per cent of GDP in 1980 and of 11 per cent in 1981, it has led to an escalation of the external debt to over US$13.5 billion (66 per cent of GDP) and of the debt service ratio (excluding the amortization of short-term debt) to over 27 per cent of foreign exchange earnings in 1982. The rate of inflation, albeit decelerating moderately in the second half of the year, remained in 1982 among the highest in the OECD. Moreover, partly in reflection of necessary adjustments in some administered prices, the rate of consumer price increases has reaccelerated over the last three months, threatening to lead to an escalation of inflationary expectations.

A major role in the deterioration of the economic performance was played by the maintenance of a high rate of growth of domestic demand, which exceeded the OECD average by a cumulative 15 percentage points since 1979. Also important has been the lack of appropriate incentives for the holding of domestic financial assets. The excessive growth of domestic demand has been fueled by a high budget deficit, by inadequate adjustments in some administered prices, and by the rapid expansion of domestic and external credit. In addition, interest rates on financial assets have been kept in real terms substantially below those prevailing abroad, and the real cost of credit, after taking into account the pervasive interest rate subsidies, has remained relatively low. At the same time, exchange rate policy has not been managed in a sufficiently flexible manner to ensure the maintenance over time of a favorable competitive position, and has thus contributed to the development of periodic waves of speculation and reduced the incentive for Portuguese enterprises to expand production and capacity in the export sector.

In the area of the budget, although a real effort was made to limit certain types of expenditure, the success in containing the borrowing requirements of the public sector has fallen well short of what would have been needed. The overall cash deficit of the General Government (including Treasury operations) at over 10.5 per cent of GDP in 1982 remained very high, especially in the light of the narrowness of Portuguese financial markets, which results in the deficit being financed almost exclusively through the creation of primary liquidity. Moreover, large deficits continued to be recorded in the operations of various autonomous funds, which are not fully reflected in the accounts of the General Government, and the financial position of many public enterprises continued to deteriorate. Over the past few years these enterprises have often been utilized for the pursuit of policy objectives, particularly with respect to inflation, employment and external borrowing, which ran counter to those of economic profitability and sound financial management. The lack of timely information on their financial position and of effective control over their investment programs has led in several instances to inappropriate investment decisions, with substantial costs for the Portuguese economy.

Unless prompt and substantial measures are taken in various areas of economic policy, the underlying rate of inflation is unlikely to improve significantly and the current account deficit will probably remain at an unsustainably high level in 1983. In the view of the staff, there is a clear need for a strong adjustment effort to reduce the current account deficit of the balance of payments to a level which does not give rise to financing difficulties in the short run and which allows a decline of the debt service ratio to a more sustainable level over the medium term. This adjustment will become more difficult and costly the longer it is delayed. The effort will need to be focused on the finances of the public sector, including the public enterprises, and will have to be supported by a more flexible use of interest rate and exchange rate policies, by a significant reduction in the rate of growth of domestic credit, and by a more effective control over external borrowing. The costs of a tighter stance of financial policies on output and employment could be moderated by a deceleration in the growth of nominal wages. An important role in this respect can be played by an effective incomes policy, particularly in the public sector and the public enterprises.

The initial budget for 1983, which targets a reduction of the deficit of the General Government to around 7 per cent of GDP, if adhered to, would represent an important step in the right direction. However, serious doubts must be raised about the likelihood that the public deficit in 1983 will be contained to anywhere near the targeted level, given the budget outturn for 1982, the likely impact of the delayed implementation of the 1983 budget on some types of tax revenue, and especially the inadequate control over expenditures of various autonomous services and funds and of the local authorities. Moreover, the staff must emphasize its concern, both from an international perspective and from the point of view of an appropriate allocation of domestic resources, that the budget has relied on a substantial increase in the import surcharge. It is to be hoped that this measure will be reversed as soon as possible.

Additional areas of concern relate to the finances of the Supply Fund and of the public enterprises. The decline in oil prices and the expected continued moderation in the prices of imported foodstuffs provide the opportunity for a major improvement in the finances of the Supply Fund in 1983, so long as appropriate domestic pricing policies are pursued. In this respect it is important to continue the effort begun over the last few months to raise the prices of some oil products and of other subsidized commodities. Additional price increases for some public tariffs would also appear to be called for to improve the financial position of some public enterprises, especially in the transport and energy fields. The effort to strengthen the finances of the public enterprises will, however, need to be a comprehensive one, in reflection of the complex nature of their problems. It will also need to involve measures to contain the growth of labor costs and in some instances to reduce overmanning and capacity. A strict scrutiny of proposed investment projects will be necessary to ensure the allocation of scarce domestic and foreign financial resources to projects with the largest and quickest payoff in terms of foreign exchange earnings or savings. In this respect a beginning appears to have been made in the preparation of the public sector investment program for 1983.

As regards monetary policy, it is crucial that the inevitable boost to the price level stemming from the recent and prospective increases required in administered prices, as well as from the depreciation of the exchange rate, not be fully accommodated by financial policies. Rather, the growth in domestic credit should be progressively scaled down so that the adjustment in prices be allowed to play its role in reducing real domestic demand. A more effective control of domestic credit should be complemented by a determined effort to check resort to external credit, especially by public entities. In the area of interest rate policy, the recent increases, albeit belated, represent an important step in the right direction. They should help contain the demand for domestic credit as well as the overt and disguised capital outflows in the balance of payments. The re-establishment, and subsequent maintenance through greater flexibility than in the past, of a positive rate of return on financial assets should also promote a recovery in the savings propensity, thus moderating the reduction in real incomes required to secure the necessary decline in domestic demand. A greater flexibility in interest rate policy would appear to be an essential condition for a needed change in the structure of financing of the public sector deficit, to reduce its impact on primary liquidity and to promote the demand for government securities by the nonbank public.

In the view of the staff, an important role in the adjustment effort should be played by exchange rate policy if the full burden of adjustment is not to fall on expenditure-reducing measures. The re-establishment and subsequent broad maintenance of an adequate level of competitiveness is essential to promote a sustained reallocation of resources toward the traded goods sector. Given the major structural changes that have affected the balance of payments of Portugal in the last few years, such as the impact of the oil price increases in 1979-80, the emergence of a substantial debt service burden and the structural downward trend in emigrants' remittances, the staff believes that it would be appropriate to aim at a level of competitiveness significantly above its previous 1979 peak. The recent adjustment in exchange rate policy, while a step in the right direction, appears to fall short of what would have been needed.

The magnitude of the adjustment required to restore the Portuguese economy and especially its external accounts to a sustainable position underlines the importance of a well coordinated, determined and timely effort in the various areas of economic policy. The staff hopes that the design and implementation of such an effort will be viewed as a priority task by the new Government that will take office after the forthcoming elections.

It is recommended that the next Article IV consultation with Portugal take place on the standard cycle.

IV. Proposed Decision

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

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Portugal, in the light of the 1983 Article IV consultation with Portugal conducted under Decision No. 5392-(77/63) adopted April 29, 1977 (Surveillance Over Exchange Rate Policies).

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

Fund Relations with Portugal

(As at end-March 1983)

Quota:	SDR 258 million
Fund's holdings:	SDR 211.8 million or 82.1 per cent of quota, including holdings under the oil facility amounting to SDR 2.6 million (1.0 per cent of quota).
Holdings of SDRs:	SDR 2.1 million or 3.9 per cent 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 revaluation of 6 per cent in February 1980, the monthly rate of crawl was reduced to 0.5 per cent in June 1980. This shift in exchange rate policy resulted in a sizable loss in competitiveness despite the restoration of the rate of crawl to 0.75 per cent a month in December 1981. Against this background, at the time of the EMS realignment in June 1982 the escudo was depreciated by 9 1/2 per cent in effective terms. This restored Portugal's competitive position to the level prevailing at the end of 1980, but the pace of the crawl was maintained at 0.75 per cent a month or less than the differential rate of inflation between Portugal and its main trading partners. On March 24, 1983 the authorities announced the stepping-up of the rate of crawl to 1 per cent a month and a 2 per cent effective depreciation of the escudo.
Last consultation:	March 1982. The staff report (SM/82/87, 4/30/82) was discussed by the Executive Board on May 28, 1982.

Basic Data

Area and population			
Area	34,312 square miles		
Population (1981 estimate)	10 million		
GDP per capita (1981 estimate)	US$2,361		

Income and expenditure in 1981 (at current prices)	In billions of escudos	In per cent
Private consumption	1,110	76
Public consumption	231	16
Gross capital formation	394	27
Exports of goods and services	386	27
Aggregate expenditure	2,121	146
Imports of goods and services	668	46
GDP at market prices	1,453	100

	1980	1981	1982 Estimate
Selected economic indicators (annual percentage change)			
Real GDP at market	4.9	1.8	3.3
Manufacturing output	6.0	1.5	3.2
Wage per man in manufacturing	23.5	19.8	22.5
Consumer prices	16.6	20.0	22.4
Unemployment rate (level)	7.8	8.2	7.2
Broad money, year-end	34.8	28.6	26.9
Domestic credit, year-end	28.2	28.6	26.5
Public sector accounts (as per cent of GDP)			
General Government			
Tax revenue	28.3	29.8	29.4
Current expenditure	33.5	36.3	34.6
Current balance	-3.5	-5.5	-3.8
Overall balance	-10.6	-11.4	-9.6
Balance of payments (in millions of U.S. dollars)			
Exports	4,575	4,089	3,997
Imports	8,781	9,251	8,927
Trade balance	-4,206	-5,162	-4,930
Net invisibles	2,955	2,452	1,615
Current account balance	-1,251	-2,710	-3,315
Medium- and long-term capital	718	1,282	2,186
Short-term capital	1,391	1,268	1,224
Overall balance	858	-160	95
Foreign exchange reserves, year-end	751	477	393
External debt outstanding, year-end	7,680	11,015	13,464
Gold, year-end (in millions of ounces)	22	22	22
Effective exchange rate (per cent change)	-3.4	-4.9	-12.1

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

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

(In millions of U.S. dollars)

	1979	1980	1981	1982 1/	1983 2/
Exports, f.o.b.	3,550	4,575	4,089	3,997	4,280
Imports, f.o.b.	6,182	8,781	9,251	8,927	8,970
Merchandise trade balance	-2,632	-4,206	-5,162	-4,930	-4,690
Services, net	104	-45	-441	-1,035	-900
Of which:					
Tourism, net	695	859	778	634	700
Investment income, net	-437	-612	-960	-1,215	-1,200
Transfers, net	2,476	3,000	2,893	2,650	2,700
Of which:					
Emigrants' remittances	2,455	2,931	2,839	2,581	2,700
Current balance	-52	-1,251	-2,710	-3,315	-2,850
As per cent of GDP	(0.2)	(5.2)	(11.5)	(14.5)	(12.0)
Medium- and long-term capital	813	718	1,282	2,186	...
Short-term capital 3/	617	1,391	1,268	1,224	...
Overall balance	1,378	858	-160	95	...
Change in net foreign assets of commercial banks 4/	-995	-496	48	18	...
Change in official net foreign assets 4/	-383	-360	-112	-113	...
Memorandum items: (percentage change)					
Market growth	8.9	0.2	-1.5	0.9	3.1
Partner countries' export prices (in U.S. dollars)	19.6	20.4	-1.2	-3.8	-0.4
Effective exchange rate	-14.7	-3.0	-3.6	-13.9	-15.0
U.S. dollar/escudo rate	-10.5	-2.0	-18.7	-22.6	...
Export, f.o.b., unit value (in escudos) 5/	28.0	21.6	13.1	17.4	22.0
Export, f.o.b., volume 5/	29.2	8.2	-2.0	7.8	4.5
Import, c.i.f., unit value (in escudos) 5/	35.2	27.9	21.3	16.6	19.5
Import, c.i.f., volume 5/	6.7	12.0	5.2	5.6	0.5

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: Selected Economic Indicators, 1979-83

(Annual percentage change)

	1979	1980	1981	1982 1/	1983 2/
Real demand and output					
Gross domestic expenditures	1.6	6.7	4.3	4.3	-0.7
Private consumption	1.7	5.0	3.5	2.5	--
Public consumption	5.2	2.7	5.1	3.5	1.5
Gross fixed investment	-1.6	9.0	5.0	2.6	-1.0
Increase in inventories 3/	-0.1	1.5	0.3	2.1	-0.8
Foreign balance 3/	3.2	-2.5	-3.1	-1.8	0.9
GDP at market prices	4.5	4.9	1.8	3.3	--
Value added in manufacturing	4.9	6.0	1.5	3.2	-1.0
Partner industrial countries' GNP 4/	3.2	0.9	-0.2	--	1.1
Labor market					
Employment	2.1	1.9	1.1	-0.7 5/	-1.0
Unemployment rate (level)	8.2	7.8	8.2	7.2 5/	8.5
Wage per man in manufacturing	19.9	23.5	19.8	22.5	20.0
Productivity in manufacturing	5.7	5.6	2.0	4.0	--
Unit labor costs in manufacturing	13.4	17.0	17.5	17.8	20.0
Prices					
Consumer prices	24.2	16.6	20.0	22.4	22.5
GDP deflator	22.0	15.7	18.3	22.1	23.0
Income					
Gross wage share in national income	54.3	57.4	59.9	58.9	...
Household disposable income	30.5	20.0	20.1	23.0	21.7
Savings rate (level)	17.7	15.8	12.9	11.2	10.6

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

1/ Provisional estimates.
2/ Staff forecast.
3/ Contribution to GDP growth.
4/ Weighted by value of trade
5/ Based on available indicators for the first half of 1982.

Table 3. Portugal: Summary of Public Sector Accounts, 1980-83

(In billions of escudos, except as otherwise indicated)

	1980	1981	1982	1983 Budget	1981	1982	1983
					Percentage changes		
General Government (national accounts basis)							
Current revenue	362.6	447.1	564.0	746.7	23.3	26.1	32.4
Of which:							
Direct taxes and social security contributions	168.1	220.8	227.8	349.6	31.4	25.8	25.8
Indirect taxes	173.0	212.0	261.1	347.3	22.5	23.2	33.0
Nontax revenue	21.5	14.3	25.1	49.8	33.5	75.5	98.4
Current expenditure	404.6	527.3	633.6	774.7	30.3	20.2	22.3
Of which:							
Goods and services	185.6	230.8	276.7	333.4	24.4	19.9	20.5
Subsidies	59.8	69.4	76.7	56.3	16.1	10.5	-26.5
Interest payments	38.8	79.7	101.1	160.0	105.4	26.9	58.3
Transfers	120.4	147.4	179.2	225.0	22.4	21.6	25.6
Current balance	-42.0	-80.2	-69.6	-28.0	...	...	...
As per cent of GDP	3.5	5.5	3.8	1.2	...	...	...
Capital receipts	5.8	8.5	14.2	11.4	46.6	67.1	-20.0
Capital expenditure	91.2	94.5	121.3	139.0	3.6	28.4	14.6
Of which:							
Fixed investment	49.4	62.5	70.9	98.0	26.5	13.4	38.2
Capital transfers	20.7	14.0	27.6	20.2	-32.4	97.1	-26.8
Net lending	21.1	18.0	22.8	20.8	-14.7	-26.7	-8.8
Overall balance	-127.4	-166.2	-176.7	-155.6	...	...	...
As per cent of GDP	10.6	11.4	9.6	7.1	...	...	...
Total borrowing requirements (cash basis)	120.6	172.3	196.3	...	...	...	...
(as per cent of GDP)	10.0	11.9	10.7	...	...	...	...
External financing, net	21.5	34.6	53.5	...	...	...	...
Domestic financing, net	99.1	137.7	142.8	...	...	...	...
Of which:							
From banking system	89.0	133.6	140.4	...	...	...	...
Nonfinancial public enterprises							
External borrowing, net	65.5	96.9	143.0	...	41.3	43.2	...
Domestic bank financing, net	34.1	37.7	64.2	...	13.3	20.0	...
Domestic nonbank	--	5.7	6.6	...	...	...	...
Total as per cent of GDP	8.3	9.7	11.7	...	...	...	...

Sources: Data provided by the Portuguese authorities.

Table 4. Portugal: Monetary Aggregates, 1979-82

	1979	1980	1981	1982
	(In billions of escudos; end of period)			
Net foreign assets	272.1	339.4	411.7	569.1
Bank of Portugal	237.7	276.3	336.8	...
Other banks	34.4	63.1	74.8	...
Net domestic credit	934.7	1,246.1	1,651.6	2,131.7
Public sector 1/	82.0	171.0	304.6	445.0
Private sector	852.7	1,075.1	1,347.1	1,686.7
Of which:				
Public enterprises	248.6	282.7	320.4	384.6
Monetary liabilities	994.1	1,340.4	1,723.6	2,177.6
Currency and demand deposits	390.9	477.4	517.2	599.2
Quasi-money	603.2	863.0	1,179.2	1,578.4
Of which:				
Emigrants' deposits	133.5	229.9	352.2	487.8
Other items, net	212.7	245.0	339.7	523.1
Of which:				
Counterpart of valuation changes	18.0	37.6	101.4	231.2
	(12-month percentage change) 2/			
Total domestic credit 2/	25.8	28.8	28.7	26.4
Credit to the private sector	21.2	26.0	25.3	25.2
Credit to public enterprises	18.5	13.7	13.3	20.0
Credit to public sector 1/3/	10.6	8.9	10.0	8.1
Broad money	36.4	34.8	28.6	26.9
Emigrants' deposits	66.5	72.2	53.2	41.4

Source: Data provided by the Portuguese authorities.

1/ General Government plus the Housing Development Fund, the Highway Authority, and the autonomous regions of Azores and Madeira, but excluding public enterprises.

2/ Calculated including Esc 168.7 billion as counterpart of public debt resulting from the valuation of gold reserves in January 1980.

3/ Change in net credit to the public sector as percentage of previous period broad money stock.

Table 5. Portugal: External Debt Outstanding and Debt Service Ratio, 1979-82

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

	1979		1980		1981		1982 (Prov.)	
	Total	Of which: Short-term	Total	Of which: Short-term	Total	Of which: Short-term	Total	Of which: Short-term
General Government	1,276	--	1,691	--	2,195	--	2,856	--
Bank of Portugal	1,617	582	1,116	220	962	250	670	120
Other monetary institutions and nonmonetary financial sector	532	--	737	3	882	23	1,331	50
Public enterprises	3,395	1,010	4,603	1,939	5,974	2,754	7,702	3,618
Nonfinancial private sector	447	59	831	235	1,002	262	905	169
Total	7,267	1,651	8,978	2,397	11,015	3,289	13,464	3,957
Of which:								
Public and publicly guaranteed	3,891	582	3,785	220	4,120	251	4,666	120
Bank-guaranteed	1,623	714	1,085	68	926	13	799	6
Memorandum items: (in per cent)								
Share of short-term debt	22.7	...	26.7	...	29.9	...	29.4	...
Ratio of debt to GDP	36.4	...	39.5	...	49.7	...	66.2	...
Ratio of debt to foreign exchange earnings 1/	92.4	...	92.1	...	120.5	...	161.6	...
Ratio of debt to gross official reserves 2/	372.7	...	61.1	...	111.8	...	130.9	...
Ratio of debt service to foreign exchange earnings	16.8	...	14.6	...	22.5	...	27.3	...

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.