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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/84

10:00 a.m., June 13, 1983

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	H. G. Schneider
	A. Le Lorier
	J. Delgadillo, Temporary
R. D. Erb	
M. Finaish	T. Alhaimus
	I. R. Panday, Temporary
	T. Yamashita
R. K. Joyce	M. Casey
	C. Robalino
G. Laske	
G. Lovato	C. P. Caranicas
	C. J. Batliwalla, Temporary
	J. E. Suraisry
	T. de Vries
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	O. Kabbaj
	M. Camara, Temporary
M. A. Senior	
J. Tvedt	
	C. Taylor
	M. Hull, Temporary
Zhang Z.	Wang E.

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present
European Department: T. Catsambas, P. B. de Fontenay, D. N. Lachman, L. L. Perez, E. Spitaeller, K. A. Swiderski, T. M. Ter-Minassian. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director. Legal Department: Ph. Lachman, J. M. Ogoola. Middle Eastern Department: A. K. El-Selehdar, Deputy Director; P. L. Clawson, F. Drees, S. H. Hitti, B. A. Karamali, D. B. Noursi, L. A. Wolfe. Secretary's Department: A. P. Bhagwat. Treasurer's Department: J. Ramos. Western Hemisphere Department: J. M. F. Braz. Advisors to Executive Directors: A. A. Agah, P. Kohnert, P. D. Péroz. Assistants to Executive Directors: E. M. Ainley, H. Arias, L. Barbone, R. Bernardo, M. B. Chatah, T. A. Connors, G. Ercel, I. Fridriksson, G. Gomel, H. Kobayashi, Y. Okubo, G. W. K. Pickering, E. Portas, M. Z. M. Qureshi, C. A. Salinas, J. Schuijer, Shao Z., D. I. S. Shaw, Wang C. Y.

1. PORTUGAL - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with Portugal (SM/83/88, 5/18/83). They also had before them a report on recent economic developments in Portugal (SM/83/94, 5/25/83).

The staff representative from the European Department stated that at the request of the Portuguese Government she had visited Lisbon the previous week, and had had the occasion to meet the new Prime Minister and Deputy Prime Minister, the Minister of Finance, and the Governor and Deputy Governors of the Bank of Portugal. The Portuguese authorities had indicated that, while they had not yet defined the details of their economic policy for the rest of 1983 and for 1984, they shared the staff concern about the economic situation, in particular the balance of payments, and intended to give priority in the short run to the prompt restoration of a sustainable external position. They recognized that that objective would require a broad-based effort, involving a determined and well-coordinated use of the various economic policy instuments. They had also indicated interest in cooperating with the Fund in the next few months in designing and implementing such an adjustment program.

Mr. Lovato made the following statement:

The 1983 Article IV consultation mission was held and the present Board discussion takes place at a particularly delicate and unusual juncture: the Portuguese Government resigned toward the end of last year; four months went by before new elections were held; after another one-and-a-half months of political uncertainty, a new coalition cabinet took charge. It is expected to present its economic program to Parliament on June 19; while the details are yet to be defined, I understand that priority will be given to securing a prompt and sustained improvement in the economic performance, especially in the external accounts. I believe this consultation exercise can be helpful in expressing to the newly formed Government the Fund's support and encouragement in its endeavors.

My authorities are appreciative of the staff's work in reviewing Portugal's economic performance and prospects and attach great importance to present and future cooperation with the Fund in designing policies conducive to adjusting the imbalances that seriously beset the economy. There are no major areas of disagreement over the issues raised in the report, even though the authorities wish to stress a number of points that have a bearing on the Board discussion.

They regard, with the staff, economic outcomes over the last few years as being disappointing, especially on the balance of payments and inflation fronts. In this respect, they emphasize the critical role played by external, noncontrollable factors in engineering a dramatic worsening of the payments position, in a fashion similar to other developed and developing economies. The particular constellation of external events that has prevailed since 1980--a sizable deterioration in the terms of trade, the recession in world output and demand, the sharp increases in the value of the U.S. dollar and in world interest rates--has been the background against which Portugal's performance is to be assessed.

Political and institutional constraints have moreover undercut domestic demand control: a sustained rate of investment was deemed necessary in a semi-industrialized economy in need of expanding and modernizing its productive potential and high rates of public and private consumption are still to some degree a legacy of unsettling social and demographic changes. My authorities recognize, however, that the accomodative stance of policies pursued over the period under review contributed to the large and widening current account deficit and broadly concur with the staff's view about the necessity and urgency of a correction.

The current account deficit--which steadily widened to approximately 14.5 percent of GDP, coupled with external debt outstanding in excess of 60 percent of GDP and with a high debt service ratio--cannot be sustained in the medium run and is to be contained through a combination of expenditure-reducing and expenditure-switching measures. However, the trade account improved slightly in 1982. The time profile of the current account was also encouraging, the fourth quarter deficit being smaller than in the corresponding period of 1981.

In addition, inflation has persisted at too high a level, causing growing concern and prompting the authorities to consider and partly adopt policy actions designed to reduce it.

Concerning 1983, my authorities broadly concur with the staff's appraisal of the current situation and of the priorities to be attached to policy formulation and implementation.

The new Government, upon taking office, will endeavor to execute the budget program approved last February, which envisaged a decline in the general government deficit as a ratio to GDP from 9.6 percent to 7.1 percent to be attained through revenue-increasing measures and controls on public expenditures. As for the former, tax receipts are expected to increase considerably owing to both surcharges on selected direct taxes and rises in some indirect taxes. Current revenues of the Government are projected to almost offset current expenditures, as subsidies are being drastically curtailed. Capital spending is to decelerate as transfers to public enterprises are supposed to be cut.

The finances of public enterprises are a matter of growing concern to my Portuguese authorities since they continued to lead, as the staff correctly indicates, to budgetary overruns and excessive domestic and external borrowing. The Government is committed to confining the investment outlays of public enterprises to projects already under way and having the highest and quickest payoff in terms of the balance of payments. Moreover, my authorities intend to further adjust some administered prices to ensure a continued improvement in the position of the Supply Fund, which is targeted to show a sizable surplus this year, compared with a deficit of over 1 percent of GDP in 1982.

Monetary policy has been severely constrained by the sizable public sector borrowing requirement, which has been financed mainly by domestic bank credit and, to a lesser degree, by external debt. A historical legacy of low and slowly changing interest rates, combined with an ever-present concern with cost pressures in industry, have led to the adoption of domestic credit ceilings as the preferred instrument of monetary control. Technical problems have however impaired the efficacy of monetary control, and credit ceilings have been overshot, as penalties did not provide an effective deterrent to such excesses. Problems have arisen both from the difficulties encountered by banks in knowing with certainty the maturity structure of their portfolios and from their need to renew credits coming due so as not to force enterprises into default, thereby stifling domestic business activity.

Lately my Portuguese authorities have taken strong corrective actions, in accordance with the staff's suggestions, aiming at containing domestic credit demand, checking and possibly reversing capital outflows, and promoting greater savings. Lending and deposit rates were increased significantly on March 24, 1983: interest rates on most maturities are now positive in real terms and comparable to those prevailing in world financial markets. The authorities proved thereby to be committed to flexibly managing interest rates. An important by-product of this can be expected to be a larger nonmonetary financing of the budget deficit with beneficial effects on liquidity control and disinflation.

As regards incomes policies, they are seen as helpful in reducing the output and employment costs of the necessary restraint in domestic demand. Wage guidelines, set in keeping with official inflation targets, proved difficult to adhere to in 1981-82. Although the details of the incomes policies of the new Government have not been announced as yet, my authorities are keenly aware of the need to secure wage moderation and determined to work toward it.

On the external front, the authorities have acted to switch demand from domestic to foreign sources as a stimulus to real output growth and redirect resources from the nontraded to the traded goods sector.

The exchange rate correction of mid-1982 seems to have worked effectively in restoring Portugal's competitive position to appropriate levels, as evidenced by the observed buoyancy of export volumes in the past year (a 7.8 percent annual increase against an export market growth estimated at about 1 percent). The authorities are inclined to maintain competitiveness at the levels which were already attained. The recent increase in the rate of monthly effective depreciation to 1 percent is intended for this purpose. The authorities, being aware of the continuing and prospective inflation differential vis-à-vis Portugal's trading partners, will flexibly manage the escudo exchange rate to prevent any sustained loss of competitiveness.

Complementary measures in the trade area have also been recently adopted: while Portugal's structural import dependence on raw materials, basic consumer goods, and foodstuffs does not give much leeway for a compression of import flows, an export promotion mechanism is being activated complementing interest-rate subsidies with letters of credit granted selectively so as to promote nontraditional export products and markets. An effective system of export incentives coupled with a suitable marketing strategy might give stronger impetus to exports than a strict reliance on exchange rate changes. Invisibles, notably tourism receipts and emigrants' remittances, should recover from the depressed levels recorded in 1982, as adverse exchange rate expectations have somewhat subsided and interest rates differentials have been largely offset.

On external debt management policy it is the authorities' intention to monitor more closely borrowing by public entities and enterprises, especially on short-term maturities, where debt has been quickly expanding in recent years. Queuing mechanisms have been enforced in regulating Portuguese borrowers' access to international capital markets, thus helping maintain a good credit standing for the country. A closer coordination with public investment policy and budgetary actions is, however, recognized as necessary to exercise a stricter control over external borrowing, especially by public enterprises.

Mr. Taylor commended the authorities and the staff for conducting the consultation at a rather inconvenient time. The advantage of holding the consultation was that it gave the staff and the Board an opportunity to offer advice and encouragement to the new Government before its policies had become finalized, an appropriate procedure from the viewpoint of Fund surveillance, and one that might be followed in other countries where the circumstances were similar.

He could support the staff appraisal and the proposed decision, Mr. Taylor stated. The present economic situation in Portugal was clearly unsustainable, and past policies had been, for the most part, inadequate to deal with the problems. The staff had clearly pointed out the areas of weakness in the economy and had indicated measures that needed to be taken. In many respects, the recommendations were in line with the concerns expressed by many Executive Directors during the 1982 consultation with Portugal.

While correction might not be easy, there were at least three reasons for being relatively optimistic, Mr. Taylor said. First, external developments were looking slightly more favorable for the smaller industrial countries than they had for some time. Oil prices were weaker, interest rates had declined, and there were clear signs of recovery in some of the larger economies. Second, several constructive policy steps had been taken in the past few months, including a sizable upward adjustment in interest rates and an increase in the monthly rate of effective exchange rate depreciation. Third, it was encouraging that the new Government recognized the seriousness of the situation and broadly concurred with the staff on what needed to be done, as confirmed by the staff and Mr. Lovato in his statement.

He supported the staff view that fiscal policy was a cause for serious concern, Mr. Taylor continued. Although a real effort had been made to limit certain types of expenditure, the measures introduced earlier in 1983 were not, in themselves, sufficient to produce the necessary adjustments. The reduction in the general government deficit projected at 2.5 percent of GDP for 1983 was a step in the right direction, but he wondered whether there wasn't scope for further public expenditure cuts, particularly in the social security budget. Improvements in the operations of the Supply Fund were welcome, but the accumulation of arrears vis-à-vis the distributors was a worrying development. Could the staff suggest a feasible time scale for, making the Supply Fund self-financing, as had been the original intention? It was also worrying that public enterprises had found it necessary to borrow from abroad and from the Government to support current expenditure.

On the revenue side, Mr. Taylor remarked that he shared the staff view that the structure of taxation had become too complex and relatively income inelastic, and that some reform seemed desirable. Perhaps the authorities should see the reform as a short-term objective rather than a long-term one. In addition, was there not some scope for improving social security contributions, which appeared to have grown somewhat out of line with social security benefits?

On the subject of monetary policy, Mr. Taylor welcomed the action taken in March to raise interest rates, which seemed particularly appropriate in view of the existence of disguised capital exports and weaker remittances. However, in a country in Portugal's position, the mere elimination of the interest rate differential with the United States might be inadequate, and the authorities should consider whether they might not need to take further action. Domestic credit creation should not be allowed to accommodate a faster rate of inflation; in the past, credit ceilings had either been too generous or ineffective in controlling the growth of domestic demand for finance.

Turning to the external sector, Mr. Taylor noted with some concern the size of the cumulative external debt--equivalent to two thirds of GDP--and the debt service ratio of 27 percent. Would Portugal be able to continue financing deficits on that scale through the banking system? Although the medium-term balance of payments projections suggested that the situation could be improved, they nevertheless presented a disturbing picture. A reduction of the current account deficit to 7.5 percent of GDP, while in itself quite a strong improvement, nevertheless remained a high-risk strategy, and it might be prudent to aim for a larger improvement. As the Executive Board had seen in a number of cases, the debt crisis could result in the necessity for much more abrupt and painful adjustment measures than would have been necessary if the appropriate steps had been taken at an early stage.

With regard to the exchange rate, Mr. Taylor commented that he detected a difference of view between the staff and the authorities, and that he tended to agree with the staff. The authorities had been pleased with the growth in export volume in 1982, but part of that growth could be attributed to the coming on stream of a large petrochemical complex. The authorities were no doubt aware that the trade deficit was about 20 percent of GDP; either Portugal would have to begin running a trade surplus in the near future or there would have to be an enormous flow of foreign private capital into the private economy. In that context, Ford Motor Company had decided to postpone a major investment in the country, which suggested that competitiveness--in particular with regard to labor costs--was not as good as it should be. Measures to improve the competitive position were urgently needed, particularly in the light of Portugal's heavy reliance on such an extremely competitive activity as tourism.

The references in Mr. Lovato's statement to export promotion schemes were interesting, Mr. Taylor considered. As he understood it, the authorities were putting their faith in somewhat selective schemes, such as providing interest rate subsidies to certain export industries, which they believed were more effective than relying on general price mechanisms. What was the staff's view on the effectiveness of those measures? He shared the staff's concern that the temporary increase in the import surcharge of 20 percentage points should be removed as soon as possible. The surcharge should help to reduce the demand for nonessential imports, an understandable objective in the short term; nevertheless, it was an indication that the exchange rate was still not at an appropriate level. There had been a number of developments that would affect the forecasts for the 1983 current account, including the import surcharge, the export incentives, and the drought, which would affect agricultural production and hydroelectric power generation. Did the staff think that its projections for 1983 might need to be revised?

Inflation, at 22.5 percent in 1983, was a major concern for the authorities, Mr. Taylor continued. They needed to tackle that problem as a matter of urgency, using an appropriate combination of demand management and incomes policy. Like the staff, he was concerned about the acceleration of wage increases in 1982.

Supply-side policy was also an area that needed attention, Mr. Taylor said, although perhaps in a slightly longer-term context. Agriculture still accounted for 12 percent of GDP in Portugal, but figures in the staff report on recent economic developments indicated that agricultural output had, in fact, stagnated over the last decade. Production per unit of labor or per unit of land was among the worst of Western European countries, and crop yields were substantially lower than in Spain or Greece. It would be desirable for the authorities to take steps to improve agricultural efficiency prior to the entry of Portugal into the European Community. No doubt, the staff would be looking into those questions with the World Bank.

In conclusion, Mr. Taylor commented that the only course for Portugal to follow was one of carefully coordinated monetary and fiscal restraint, in the context of flexible interest and exchange rate policies. The authorities should tighten their policies as quickly as possible, in the manner recommended by the staff. It would be wise if economic adjustment were carried out within the context of a Fund program; given the need for extensive supply-side adjustment, a multiyear program would perhaps be most appropriate. Any program would have to contain sufficiently strong adjustments to correct the deteriorating economic position and to restore international banking confidence.

Mr. de Vries stated that he agreed with Mr. Taylor that the economic situation in Portugal was unsustainable. The staff representative's assurance that the authorities were aware of the need for a substantial adjustment program was encouraging and reassuring. He shared Mr. Taylor's view that the timing of the Article IV consultation was fortunate and should be encouraged for other countries as well. A new Government had taken office, and many economic policies still had to be worked out in detail, and it was possible that use of Fund resources might be contemplated.

The economic difficulties faced by the authorities were clear, Mr. de Vries continued. The fiscal situation was unsatisfactory, monetary policy was loose, and domestic demand had increased rapidly, resulting in a serious deterioration in the external situation. The authorities' intention to reduce the general government deficit by 2.5 percentage points to about 7 percent of GDP was an important, but insufficient, step in the right direction, considering that the overall public sector deficit--including the state economic enterprises (SEEs)--was 12 percent. Even after the measures were implemented, Portugal would still have a public sector deficit of almost 20 percent of GDP, a completely unsustainable position. Therefore, in addition to the reduction in the general government deficit, there needed to be a substantial reduction in the deficit of the rest of the public sector, most particularly in the state economic enterprises. In Portugal, as in other countries with SEEs, there was a need for competition, appropriate pricing, efficient management, rational investment decisions, and perhaps privatization of some enterprises.

On a related point, the rate of increase of nominal wages should be reduced, Mr. de Vries went on. There would also need to be more flexibility in manpower policies, and, where there was overmanning, people should be released and made available for more productive enterprises. The budget and wage policies needed to be supplemented by monetary policy; in the past, monetary policy had been loose, and liquidity creation had exceeded the rate of inflation. With appropriate policies and incentives in the medium term, there was the possibility for rapid economic growth and increases in income; for those potentials to be realized, however, a significant shift in policy was necessary.

The external situation was also serious, Mr. de Vries considered. External debt had increased, and a quite substantial reduction in the current account deficit was necessary to keep the alarming debt service ratio--of about 30 percent of exports--from rising even further. It was possible that the large current account deficit of 13 percent of GDP, which had arisen over three years as the result of the rapid increase in domestic demand, could be reduced substantially by a reduction in domestic demand. However, it was clear that even in the short and medium term, structural adjustment measures were needed.

Given the high rate of inflation, a flexible exchange rate policy seemed to be necessary, Mr. de Vries remarked. However, an exchange rate policy should be used only to supplement domestic adjustment measures and was not a sufficient policy measure by itself.

Miss Le Lorier remarked that the frank and lucid staff report left little room for complacency: the overall economic situation of Portugal was already a difficult one, and it would almost certainly become even more so during the coming months. Most immediate consideration should therefore be given to ways in which Portugal could break out from its present predicament.

The unsustainable rate of growth of external indebtedness, which had arisen as a consequence of excessive current account deficits, was a serious problem that should be urgently addressed, Miss Le Lorier considered. Although some steps had already been taken by the authorities, it was unlikely that they would do more than stabilize the present trend. The 1983 current account deficit was expected to reach the equivalent of 12 percent of GDP, but could go higher if any of the assumptions--which included an improvement in the terms of trade, a decline in international interest rates from the level in 1982, and an increase in tourism receipts and remittances--did not hold.

Assuming that the 1983 current account deficit could be reduced by the equivalent of 2.5 percent of GDP, such a reduction would still lead to a significant increase in the external debt and the debt service ratio, Miss Le Lorier noted. At a minimum, the current account deficit would have to be limited to 7.5 percent of GDP in 1983 and 5 percent for subsequent years if the debt service ratio was to be stabilized at 30 percent of external receipts. It was clear that under the current policy, those objectives would not be met, and there was little possibility of any significant improvement over the near term.

The new Government would present its economic program to Parliament soon, Miss Le Lorier observed. The stance of policy of the new program would be of special interest to the Executive Board, and she was confident that the authorities would give priorities to the areas pinpointed in the staff report. She was pleased to note from Mr. Lovato's statement that the authorities hoped to cooperate closely with the Fund in designing their economic policies, and she trusted that future cooperation with the Fund would lead to a new program.

Mr. Laske said that the Article IV consultation with Portugal was taking place at an opportune time and provided the Executive Board with a chance to examine the country's economic problems. Portugal's problems were grave indeed; the economy was suffering from serious imbalances, both internal and external, which required the implementation of fast and decisive corrective measures. He was pleased, therefore that the new authorities were fully aware of the situation that they were facing and were prepared to cooperate closely with the Fund; he assumed that they were thinking about drawing on Fund resources.

Commenting on more specific points, Mr. Laske observed first, that domestic inflation, the external current account deficit, and the public sector deficit had all deteriorated over the previous three years. Some progress had been projected for 1983, but the levels were likely to remain so high as to be unsustainable. He shared the staff view that factors beyond the authorities' control had played some role in the economic deterioration. However, accommodating financial policies had also played an important part. The policies pursued had permitted an expansion of domestic demand at a time when balance of payments pressures were building up.

Second, the new Government had inherited from its predecessor a budget proposal for 1983 that was in need of improvement on both the expenditure and revenue sides, Mr. Laske considered. Improvements were also needed in public enterprises, which had been allowed to become a heavy drain on the budget, thereby causing a rapid expansion of foreign borrowing and unduly fast monetary expansion. Loose monetary policy had been characterized by highly negative real rates of interest and by continuous overshooting of the ceilings on bank credit. While interest rates had been adjusted upward in March 1983, the adjustments had already been overtaken by rapidly increasing domestic inflation and a further rise of international interest rates. Perhaps the interest rate adjustments made in March were insufficient, and further action might be required.

Third, with respect to the external sector, the rather timid exchange rate policy had allowed international competitiveness to slip and had encouraged capital outflows in both open and disguised forms, Mr. Laske continued. Early action was essential to correct the public sector deficit, restrict further monetary expansion, raise the level of interest rates, and adjust the exchange rate to eliminate the differential in costs and prices.

The high level of international indebtedness was a particular concern to him, Mr. Laske remarked. He suspected that for a long time Portugal had been able to borrow from international banks at terms comparable with those for major industrial countries, since Portugal held a relatively large amount of gold in its national reserves. That situation seemed to have come to an end, however, since spreads had been increased in 1983. Even under optimistic assumptions with respect to world economic recovery, and a hoped-for decline in international interest rates, a steep reduction in the current account deficit was needed to stabilize the debt service ratio even at a rather high level. The amount of external borrowing needed by Portugal--over and above the amortization of maturing medium- and long-term debt--came close to the borrowing needs of economies that were much larger in size, and that did not even take into account the necessity to roll over the short-term external debt assumed in 1982. The staff paper gave the impression that the authorities might face a severe external liquidity problem in 1983. Could the staff or Mr. Lovato provide additional information on that issue?

The increase in the rate of the import surcharge from 10 percent to 30 percent could be regarded as a protectionist measure, even though it might have been introduced primarily with its revenue-raising benefits in mind, Mr. Laske concluded. The actual effect of the surcharge might turn out to be counterproductive since it could encourage other countries to retaliate against Portugese exports. Therefore, he strongly supported the staff view that the surcharge should be reduced to the previous level.

Mr. Casey commented that the Article IV consultation with Portugal had been made rather difficult by the political uncertainty at the time of the staff discussions, which explained why the staff report was a little unclear, particularly with respect to prospects and policies for 1983. It would be necessary to get greater clarification on those issues, especially if Portugal intended to request a Fund program. In light of the political uncertainty, he was not sure that the timing of the mission had been all that good in terms of producing a good Article IV report.

Monetary policy had been too accommodating, and perhaps even nonexistent, in the past, Mr. Casey noted. The limits on private sector borrowing had been overly generous. Given the ease with which credit targets could be exceeded, it was doubtful whether credit to the private sector would increase by only 25 percent in 1983. However, the authorities were considering raising the penalties for breaching credit ceilings to the private sector, and he would certainly welcome those measures. No

Inflation, at 22.5 percent in 1983, was a major concern for the authorities, Mr. Taylor continued. They needed to tackle that problem as a matter of urgency, using an appropriate combination of demand management and incomes policy. Like the staff, he was concerned about the acceleration of wage increases in 1982.

Supply-side policy was also an area that needed attention, Mr. Taylor said, although perhaps in a slightly longer-term context. Agriculture still accounted for 12 percent of GDP in Portugal, but figures in the staff report on recent economic developments indicated that agricultural output had, in fact, stagnated over the last decade. Production per unit of labor or per unit of land was among the worst of Western European countries, and crop yields were substantially lower than in Spain or Greece. It would be desirable for the authorities to take steps to improve agricultural efficiency prior to the entry of Portugal into the European Community. No doubt, the staff would be looking into those questions with the World Bank.

In conclusion, Mr. Taylor commented that the only course for Portugal to follow was one of carefully coordinated monetary and fiscal restraint, in the context of flexible interest and exchange rate policies. The authorities should tighten their policies as quickly as possible, in the manner recommended by the staff. It would be wise if economic adjustment were carried out within the context of a Fund program; given the need for extensive supply-side adjustment, a multiyear program would perhaps be most appropriate. Any program would have to contain sufficiently strong adjustments to correct the deteriorating economic position and to restore international banking confidence.

Mr. de Vries stated that he agreed with Mr. Taylor that the economic situation in Portugal was unsustainable. The staff representative's assurance that the authorities were aware of the need for a substantial adjustment program was encouraging and reassuring. He shared Mr. Taylor's view that the timing of the Article IV consultation was fortunate and should be encouraged for other countries as well. A new Government had taken office, and many economic policies still had to be worked out in detail, and it was possible that use of Fund resources might be contemplated.

The economic difficulties faced by the authorities were clear, Mr. de Vries continued. The fiscal situation was unsatisfactory, monetary policy was loose, and domestic demand had increased rapidly, resulting in a serious deterioration in the external situation. The authorities' intention to reduce the general government deficit by 2.5 percentage points to about 7 percent of GDP was an important, but insufficient, step in the right direction, considering that the overall public sector deficit--including the state economic enterprises (SEEs)--was 12 percent. Even after the measures were implemented, Portugal would still have a public sector deficit of almost 20 percent of GDP, a completely unsustainable position. Therefore, in addition to the reduction in the general government deficit, there needed to be a substantial reduction in the deficit of the rest of the public sector, most particularly in the state economic enterprises. In Portugal, as in other countries with SEEs, there was a need for competition, appropriate pricing, efficient management, rational investment decisions, and perhaps privatization of some enterprises.

On a related point, the rate of increase of nominal wages should be reduced, Mr. de Vries went on. There would also need to be more flexibility in manpower policies, and, where there was overmanning, people should be released and made available for more productive enterprises. The budget and wage policies needed to be supplemented by monetary policy; in the past, monetary policy had been loose, and liquidity creation had exceeded the rate of inflation. With appropriate policies and incentives in the medium term, there was the possibility for rapid economic growth and increases in income; for those potentials to be realized, however, a significant shift in policy was necessary.

The external situation was also serious, Mr. de Vries considered. External debt had increased, and a quite substantial reduction in the current account deficit was necessary to keep the alarming debt service ratio--of about 30 percent of exports--from rising even further. It was possible that the large current account deficit of 13 percent of GDP, which had arisen over three years as the result of the rapid increase in domestic demand, could be reduced substantially by a reduction in domestic demand. However, it was clear that even in the short and medium term, structural adjustment measures were needed.

Given the high rate of inflation, a flexible exchange rate policy seemed to be necessary, Mr. de Vries remarked. However, an exchange rate policy should be used only to supplement domestic adjustment measures and was not a sufficient policy measure by itself.

Miss Le Lorier remarked that the frank and lucid staff report left little room for complacency: the overall economic situation of Portugal was already a difficult one, and it would almost certainly become even more so during the coming months. Most immediate consideration should therefore be given to ways in which Portugal could break out from its present predicament.

The unsustainable rate of growth of external indebtedness, which had arisen as a consequence of excessive current account deficits, was a serious problem that should be urgently addressed, Miss Le Lorier considered. Although some steps had already been taken by the authorities, it was unlikely that they would do more than stabilize the present trend. The 1983 current account deficit was expected to reach the equivalent of 12 percent of GDP, but could go higher if any of the assumptions--which included an improvement in the terms of trade, a decline in international interest rates from the level in 1982, and an increase in tourism receipts and remittances--did not hold.

Assuming that the 1983 current account deficit could be reduced by the equivalent of 2.5 percent of GDP, such a reduction would still lead to a significant increase in the external debt and the debt service ratio, Miss Le Lorier noted. At a minimum, the current account deficit would have to be limited to 7.5 percent of GDP in 1983 and 5 percent for subsequent years if the debt service ratio was to be stabilized at 30 percent of external receipts. It was clear that under the current policy, those objectives would not be met, and there was little possibility of any significant improvement over the near term.

The new Government would present its economic program to Parliament soon, Miss Le Lorier observed. The stance of policy of the new program would be of special interest to the Executive Board, and she was confident that the authorities would give priorities to the areas pinpointed in the staff report. She was pleased to note from Mr. Lovato's statement that the authorities hoped to cooperate closely with the Fund in designing their economic policies, and she trusted that future cooperation with the Fund would lead to a new program.

Mr. Laske said that the Article IV consultation with Portugal was taking place at an opportune time and provided the Executive Board with a chance to examine the country's economic problems. Portugal's problems were grave indeed; the economy was suffering from serious imbalances, both internal and external, which required the implementation of fast and decisive corrective measures. He was pleased, therefore that the new authorities were fully aware of the situation that they were facing and were prepared to cooperate closely with the Fund; he assumed that they were thinking about drawing on Fund resources.

Commenting on more specific points, Mr. Laske observed first, that domestic inflation, the external current account deficit, and the public sector deficit had all deteriorated over the previous three years. Some progress had been projected for 1983, but the levels were likely to remain so high as to be unsustainable. He shared the staff view that factors beyond the authorities' control had played some role in the economic deterioration. However, accommodating financial policies had also played an important part. The policies pursued had permitted an expansion of domestic demand at a time when balance of payments pressures were building up.

Second, the new Government had inherited from its predecessor a budget proposal for 1983 that was in need of improvement on both the expenditure and revenue sides, Mr. Laske considered. Improvements were also needed in public enterprises, which had been allowed to become a heavy drain on the budget, thereby causing a rapid expansion of foreign borrowing and unduly fast monetary expansion. Loose monetary policy had been characterized by highly negative real rates of interest and by continuous overshooting of the ceilings on bank credit. While interest rates had been adjusted upward in March 1983, the adjustments had already been overtaken by rapidly increasing domestic inflation and a further rise of international interest rates. Perhaps the interest rate adjustments made in March were insufficient, and further action might be required.

Third, with respect to the external sector, the rather timid exchange rate policy had allowed international competitiveness to slip and had encouraged capital outflows in both open and disguised forms, Mr. Laske continued. Early action was essential to correct the public sector deficit, restrict further monetary expansion, raise the level of interest rates, and adjust the exchange rate to eliminate the differential in costs and prices.

The high level of international indebtedness was a particular concern to him, Mr. Laske remarked. He suspected that for a long time Portugal had been able to borrow from international banks at terms comparable with those for major industrial countries, since Portugal held a relatively large amount of gold in its national reserves. That situation seemed to have come to an end, however, since spreads had been increased in 1983. Even under optimistic assumptions with respect to world economic recovery, and a hoped-for decline in international interest rates, a steep reduction in the current account deficit was needed to stabilize the debt service ratio even at a rather high level. The amount of external borrowing needed by Portugal--over and above the amortization of maturing medium- and long-term debt--came close to the borrowing needs of economies that were much larger in size, and that did not even take into account the necessity to roll over the short-term external debt assumed in 1982. The staff paper gave the impression that the authorities might face a severe external liquidity problem in 1983. Could the staff or Mr. Lovato provide additional information on that issue?

The increase in the rate of the import surcharge from 10 percent to 30 percent could be regarded as a protectionist measure, even though it might have been introduced primarily with its revenue-raising benefits in mind, Mr. Laske concluded. The actual effect of the surcharge might turn out to be counterproductive since it could encourage other countries to retaliate against Portugese exports. Therefore, he strongly supported the staff view that the surcharge should be reduced to the previous level.

Mr. Casey commented that the Article IV consultation with Portugal had been made rather difficult by the political uncertainty at the time of the staff discussions, which explained why the staff report was a little unclear, particularly with respect to prospects and policies for 1983. It would be necessary to get greater clarification on those issues, especially if Portugal intended to request a Fund program. In light of the political uncertainty, he was not sure that the timing of the mission had been all that good in terms of producing a good Article IV report.

Monetary policy had been too accommodating, and perhaps even nonexistent, in the past, Mr. Casey noted. The limits on private sector borrowing had been overly generous. Given the ease with which credit targets could be exceeded, it was doubtful whether credit to the private sector would increase by only 25 percent in 1983. However, the authorities were considering raising the penalties for breaching credit ceilings to the private sector, and he would certainly welcome those measures. No rationale was given for the authorities' belief that monetary restraint would result primarily in a fall in output and not a fall in inflation. The current situation, in which there was little monetary restraint and yet output was falling, contradicted that belief; the situation reflected the difficulties of a small open economy attempting an accommodating policy when most of its major trading partners were not.

The recent interest rate adjustments made on March 24, 1983 were welcome, Mr. Casey went on, but what had happened to the system of interest rate subsidies? The interest rate subsidy might have been reduced, but the amounts of preferential credit had been increased. It was not clear whether effective interest rates were positive in real terms, a point on which he would appreciate some clarification.

Turning to the external sector, Mr. Casey remarked that the staff had appropriately noted that the pace of accumulation of external debt in recent years could not be sustained in the future. The ratio of debt to GDP had risen from 36 percent in 1979 to 66 percent in 1982. The staff had assumed a current account deficit of 7.5 percent of GDP in 1983 when projecting that the debt service ratio--of about 30 percent in 1982--could be stabilized during the 1980s. However, the staff had also indicated in another part of the paper that Portugal's current account deficit would be 12 percent of GDP in 1983, a figure clearly implying that the 1983 debt service ratio would be much larger than in 1982. Had the staff calculated the 1983 debt service ratio based on its own forecast for the current account deficit of 12 percent of GDP?

He was not entirely convinced of the staff view that the real exchange rate of the escudo was noncompetitive, Mr. Casey went on. Chart 3 on page 8b of the staff report indicated that the real effective exchange rate had in fact improved over the last decade, although, of course, much depended on what was regarded as the starting equilibrium point in that type of analysis. However, on balance, the staff view was probably correct. While export volumes had been strong in 1982, imports had been high and were currently more than twice the volume of exports, which indicated that there were some structural weaknesses in the external sector. The recent increase in the import surcharge was also indicative of structural weakness in the external account.

With an accommodating monetary policy, the rate of inflation could accelerate in 1983 and beyond, putting more pressure on competitiveness than the current rate of exchange rate's crawl could cope with, Mr. Casey continued. The staff's view on the exchange rate might be based on the assumption that the authorities would be reluctant to tighten their fiscal policy and introduce expenditure-reducing measures. Because of structural problems, the staff might also be advising the authorities to achieve a positive competitive edge rather than merely maintain competitiveness.

On a related point, Mr. Casey remarked that a depreciation tended to increase exports in a relatively small economy but that the mechanism needed to be spelled out. At the risk of oversimplification, exporters in a small economy were price takers and therefore would be foolish to reduce their prices after a devaluation. Instead, they could sell at the same price and increase their profits, which should lead to more investment and a shift of resources to the tradable sector over time. Given Portugal's circumstances, therefore, the benefits of a depreciation would not be evident in the short term and would take much longer to work through the system, and it would be necessary to offset the inflationary consequences in the long term by appropriate macroeconomic policies.

Fiscal policy should be the priority issue, Mr. Casey agreed. He understood that the Fiscal Affairs Department had provided excellent technical assistance in designing a system of value-added taxation, which would not just improve the structure of the public sector but also be compatible with Portugal's membership in the EC. Could the staff or Mr. Lovato tell the Executive Board about the status of implementation of that system?

Wages were to be targeted to increase by 17 percent in 1983, which was below the inflation forecast of 20 percent, Mr. Casey noted. However, the staff had indicated that available information on wages suggested that similar guidelines in the previous two years had been exceeded, and he wondered whether there would be further slippages on the wage front. Indeed, Mr. Lovato had noted in his statement that the incomes policy of the new Government was not yet known. On a final point, he did not fully understand the reasons why the Portuguese held so much of their reserves in the form of gold.

Mr. Tvedt remarked that although the Portuguese economy had been negatively affected by the international recession and bad weather, the problems facing the authorities were mainly a result of policies pursued in recent years. The outlook for 1983 was a gloomy one; low, if any, growth in production, high inflation, and large current account and budget deficits.

The balance of payments situation constituted a major constraint with regard to the formulation of economic policy, Mr. Tvedt considered. Because of the increase in interest payments resulting from extensive foreign borrowing, an easing of the external constraint had to come about mainly through an improvement in the trade balance. The need to strengthen demand management policies was obvious. A most important factor in such a strategy was the control of public finances, which was also a precondition for re-establishing external equilibrium, and he hoped that the new Government would introduce restrictive budgetary measures with a sense of urgency. It was also important that efforts be made to manage monetary policy more strictly. To that end, the deficit of the Government and of the public enterprises--whose financing had entailed excessive liquidity creation in the past--should be substantially reduced.

The recent increases in interest rates were welcome, Mr. Tvedt continued. However, the credit system in Portugal seemed to be rather permissive, and a more effective control of domestic credit was called for.

He was concerned about the exchange rate policy followed by Portugal in recent years, Mr. Tvedt went on. The Board had seen a similar policy in some other countries--most recently in Uruguay--and, in general, it had not maintained satisfactory competitiveness or appropriate relative prices, perhaps because it had not been accompanied by sufficient policies in other areas. Could the staff comment on the advisability of following a policy of preannounced exchange rate changes, and whether a role could be envisaged for such a policy in a high-inflation environment, inter alia, at a time where breaking inflationary expectations was perhaps of the greatest importance?

The economic problems in Portugal were not only of cyclical origin, Mr. Tvedt concluded; there were also deep-rooted structural deficiencies. The authorities had, with some success, tried to redesign structural policies, but more was needed in that field. Those policies, together with appropriate financial and exchange rate policies, might promote a shift of resources toward the traded goods sector; such a development was a key prerequisite for a sustainable increase in the prosperity and welfare of the Portuguese people.

Mr. Salehkhou indicated his support for the staff appraisal and for the proposed decision. Adverse external factors--including a large deterioration in the terms of trade between 1979 and 1982, the world recession, high interest rates on foreign capital markets, and severe weather--had undermined Portugal's stable economy, achieved between 1977 and 1979, and had resulted in the re-emergence of large external and domestic imbalances. However, external factors had been only partly responsible for the general deterioration of Portugal's economic situation; lack of effective adjustment to adverse external and domestic developments had only exacerbated an already delicate situation.

Economic developments in 1982 had been characterized by continued growth of domestic demand fueled by a high budget deficit, inadequate wage and price policies, low credit costs, and a loose monetary policy, Mr. Salehkhou commented. In addition, the balance of payments current account deficit had worsened considerably, and consumer prices had increased at a dangerously high rate.

The weak financial position of the public sector--which included the Government, public enterprises, and autonomous entities--had contributed to the expansion of domestic demand, Mr. Salehkhou continued. Despite a relative improvement in 1982, reflected in a strong increase in revenues, reduced growth of public consumption, and a reduction of subsidies in real terms, the general government deficit had remained at about 10 percent of GDP over the previous three years, while public enterprises had registered considerable losses, mainly as a result of inadequate price adjustment and inappropriate investment programs.

The magnitude of such deficits was clearly unsustainable, Mr. Salehkhou continued, particularly since they were financed largely through the creation of liquidity. The newly elected Government would have to tackle seriously the problems of the budget deficit and the efficiency of public enterprises; much stronger measures than those envisaged by the caretaker authorities would need to be taken. The projected reform of the taxation structure aimed at improving its elasticity, and its efficiency in allocation of resources should undoubtedly be at the center of that action, together with large cutbacks in capital expenditure, and the strengthening of expenditure control and tax collection.

Turning to monetary policy, Mr. Salehkhou said that it was clear that the accommodating stance of recent years could no longer be continued if external and domestic imbalances were to be corrected. In that respect, commercial bank credit ceilings would need to be strengthened and enforced. In addition, a flexible interest rate policy aimed at developing domestic savings, increasing the real cost of bank credits, and encouraging the investment of domestic capital in Portugal would also be necessary. The authorities' recent decision to increase interest rates so as to eliminate the differential with rates in the United States was welcome. Given the prospects for continued high inflation, a close surveillance of interest rate developments was necessary to insure that no real differential would re-emerge.

The new Government should aim at a considerable improvement in the country's external position, Mr. Salehkhou considered, since large current account deficits had accumulated over the previous three years--reaching 15 percent of GDP in 1982--and since outstanding external debt had reached the equivalent of 66 percent of GDP by the end of 1982. In that context, the large cutbacks in capital expenditures, the recent effective devaluation of the escudo, and the stepping up of monthly depreciation of the exchange rate, although insufficient to restore Portugal's competitiveness to its 1979 level, should have a favorable impact on exports, and should also complement fiscal and monetary policies aimed at significantly curbing domestic demand. However, more decisive action was needed to reduce the current account deficit and to stop the dangerous growth of external debt.

Political uncertainties had prevented the authorities from implementing any meaningful adjustment policies in the previous two years, Mr. Salehkhou concluded. There was no more room for delay, and the new Government had no alternative but to tighten economic policies in order to restore Portugal's external and domestic balance in the medium term, even if that meant more inflation and less growth in 1983. In that connection, he was pleased to note in the Prime Minister's inaugural speech that the first priority of the Portuguese Government would be to secure recovery through drastic austerity measures, and that three emergency programs would be implemented to tackle foreign debt, to boost production and investment, and to modernize the agricultural sector.

Mr. Suraisry stated that the economic and financial situation in Portugal had worsened significantly over the previous three years. The new Government faced serious problems in a number of areas; inflation was running at an annual rate of over 20 percent, the current account deficit had increased to 14.5 percent of GDP--the highest figure among OECD countries--and foreign borrowing had increased sharply, much of it on a short-term basis. While those problems were due, in part, to factors beyond the authorities' control, the adoption of overexpansionary fiscal policies had resulted in a much faster growth of domestic demand in Portugal than in its major trading partners. He shared the staff view that comprehensive adjustment measures were urgently needed. Although the authorities had started to move in the right direction, policies would have to be strengthened further in 1983 and thereafter, given the extent of the imbalances.

Commenting on fiscal policy, Mr. Suraisry welcomed the authorities' intention to reduce the central government deficit to the equivalent of 7 percent of GDP in 1983. That would not be easy to achieve, particularly as the budget had not yet been implemented. Continuous efforts to improve tax administration and control expenditure, notably the subsidies and capital transfers to public enterprises, were required. If, as the staff suspected, the official projection proved overly optimistic, the authorities would have to be ready to take additional measures. Did the staff or Mr. Lovato know whether any contingency plans were under preparation? He hoped the authorities would also take steps to establish more effective control over the operations of the rest of the public sector. That applied particularly to public enterprises and local authorities, whose financing requirements had placed a serious strain on the budget and credit system. It was encouraging that the investment plans of the public enterprises were coming under closer scrutiny by the Central Government.

With respect to monetary policy, there was clearly scope to strengthen the system of quantitative credit ceilings that had not been enforced very effectively in the past, Mr. Suraisry went on. Domestic capital markets should be broadened in order to allow a larger proportion of the public sector deficit to be financed by nonmonetary means. What progress were the authorities making toward that objective?

Turning to incomes policy, it was disappointing to note that the official wage guidelines of 1981 and 1982 had been exceeded by wide margins, Mr. Suraisry went on. A period of wage restraint could help to mitigate the cost of a more restrictive financial policy, and he encouraged the authorities to hold firmly to the 17 percent guideline established for 1983. It would be particularly important to secure moderate wage settlements in the public enterprises.

Commenting on the external sector, Mr. Suraisry remarked that room for manuever was limited by the urgent need to reduce the current account deficit and foreign borrowing to more sustainable levels. The devaluation of the escudo in March 1983 and the decision to increase the monthly rate of depreciation to 1 percent should improve Portugal's competitive position, but it would need to be kept under close review in the coming months. More effective control over external borrowing was essential, and the buildup of short-term debt by the public enterprises was of particular concern, given the present uncertainties in international capital markets. In the short run, therefore, there was no alternative to demand restraint.

In the medium term, a number of structural problems would have to be addressed if Portugal was to benefit fully from membership in the European Community, Mr. Suraisry concluded. Comprehensive supply-side measures were required to modernize the agricultural sector, diversify the export base, and deal with rigidities in the tax structure and the financial system. It would be helpful to know more about the authorities' long-term development plans. Finally, the authorities faced an extremely difficult task in the period ahead. Given the magnitude of the problem, had the authorities considered a Fund program that would assist them in their efforts to adjust the economy and lay the basis for renewed growth in the medium term?

Mr. Erb stated that he agreed with other speakers who had commented favorably on the timeliness of the Article IV consultation with Portugal. The political situation might have been unclear, but the economic problems were clear. Portugal's external situation had deteriorated to the point that substantial internal and external adjustments needed to be made if external financial flows were to continue. Although some preliminary steps had been taken, the authorities should implement policies in the immediate future that would restore internal and external balance.

First, with respect to fiscal policy, Mr. Erb considered that the growth of public expenditure must be contained, and additional revenues raised, in order for the Government to meet its target in 1983 of reducing substantially the fiscal deficit. It was regrettable that an increase in the import surcharge was being relied upon to raise revenues. Adjustments in subsidized administered prices were also needed in order to restore financial balance to the Supply Fund and in order to improve the position of public enterprises generally. More fundamentally, it appeared that more effective control should be placed on the spending and borrowing decisions of the public enterprises.

Second, Mr. Erb commented that it was clear that monetary policy needed to be supportive of the adjustment effort, rather than accommodative of excessive demand pressures. A more flexible interest rate policy would help to control monetary expansion. If interest rates were allowed to rise to market levels, the authorities would not be forced to finance the fiscal deficit through monetary expansion. Higher interest rates would also stem capital outflows.

Third, discussing incomes policy, Mr. Erb stated that he shared the staff view that the Government should restrain wage increases in order to maintain competitiveness and restrain inflation. The authorities should be firm in negotiations with the public sector, especially as unemployment was projected to increase in 1983.

Fourth, on the subject of exchange rate policy, international competitiveness had been eroded because the rate of depreciation of the escudo was not sufficient to offset differentials in inflation, Mr. Erb said. As part of a comprehensive adjustment program, the authorities should be prepared to take steps to restore and maintain competitiveness.

It was important to implement a well-planned adjustment program as quickly as possible, Mr. Erb concluded. While it would be ideal for the new Government to act on its own, the authorities should not rule out the possibility of implementing an adjustment program under a Fund program, in particular a stand-by arrangement.

Mr. Prowse commended the staff for its candid and clear analysis, although perhaps the conclusions could have received more emphasis. The timing of the Article IV consultation with Portugal provided a clear opportunity for the Executive Board to exercise its surveillance role with some effect.

There had been a severe deterioration in Portugal's economic situation, partly due to the international economic environment, but partly due to the fundamental inadequacies of economic management in Portugal. The situation was certainly serious and perhaps verging on the critical, so that it was most useful for the Executive Board and the staff to be candid in their discussion. Of particular concern was the high and accelerating inflation, the large budget deficit, the inadequate monetary policy, the clearly unsustainable balance of payments deficit, and the associated rapid growth of external debt. In the absence of a prompt and concerted adjustment effort, it was difficult to see how Portugal could avoid running into severe debt and liquidity problems. The crisis in Portugal had been continuing for at least a year, and it was evident that the need for adjustment had not been sufficiently underlined in previous Article IV consultations. It was therefore essential that the summing up conveyed to the authorities the need for adjustment as distinct from financing.

Commenting on more specific points, Mr. Prowse said first, that it was a matter of concern that the incomes policy of the new Government was not yet clarified. However, fiscal, monetary, and external policies were the core of any program, and it was important not to place too much emphasis on incomes policy. The staff had therefore been wise in explaining that the costs of an adjustment program in terms of employment could be moderated by a deceleration in the growth of nominal wages; in that context, an incomes policy could be effective.

Second, the import surcharge was not an appropriate policy, Mr. Prowse considered. It appeared to have been adopted in order to delay the need for more fundamental adjustment, and he hoped that alternative arrangements could be made. Mr. Lovato had indicated in his statement that "on the external front, the authorities have acted to switch demand from domestic to foreign sources as a stimulus to real output growth and redirect resources from the nontraded to the traded goods sector." Did he see the import surcharge as significant in that context?

Mr. Schneider noted that in the absence of adequate adjustment policies, the Portuguese economy had performed poorly and was now in a rather critical position. He hoped that the new Government would take necessary measures in the monetary, and especially in the fiscal field, to reduce substantially the huge budget deficit, to improve demand management, and to adopt a more flexible exchange rate policy in order to regain competitiveness in international markets. The new Government was aware that substantial adjustment efforts were urgently needed to redress an unsustainable situation on both the domestic and the external sides, and those adjustments could only be carried out in the medium term. A Fund program would be helpful to bring about a major adjustment.

Portugal's entry into the EC would require major adjustment, Mr. Schneider remarked. Although the staff had included in its paper on recent economic developments a brief discussion on the negotiations between Portugal and the European Community, it would be useful if the next report contained a more detailed analysis of the impact on Portugal of its forthcoming membership in the EC, considering the low productivity in the agricultural sector as well as the need for adjustments in the industrial sector. Finally, could the staff or Mr. Lovato give some explanation of the last sentence on page 65 of the staff paper, which read: "Moreover, the question as to whether the European Commission would permit Portugal to join the community prior to Spain is yet to be addressed."

Mr. Zhang asked which figures in the staff report had been used to measure Portugal's level of competitiveness. What were the commodities that were competing in the world market, and had competitiveness really been lost or gained?

The Acting Chairman remarked that the chart entitled "Real Effective Exchange Rate Indices" on page 8b of the staff paper had a bearing on Portugal's competitiveness. He was aware of the limitations of index data, but the figures on relative unit labor costs adjusted for exchange rate changes indicated the changing level of competitiveness.

Mr. Casey commented that discussions that took place with a caretaker government tended to be rather difficult; he imagined that civil servants tended to be fairly guarded in their comments because of political uncertainty. That aspect did need to be taken into account in the timing of Article IV consultations, but he certainly agreed with other speakers about the need for regular surveillance when economic circumstances in a country were deteriorating.

The Acting Chairman said that, while political figures and civil servants might have to be unusually guarded at a time of political change, it was particularly useful for the Executive Board to have an opportunity to make an input when the economic situation of a country was deteriorating, and when it was likely that a use of Fund resources would be involved.

Mr. de Vries recalled that the Netherlands authorities had requested a consultation just prior to elections so that the newly elected political authorities would have the benefit of the staff's and Executive Directors' opinion on economic policy. Unfortunately, the consultation had not come about, because the staff had been busy at the time. However, judging from that and other experiences, a change of government provided a relatively favorable time to carry out a consultation.

The staff representative from the European Department noted that the Executive Directors had rightly identified fiscal policy as the center of the adjustment effort. The target of reducing the government deficit to 7 percent of GDP in 1983 represented a substantial reduction, but she had doubts that it would be possible to observe that target closely. It was necessary to look at the overall public sector, including the finances of the Supply Fund, in order to get a perspective on the problem. If the proposed price increases were introduced promptly within the coming two or three weeks, projections showed that the Supply Fund would run a considerable surplus in 1983 of about Esc 17 billion, compared to a deficit of Esc 17 billion--about 1 percent of GDP--in 1982. That would represent an improvement equivalent to 2 percentage points of GDP between 1982 and 1983, an important step in the right direction, but the staff agreed that in the medium term additional efforts would have to be made.

There was scope for improvement in the public sector finances over the medium term, the staff representative continued. The Portuguese tax system was outdated and in need of substantial overhauling; the personal income tax was not progressive and was relatively income inelastic. The structure of indirect taxation, based on a turnover tax, was even more outdated, and evasion was quite widespread. The Fund had provided technical assistance to the Portuguese authorities in designing a value-added tax. Most of the preparatory work had been completed, and the tax could be implemented, given the political will, within a couple of years. The authorities had committed themselves to introducing the value-added tax three years after joining the EC, but it was their intention to implement it much more promptly. Whether that would be feasible in 1984 was doubtful; however, it should be in place by 1985.

Discussing the social security system, the staff representative said that the rate of contributions was more or less in line with the average of other industrial countries. There was, however, scope for improving compliance with and administration of those contributions, and the authorities were quite determined to make additional efforts. As for social security benefits, pensions were relatively low, and there was no formal indexation mechanism. Although the present Government had favored a formal indexation of pensions, the staff hoped that they would realize the financial constraints and would not introduce such a system. There was certainly scope for better control of health expenditure by extending the freeze on hiring to medical personnel.

In general, control over expenditure could be improved considerably, in particular, over the large number of funds that were not fully under the Central Government's control, the staff representative continued. In addition, there was scope for the authorities to better enforce the hiring freeze.

The problems with respect to the finances of public enterprises were serious, the staff representative considered, and courageous steps needed to be taken in pricing, manpower, and investment policies. A number of recent investments would need to be abandoned, in the light of changing demands in international commodity markets. There was also a need to scrutinize future investment projects more strictly. Although the overall financial position of public enterprises had been analyzed more closely in 1983, certain investment decisions--involving external financing--had already been taken by some of those enterprises. The Portuguese authorities should be encouraged to plan their public investment program well ahead of the beginning of 1984.

On the monetary side, the staff representative recalled that a number of Directors had asked about recent trends in monetary aggregates, in particular on credit to the private sector. Data were available only through March 1983, so that it was not possible to determine whether the increase in interest rates, which had taken place at the end of March, had had any effect in moderating the demand for credit. The rate of growth of domestic credit to the public sector was about 24 percent, which was in line with the expectations for the year as a whole of 25 percent. The Executive Directors should be reminded that the projections for 1983, including the monetary projections, were only illustrative, and should not be regarded as forecasts, and certainly not as targets.

The recent adjustment in interest rates was a step in the right direction, the staff representative went on, but it was too early to determine whether the adjustment had been adequate. First, the trend of inflation seemed to be accelerating; the index at the end of April 1983 had been 11 percentage points higher than at the end of December 1982. Second, it was neccessary to determine the relationship between the interest rate and the rate of monthly crawl of the exchange rate.

Interest rate subsidies were pervasive in the Portuguese economy, the staff representative continued. Preferential credit had been growing rapidly over the previous few years and currently accounted for nearly 40 percent of total credit. The staff had repeatedly stressed to the authorities the importance of streamlining and reducing those subsidies, which, in theory, were paid by the Bank of Portugal but, in practice, reduced the profits of the Bank and were passed on to the budget.

With regard to wage policy, the staff representative indicated that the trend of real wages in Portugal had varied considerably over the previous few years. There had been a 20 percent decline in real wages between 1976 and 1979; nominal wages had rebounded by about 5 percentage points in 1980, although real wages had remained more or less stable; and it appeared that in 1983 there would be a cut in real wages. It was unlikely that the wage increases would remain within the guideline of 17 percent, because the Government had indicated in its electoral campaign that it would eliminate the wage ceiling. The Socialist Party and the Social Democratic Party had agreed to revise the labor laws, introducing greater flexibility in the management of the work force. Changes were necessary if the finances of public enterprises were to be improved, although they would be costly for the budget because unemployment compensation would need to be increased from its present low level.

Discussing the relationship between the exchange rate policy and Portugal's competitive position, the staff representative said that the charts on page 8 of the staff report were only suggestive, and that any indicator of competitiveness was subject to many qualifications. There had been a substantial improvement through 1980 in Portugal's competitive position, but since that time there had been some erosion, despite the depreciation of 1982, which had gone some way toward restoring the position. In the light of the deterioration in the balance of payments position over the previous few years--in particular the reduction in remittances--and in the light of the larger debt service burden, it was more important for Portugal to achieve sustained export growth than it had been some years previously. The staff hoped that the exchange rate would be allowed to play its full role; on the basis of experience, the response of trade flows to exchange rate changes in Portugal would be prompter than in other countries. A competitive exchange rate would also encourage the sustained growth of exports in new areas.

The question of how the crawling exchange rate policy affected inflationary expectations was a difficult one, the staff representative commented. If the rate of crawl was increased to take care of the current differential, the increase might act as a signal to the market that inflation was expected to remain at the current level. The exchange rate policy had to be designed within the context of the overall package of policies, with a clear target for inflation backed up by an appropriate target for monetary expansion. If the other policies were credible then the crawling peg rate, matched to the future differential in inflation, would also be credible. The crawling peg could not be used to regain past losses of competitiveness.

On the topic of external financing and prospects for the external account, the staff representative remarked that the Executive Directors had noted two illustrative scenarios presented in the staff report; one, based on the present policy, projected a current account deficit of 12 percent of GDP; and the other, based on a more optimistic scenario, projected a current account deficit of 7.5 percent of GDP. The more ambitious target would be difficult to achieve, particularly since the implementation of adjustment measures had already been delayed. It was however possible that financing difficulties might make the 1983 target achievable. In fact, preliminary figures on the trends in the balance of payments position in the first quarter of 1983 suggested that owing to financing difficulties, imports were being severely cut back and that external debt had increased by only about $100 million. That small increase could not immediately be translated into an equivalent current account deficit, but, since nondebt capital flows in Portugal were fairly small, it suggested that the current account deficit, which had been over $1 billion in 1982, had been substantially reduced in the first quarter of 1983.

It was clear that the authorities were experiencing financing difficulties, the staff representative continued. That was partly due to the fact that the Republic loan had been postponed by a few months as a result of the political uncertainty in Portugal, and the authorities had not allowed any public enterprises to borrow from the international capital markets during the second quarter of 1983. The authorities had also experienced difficulties in rolling over some of the external short-term debt, but the staff hoped that the difficulties would be overcome once international confidence was restored after the new Government implemented a clear economic program, possibly supported by a Fund arrangement. The next few months were not going to be easy for the Portuguese authorities, and it was essential that they take prompt and forceful action in order to strengthen confidence at home and abroad.

The authorities had already pledged 10 percent of their gold as collateral for loans from the Bank for International Settlements, the staff representative from the European Department indicated. However, gold sales under pressure were not desirable, especially as Portugal had a large short-term debt to be rolled over and, therefore, needed to maintain an image of strength and confidence in international markets.

The Acting Chairman, responding to a question from Mr. Zhang, stated that it was difficult to get a clear indication from statistics of the competitiveness of Portugal's exchange rate. The figures on exports, imports, the merchandise trade balance, and the current balance, especially when expressed as a percentage of GDP, indicated that some corrective measures were needed. In his view, the exchange rate as well as domestic policy would need to be adjusted to improve Portugal's competitiveness.

Mr. Lovato stated that the staff appraisal had been useful for the Portuguese authorities, and he reassured the staff that the authorities realized the seriousness of the economic situation and had started to act accordingly. There had been doubts about the advisability of having an Article IV consultation at the time of a government election or during a period with only a caretaker government. However, his authorities had welcomed the staff visit because it provided a good opportunity for an objective analysis of the economic situation and also some suggestions on policy issues.

The economic policies adopted in 1982 had been disappointing, Mr. Lovato considered. The 20 percent reduction in current subsidies and the marginal increase in capital transfers to the public enterprises projected for 1982 had not taken place. There were nevertheless some positive signs that the country was moving in the right direction. The growth of public expenditure had been contained at the central government level; the overall general government deficit as a percentage of GDP had been reduced from 11.4 percent to 9.6 percent; and the prices of health care and of energy had been increased to better reflect their true value, despite a decline in the international oil price and despite the approaching election.

For three main reasons, the Portuguese authorities had not succeeded in improving their economic situation, Mr. Lovato went on. First, the authorities had projected a world economic recovery. In an effort to avoid a further reduction of investment and to maintain employment, they had pursued an expansionary policy.

Second, the institutional and legal framework that evolved after the revolution did not permit adjustment of either private or public enterprises, Mr. Lovato continued. In particular, the labor law represented a burden for the public sector budget. The Government had tried to modify the constitution, but with only modest results. The problems of the public enterprises were complex, and it would take some time until they were solved. Furthermore, the situation with respect to the agricultural sector was also unsatisfactory, and there would be no improvement if the Government did not have the power or the courage to change the legal structure.

Third, owing to political pressure the authorities had not had the strength to take the necessary, but politically difficult, measures, Mr. Lovato explained. At the end of 1982, and particularly in the first month of 1983, the authorities--realizing that the financial policies had contributed to high inflation and a widening of the balance of payments deficit--had adopted a more restrictive stance on wage and monetary policies, while at the same time introducing more appropriate interest rate and exchange rate policies. Thus far, the rise in wages had been kept within the guidelines of 17 percent.

Commenting on the interest rate, Mr. Lovato said that there was still some interest rate subsidies, but the new Finance Minister had indicated that there would be subsidies only in the export sector.

He did not understand some members' remarks on the need to improve competitiveness through adjustment of the exchange rate policy, Mr. Lovato explained. The authorities were following an appropriate exchange rate policy, and in 1982 they had succeeded in increasing productivity. Competitiveness had been regained, and there had been a remarkable increase in export volume, although conditions had been difficult in a number of markets.

In stating that demand had been shifted from domestic to foreign sources, Mr. Lovato explained that he meant that the exchange rate of the escudo had been used to modify relative prices in order to encourage Portuguese producers to shift output from domestic markets to exports. The import surcharge had been introduced in order to raise revenues, and did not have a major impact on trade, other than reducing some nonessential imports.

It was only a temporary measure. On taking office, Portugal's new Prime Minister had painted a grim picture of the country's economic situation, Mr. Lovato noted. He had announced in his speech that he would take all the measures needed to ensure economic recovery, however unpopular they might be. A series of three programs would be introduced: first, a national emergency program--lasting 18 months--would be aimed at restoring the external situation, in particular. Second, the financial economic adjustment program--lasting two to three years--would create sound conditions for investment, production, and savings. Third, a program to modernize the economy would be introduced and would last for four years. Priority would be given to the emergency program.

The new Prime Minister had indicated that there was no alternative to a reduction of subsidies, a more realistic pricing policy, and more flexible interest and exchange rate policies, Mr. Lovato concluded. The labor law would be changed to introduce more efficiency into the public sector and, in particular, in the public enterprises. Banking, insurance, and cement industries would be open to the private sector. Those measures would be politically and socially difficult. Therefore, the Prime Minister had announced the intention to establish a social economic council. That council of workers, employers, and the Government, would share responsibility and would develop a solid program for the country. Finally, it was a delicate and particularly important moment for the authorities. Given the authorities' determination to take austerity measures, it would be useful if the Fund could send a clear message of support and encouragement.

The Acting Chairman made the following summing up:

Executive Directors broadly welcomed the timeliness of the Article IV consultation with Portugal, which gave the Board an opportunity to express its views at a moment when the Portuguese authorities were reformulating economic policy.

Directors expressed serious concern at the deterioration in Portugal's economic performance over the last few years; particularly in the balance of payments, the external debt, the public sector deficit, and the high and rising rate of inflation. The current account deficit reached the equivalent of over 14 percent of GDP in 1982, a level which clearly could not be sustained. It was recognized that, in part, the deterioration was due to external factors beyond the authorities' control. However, Directors noted that a major role had been played by a growth of domestic demand far in excess of the OECD average, and by the failure to preserve the relative attractiveness of holding domestic financial assets.

Directors welcomed the new Government's commitment to securing a prompt and substantial improvement in the economic performance of the country, and urged the authorities to adopt a comprehensive set of policy measures toward that objective. In this regard, they observed that the seriousness of the external position would require a broad-based effort using the various policy instruments at the authorities' disposal in a well-coordinated fashion. The emphasis of this effort would need to be on a significant tightening of financial policies. In addition, measures would be required to assure an adequate level of competitiveness and to restore the relative attractiveness of holding domestic financial assets.

Directors stressed that the finances of the public sector continued to be a major source of weakness, contributing to the excessive growth of domestic demand. Directors welcomed the authorities' commitment to reducing the deficit of the general Government from about 10 percent of GDP in 1982 to about 7 percent in 1983. They stressed that the attainment of this target would require very firm control over expenditures and that beyond 1983 a further reduction in the deficit would be necessary. They emphasized that fiscal discipline would need to be strengthened in the years to come through further effective expenditure cuts, moderation in the growth of social spending, and a comprehensive reform of the tax system together with improved enforcement. Directors noted that there had been some progress in administered price policy, but emphasized the need for further measures to secure the targeted improvement in the finances of the Supply Fund. On public enterprises, Directors urged decisive action to improve their efficiency and profitability. The financing requirements of these enterprises, of the order of 12 percent of GDP in 1982, imposed heavy pressures on the government budget, on the credit system, and on external borrowing. These refinancing requirements would need to be scaled back sharply through more realistic pricing policies, and through measures aimed at containing labor costs and at phasing out nonproductive investments. In this respect, Directors were encouraged by the beginning made in the preparation of the public investment program for 1983.

In the view of Directors, the improvement in public sector finances would need to be complemented by a firm stance of monetary policy; the rate of growth of the credit and monetary aggregates would need to be reduced vigorously from the high levels of the past three years. In this endeavor, Directors saw a need for a tighter enforcement of credit ceilings, as well as for a more flexible interest rate policy. Directors welcomed the recent increase in interest rates as an important step in the right direction, but they stressed the importance of maintaining positive real rates of interest both from a domestic and an external point of view.

As regards the external sector, Directors underlined the importance of exchange rate policy. They stressed that appropriate conditions will need to be established to secure a sustained growth in foreign exchange earnings. The trade deficit, now at some 20 percent of GDP, was regarded as unsustainable, and an improvement in competitiveness appeared to be required. Directors observed that an important role in this regard could also be played by policies to moderate wage increases and to promote productivity through a reduction in labor market rigidities. It was regretted that the authorities had raised the import surcharge recently, and the hope was expressed that this action would promptly be reversed. A particular concern was expressed at the high level of Portugal's external debt, including short-term debt, and about the debt servicing burden.

Finally, Directors welcomed the new Government's determination to restore a sustainable external position through a broad-based national effort. Since there is no room for further delay, Directors urged that a comprehensive economic policy program be promptly worked out in cooperation with the Fund. Portugal's medium-term economic potential was considerable, and the Fund should stand ready to help lay the basis for a sustainable growth in the medium term.

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

The Executive Board then took the following decision:

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.

Decision No. 7428-(83/84), adopted
June 13, 1983

2. UNITED ARAB EMIRATES - 1983 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1983 Article IV consultation with the United Arab Emirates (SM/83/97, 5/23/83). They also had before them a report on recent economic developments in the United Arab Emirates (SM/83/108, 6/31/83).

Mr. Finaish made the following statement:

The United Arab Emirates has, over the past decade, pursued a policy of rapid growth made possible by the inflow of oil export revenues. While this policy permitted substantial development over a relatively short period, it also generated considerable economic and social strains, which in recent years have led the authorities to restrain the pace of growth. At the same time, in recognition of the economy's heavy dependence on a depletable resource, the authorities have been placing greater emphasis on diversification of the productive base and improvement in the efficiency of resource allocation. The oil market developments of the past two years, and 1982 in particular, have increased the importance of these objectives as well as of the need to adopt measures that would enable the economy to adjust to prospective trends in oil income.

The continued weakening in the demand for oil in 1982, intensified by the persistence of the worldwide recession and substantial destocking of oil inventories in industrial countries, resulted in a 21 percent drop in oil export revenues from 1981. This drop led to a deficit in the overall government budget amounting to about 8 percent of expenditures. The current account balance, however, continued to show a surplus, although a significantly smaller one than those recorded in 1980 and 1981. The real rate of growth in non-oil GDP was approximately 3-4 percent in 1982, compared with 9 percent in 1981 and 14 percent in 1980. At the same time, domestic prices are estimated to have risen by 8-10 percent, compared to 15 percent in 1981.

In response to the drop in revenues from oil exports, public sector expenditures in 1982 were reduced by 5 percent from the 1981 level. However, the development component of those expenditures recorded an increase of about 16 percent over the 1981 level, while subsidies and transfers were substantially reduced. The developments on the revenue and expenditure sides resulted in a budget deficit, as mentioned earlier, which was financed by drawing down the accumulated reserves of the Federal Government. Although the figures for the 1983 budget are not yet available, a somewhat larger government budget deficit is expected, in light of a further drop in oil receipts expected during the year.

Serious consideration is currently being given to policies aimed at raising revenues and cutting expenditures with the objective of a balanced budget by 1985. On the revenue side, these policies are aimed at raising the share of taxes and fees to 15 percent of total revenue over the long run, compared to the current share of 3 percent. Among the measures being considered are raising indirect taxes and charging fees for certain public services, such as medical care, education, and transportation, which in the past have been provided freely. The authorities are also aiming at increasing the Emirates' contributions to the Federal Government closer to the level of 50 percent of oil revenue agreed to in 1980.

On the expenditure side, consideration is being given to trimming the federal bureaucracy, which had expanded at a rapid rate in the last few years. A freeze on new hirings in the public sector has already been imposed by both the Federal and the Emirates Governments. The authorities are also considering gradual cutbacks in subsidies on fuel, electricity, and certain food items, which amounted to more than 6 percent of government current expenditures in 1982. With respect to development expenditures, projects are being subjected to increased scrutiny, and those judged not to meet project feasibility criteria are being shelved. Moreover, the authorities are placing great emphasis on encouraging the private sector to participate more vigorously in the development effort and joint ventures with the public sector, given the success of such participation in the past. In support of this policy, plans have already been drawn up for the establishment of a stock market on a gradual basis. While most of these measures are medium and long term, the authorities intend to keep borrowing to a minimum and use it only as a stop-gap measure of last resort in order to facilitate the adjustment of the economy to these measures or to supplement them in the short run.

Regarding the monetary sector, the Central Bank in the United Arab Emirates continues to play an increasing role as a vital federal institution. In its effort to streamline the financial system, it adopted a number of measures in 1982 to strengthen financial stability and improve credit policies of commercial banks. These measures include stricter rules concerning minimum paid-up capital and the establishment of a Risk Bureau to collect information on individuals with accounts at different banks. In October 1982 interest rate ceilings on deposits of less than Dh 5 million were abolished, thus lifting all restrictions on interest rates in the United Arab Emirates on both deposits and advances.

The Central Bank also responded to the particularly slow growth of liquidity in the first half of 1982 by easing reserve requirements on domestic deposits and raising the deposit requirement for lending in dirhams to nonresidents from 15 percent to 30 percent. The overall position of commercial banks continued to strengthen in 1982, as revealed by the decline in the ratio of credit to total deposits and the increase in the ratio of reserves to deposits.

Concerning the external sector, the United Arab Emirates current account surplus, including official grants, declined from Dh 33 billion in 1981 to Dh 25.7 billion in 1982. The substantial drop in revenues from exports of crude oil was partially offset by significant increases in exports of natural gas and petroleum products from the newly opened Ruweiss refinery. Merchandise imports recorded a 5.4 percent drop during the period. The forecast for 1983 suggests a further decline of Dh 8 billion in the current account surplus. The Central Bank continued its policy toward reserve management, which emphasizes the maintenance of adequate liquidity and security of reserve assets. Although foreign loans and grants were reduced in 1982 as part of the general policy of cutting back on government spending, they still constituted a high proportion of GDP, at about 5 percent.

Extending his statement, Mr. Finaish stated that on page 6 of the staff appraisal the staff had estimated that at the end of 1982 net foreign assets of the Government had amounted to $27 billion. That figure had not been verified with the authorities and was not based on official data. In addition, on page 9, there was a small correction; the country's SDR holdings were 50.3 million, not 503.1 million. Mr. Suraisry remarked that the sharp decline in world demand for oil over the previous two years had led to a considerable weakening in the balance of payments and fiscal position of the United Arab Emirates. Receipts from exports of crude oil had declined sharply in 1982, and a further large decline was projected for 1983.

To deal with the changing financial situation, the authorities had taken several measures in 1982, most notably a reduction of public expenditure by about 5 percent in nominal terms, Mr. Suraisry went on. That had been brought about by reducing foreign grants and loans, and reducing current and domestic lending expenditure in real terms although they had remained at about 1981 levels. Development expenditures, however, had increased by 16 percent since 1981. The authorities were to be commended on their adjustment to changing circumstances.

A medium-term objective of the authorities was to have a balanced budget by 1985, Mr. Suraisry continued. For that purpose, they were considering several measures that had been summarized in Mr. Finaish's statement.

On the revenue side, Mr. Suraisry noted, policies would be aimed at raising the share of non-oil revenues from the current level of 3 percent to 15 percent. Consideration was also being given to trimming the federal bureaucracy, and a freeze on new hirings by the public sector had already been imposed. The authorities were considering plans for a greater mobilization of private savings to finance domestic investment through the establishment of joint ventures with the public sector. On the institutional side, the authorities were continuing with their efforts to strengthen the banking system. In 1982, additional measures had been taken to ensure that commercial banks were established on a sound financial basis and that they followed prudent lending policies. Those were important measures, as the banking problem that had emerged in the late 1970s pointed to the need for streamlining the financial system. Finally, the authorities had adjusted smoothly to the sharp fluctuations in oil receipts during 1979-82, and they should be commended for their ability to manage the economy.

Mr. Salehkhou commented that oil revenues had declined in 1982 as a result of a drop in international demand for oil. However, despite the dominance of the oil sector in the economy, the effects of that decline had been largely contained owing to the country's limited population and to the surpluses accumulated earlier.

The decline in oil revenues had made it necessary for the authorities to reassess their overall economic policies and to adjust to the lower level of income, Mr. Salehkhou considered. Such an adjustment was undoubtedly overdue after a long period of highly expansionary policies, large public sector investments, and extensive social welfare programs. While those policies had provided a stimulus to private sector activity and had succeeded in diversifying export earnings, they had also resulted in inefficiency, in substantial subsidies, and in an unwelcome distortion of resource allocation.

It was appropriate that the authorities should envisage adjusting fiscal policies, since the decline in oil revenues had led to the development of a relatively large budget deficit equivalent to 3.3 percent of GDP in 1983, Mr. Salehkhou commented. In particular, the authorities intended to rationalize expenditures and widen revenue sources by raising indirect taxes and introducing fees for government services. Also important in the 1982 and 1983 adjustment efforts were the substantial reductions in subsidies and transfers, the large cuts in foreign loans and grants, and the marked deceleration in the growth of current and development expenditures.

While the authorities should be commended for maintaining their development aid at a high level, both as a proportion of GDP and by international standards, Mr. Salehkhou said that he hoped that the large fall in oil exports would not result in further cuts in 1983, since the economic situation of the beneficiary countries remained critical.

The Central Bank continued to take steps to improve the banking and commercial structure, Mr. Salehkhou noted. Inflation had been reduced from 15 percent in 1981 to about 8.1 percent in 1982. Uncertain economic prospects had resulted in the reduction in demand for private sector credit. He shared the staff view that, in the face of lower transfers from Emirates' Governments to the federal budget, the Central Bank should be in the position to prevent any shortage of liquidity in the banking system.

Discussing the external sector, Mr. Salehkhou remarked that the United Arab Emirates maintained a large current account surplus despite the substantially reduced crude oil export receipts. Such a strong outcome was mainly due to the continued rise in net investment income, the increase in gas exports, a relatively small decline in imports, and to a lesser extent, the general policy of reducing government expenditures, including foreign grants.

Mr. Hull stated that while he was pleased at the conciseness of the staff report, more detail was needed in order to carry out surveillance effectively, particularly since the United Arab Emirates was a major oil exporter and a major lender in the international capital markets. The depth of information and analysis in the paper seemed to fall short of staff appraisals of other less important economies. To some extent, the report on recent economic developments made up for that lack of detail, and the staff might consider whether it could transfer some of the more useful information--in particular, much of the material on government finance and banking, and on the balance of payments--from the report on recent economic developments to the staff appraisal in future. But what he most missed was an in-depth discussion of short-term prospects and policies.

On the domestic side, the economic circumstances of the United Arab Emirates had changed as a result of declining oil revenues, implying a need for both greater vigilance over expenditure and some expansion of the domestic tax base, Mr. Hull went on. He welcomed the authorities' recognition that the change in economic circumstances might not be temporary, and the authorities' initial actions to reduce government expenditure seemed appropriate. He endorsed the staff view that "the present situation offers an opportunity for consolidation...of policies...which if carried out within the medium-term framework, can lead to the attainment of social goals such as reduced dependence on foreign labor."

The more intensive scrutiny being accorded to government development expenditures, transfer payments, and subsidies was welcome, Mr. Hull continued. Although additional revenue measures were being contemplated, there was no federal tax law relating to income, and no federal or Emirate taxes on property or capital gains. Could the staff or Mr. Finaish give some indication of the time scale that was envisaged for achieving the target of obtaining 15 percent of federal receipts from taxes and fees? Could anything further be said about the Government's other fiscal objectives in the longer term?

Discussing the monetary and banking sector, Mr. Hull agreed with the staff that it was legitimate to be concerned about the tightness of liquidity in the commercial banking system, particularly as the deposit bases of many of the banks were relatively low. While the authorities were correct in adopting a cautious fiscal stance, they should not adjust too drastically. Given the size of foreign exchange reserves and overseas assets, a suitable trade-off should be possible. The staff estimates of net foreign assests--although unverified--were welcome but did raise some questions. In particular, the stock level at the end of 1982 had been well below the sum of current account surpluses since 1973/74. Private sector holdings could account for some of the discrepancy, but in other respects, could it be assumed that the estimates were comprehensive?

The United Arab Emirates was important in recycling current account surpluses in the global economy and had a good record of foreign assistance, Mr. Hull concluded. There had been improvements in the thoroughness of Article IV consultations with the major oil exporting members of the Fund, and he hoped that the next consultation with the United Arab Emirates would be more detailed and penetrating.

The staff representative from the Middle Eastern Department remarked that the staff estimate of net foreign assets was based on the previously reported stock of net foreign assets, plus the surpluses that had accumulated in the previous three years. With respect to the time scale of the 15 percent target for non-oil revenue, the authorities had not indicated a definite time schedule, but it was his impression that they hoped to achieve that target by 1985/86.

Mr. Finaish agreed that, in the past, the rate of growth of government spending had been high. Present circumstances provided an important opportunity for the authorities--and indeed, other oil countries--to rethink and re-evaluate their policies, in particular, their expenditure policies. On the question of foreign aid, foreign loans and grants in 1982 had amounted to 5 percent of GDP, a high proportion by any standard.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the analysis sis in the staff appraisal of the 1983 Article IV consultation with the United Arab Emirates. They noted the considerable slowdown in economic activity in 1982, reflecting mainly a deceleration in government domestic expenditures brought about by a sharp decline in oil receipts. They also noted that the outlook for 1983 was for a further large decline in oil receipts with a further weakening of public finances and the balance of payments.

Directors welcomed the intention of the U.A.E. authorities to adjust their economic policies to the lower oil revenue; in particular, they welcomed policies aimed at mobilizing private savings for the financing of domestic investment. Directors endorsed the view that the emerging situation offered the U.A.E. authorities an opportunity to consolidate and rationalize budgetary policies and practices. This might assist in the attainment of social goals. In this connection, increased scrutiny of current and development outlays was welcomed, but caution was voiced regarding unduly abrupt cutbacks in public expenditures.

Directors noted the intention of the U.A.E. authorities to balance the government budget by 1985, compared with a deficit in 1982 equivalent to about 3 percent of GDP. Directors noted that the reduced level of government oil revenue and the accompanying smaller transfers to the Federal Government might reduce the availability of foreign exchange to the Central Bank and cause some difficulty in the banking system. Directors endorsed the staff view that, in these circumstances, deposits and transfers from the Emirate Governments would need to play an increasingly important role in providing the needed foreign exchange reserves to the banking system through the Central Bank.

Directors commended the authorities for intending to honor all prior foreign aid commitments, and expressed the hope that the United Arab Emirates would continue to provide foreign assistance on a generous scale.

Finally, it is expected that the next Article IV consultation with the United Arab Emirates will be held on the standard 12-month cycle.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/83/83 (6/10/83) and EBM/83/84 (6/13/83).

3. BHUTAN - TECHNICAL ASSISTANCE

In response to a request from Bhutan for technical assistance, the Executive Board approves the proposal set forth in EBD/83/164 (6/7/83).

Adopted June 10, 1983

APPROVED: October 28, 1983

LEO VAN HOUTVEN
Secretary