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Minutes of Executive Board Meeting 83/148

10:00 a.m., October 7, 1983

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	N. Toe, Temporary
	H. G. Schneider
B. de Maulde	X. Blandin
	M. Teijeiro
R. D. Erb	
	T. Alhaimus
T. Hirao	T. Yamashita
	Jaafar A.
R. K. Joyce	
	C. Robalino
	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	
A. R. G. Prowse	
G. Salehkhou	O. Kabbaj
F. Sangare	
M. Senior	J. L. Feito
J. Tvedt	
N. Wicks	A. Clark
Zhang Z.	

L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

Administration Department: J. R. Wein. Asian Department: J.-P. C. Golle. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, D. N. Lachman, S. Mitra, L. L. Perez, H. O. Schmitt, E. Spitaeller, T. M. Ter-Minassian, H. Vittas. Exchange and Trade Relations Departmant: S. Mookerjee, Deputy Director; S. J. Anjaria, E. R. J. Kalter. External Relations Department: H. P. Puentes. IMF Institute: A. N. Correia, I. J. C. Toscano, Participants. Legal Department: Ph. Lachman. Research Department: K.-Y. Chu, N. M. Kaibni, E. A. Milne, H. H. Zee. Treasurer's Department: J. V. Soromenho-Ramos. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, E. A. Ajayi, J. R. N. Almeida, C. J. Batliwalla, T. A. Connors, K. A. Hansen, Y. Okubo, P. D. Péroz. Assistants to Executive Directors: H. Alaoui-Abdallaoui, M. Camara, R. J. J. Costa, G. Ercel, I. Fridriksson, G. Gomel, V. Govindarajan, D. Hammann, C. M. Hull, H. Kobayashi, M. J. Kooymans, G. W. K. Pickering, M. Rasyid, A. A. Scholten, J. Schuijer, Shao Z.

1. PORTUGAL - STAND-BY ARRANGEMENT, AND PURCHASE TRANSACTION - COMPENSATORY FINANCING FACILITY

The Executive Directors considered Portugal's requests for a 16-month stand-by arrangement in an amount equivalent to SDR 445 million (EBS/83/196, 9/9/83) and a purchase under the compensatory financing facility equivalent to SDR 158 million (EBS/83/197, 9/9/83; and Sup. 1, 10/5/83).

Mr. Lovato made the following statement:

In the Acting Chairman's summing up at the conclusion of the 1983 Article IV consultation with Portugal last June, it was stated that "...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."

A new coalition cabinet took charge last June following a prolonged and tormented period of political uncertainty. This Government attaches great importance to present and future cooperation with the Fund in designing and implementing a comprehensive strategy of adjustment of the Portuguese economy, and it regards the program presented today to the Executive Board as the centerpiece of its economic policy. In this regard, my authorities wish to express their appreciation for the decision of the Board to proceed with the consideration of this program in the amount negotiated with the staff and agreed upon by management, even in the face of the Fund's current liquidity constraints.

My authorities recognize that economic outcomes since 1980 have been disappointing, especially on the balance of payments and inflation fronts, owing to external, uncontrollable events, but also to some degree to the policies then being implemented. Too accommodating a stance of policies pursued over that period contributed to the large and widening current account deficit and the rapid accumulation of external debt. Upon taking office, the new Government strongly committed itself to redressing the financial imbalances in the country and promptly put appropriate corrective policies in place. With a current account deficit exceeding 13 percent of GDP in 1982, coupled with external debt outstanding equivalent to over 65 percent of GDP and a relatively high debt service ratio, it was imperative that expenditure-reducing and expenditure-switching measures be taken to restore the payments position to a more sustainable level.

Prior to the commencement of the negotiations that led to the present stand-by program, the Portuguese authorities took strong action to that end. The escudo was devalued by 12 percent, prices of several subsidized commodities were increased, a company profits tax was levied, and the public sector investment program was suspended. Subsequently, deposit and lending rates were raised on most maturities to levels that are positive in real terms and comparable to those prevailing in world financial markets.

Given the pivotal role assigned to budgetary restraint in adjusting the external position, new revenue-generating measures were introduced in September as part of the Government's endeavor to reduce its deficit on a cash basis from the equivalent of 11.7 percent of GDP in 1982 to 9.9 percent in 1983, and to 7.3 percent in 1984. Following the introduction of surcharges on several existing taxes in the 1983 budget approved in February, rates on some indirect taxes were further increased, and an extraordinary tax on incomes was introduced in September.

Fiscal restraint will continue to be exercised in 1984. In my authorities' view, little room for maneuver exists on the revenue side, since the average tax ratio has reached a relatively high level and the tax reform will require a longer gestation period, but a substantial effort is envisaged on the expenditure side. Total public spending as a proportion of GDP is targeted to decline by nearly 2 percentage points next year. An important contribution to this end is to be made by a further reduction in the subsidies paid by the Supply Fund as a consequence of new price increases for subsidized items and petroleum products. Salaries, transfers, and capital expenditures will also be held back. The 1984 budget, which is currently in preparation and will be presented at the end of October, is being shaped in accordance with the program targets and along the lines discussed with the staff in August.

The finances of public enterprises have been recognized as an area of great weakness and therefore have been a matter of concern in recent years since they resulted, as noted in previous staff reports, in budgetary overruns and excessive domestic and external borrowing. The Government is resolved to monitor the operations of these enterprises more closely and to confine their investment outlays to projects already under way and having the largest and quickest payoff in foreign exchange terms. In any event, capital spending by these enterprises is estimated to decline substantially in real terms in both 1983 and 1984. Measures have already been announced to increase the self-financing of these enterprises: public utility charges were raised, and legislation has been proposed authorizing temporary layoffs of redundant labor.

Incomes policies are supposed to play an important role in the adjustment program, with a view to moderating inflation and reducing the output and employment costs associated with the required restraint in domestic demand. Although specific wage guidelines, which proved difficult to adhere to in 1981-82, have not been announced in the present circumstances, wage increases are expected to be contained below the inflation rate in both 1983 and 1984. Such an outcome will be helped by the firm stance of government policy vis-à-vis civil servants' salaries and by the restraining effect on wage settlements in the private sector arising from high actual and anticipated unemployment rates.

Monetary policy is to be directed toward the objectives of reducing the external imbalance and moderating the inflation rate. Accordingly, domestic credit expansion is to decelerate and interest rates are being managed with a view to increasing savers' propensity to hold domestic financial assets and fostering a reflow of capital from abroad. The envisaged decrease in the rate of domestic credit expansion from over 29 percent in 1982 to 27.5 percent in 1983 and to about 21.5 percent in 1984 will be helped by the targeted cutbacks in the public sector borrowing requirement, which, having been financed mainly by domestic bank credit, has severely constrained monetary policy to date. In recent times, technical problems have also undercut the efficacy of monetary control, and credit ceilings have often been overshot as penalties did not provide an effective deterrent to such excesses. The present program envisages new measures designed to overcome these drawbacks. On the one hand, penalties for noncompliance with the credit ceilings have been increased significantly, and interbank bond market rates are being gradually raised in order to help absorb excess bank liquidity. On the other hand, the effective cost of credit is now substantially higher following the upward adjustments in lending rates in the spring and summer of this year, and is likely to have a moderating effect on the demand for credit. Rates on bank deposits have also risen to levels that are currently positive in real terms. The authorities proved thereby to be prepared to flexibly manage interest rates, and they intend to continue to do so in line with developments in domestic inflation and foreign interest rates.

On the external front, the 12 percent devaluation of the escudo in mid-1983 has restored Portugal's competitive position to a favorable level and is likely to foster a continued strong performance of exports in volume as well as a reflow of capital through the current account as adverse exchange rate expectations subside. Preliminary figures for the first half of 1983 indicate that the trade deficit narrowed from $2.8 billion in the first half of 1982 to $1.9 billion this year, as export earnings rose by 12 percent in dollar terms and imports declined by 15 percent. The current account deficit for the same period turned out to be smaller than expected, and official estimates point to a deficit for the year as a whole of about $1.9 billion, or below the target of $2 billion in the stand-by program under consideration.

The Portuguese authorities will continue their current policy of a monthly effective depreciation of 1 percent in the trade-weighted exchange rate. Being aware of the continuing and prospective inflation differential vis-à-vis Portugal's trading partners, they will manage the crawling peg policy so as to prevent any sustained loss of competitiveness. My authorities are committed to an open trade and payments system and will enact in the 1984 budget a rollback of the import surcharge from 30 percent at present to 10 percent.

On external debt management policy, it is the authorities' intention to monitor more closely borrowing by public entities and enterprises in order to reduce the debt service ratio to a level sustainable over the medium term. They are particularly concerned about the relatively high level in recent years of the short-term debt. Therefore, total disbursed external debt--including short-term and nonguaranteed debt--will not be permitted to rise beyond $13.8 billion at the end of 1983, which implies a small increase in the second half of the year. Short-term debt, which stood at around $4 billion at the end of 1982, according to preliminary information, has declined since the beginning of the year by almost $500 million. Indicative targets set for 1984 envision small increases in the two ceilings; the share of the short-term debt in total debt is expected to decline, however.

Queuing mechanisms have been enforced, inter alia, to regulate Portuguese borrowers' access to capital markets, thus helping to maintain a good credit standing for the country.

The program of adjustment on which the Portuguese Government has embarked with courage and determination will undoubtedly have significant political and social costs in the short run. My authorities are aware of them but recognize that the restoration of a sustainable external position is an essential condition for the resumption of growth of output and employment over the medium term and for the successful integration of Portugal into the European Communities in the second half of the 1980s. They look forward to the support of the Fund not only in this first phase of the adjustment process, but also over the longer term as they endeavor to address the many structural weaknesses that beset the Portuguese economy.

With regard to the request for a drawing under the compensatory financing facility, I believe that the staff paper makes a sufficiently strong and clear case for a purchase. The shortfall appears to be largely due to factors beyond the control of the authorities. The projections for foreign exchange receipts beyond the shortfall year are relatively conservative, and the requirement of cooperation with the Fund is certainly met. I therefore would simply like to recommend the proposed decision for approval by the Executive Board.

Mr. Grosche stated that he broadly agreed with the staff appraisal and accepted both draft decisions. During the discussion on the 1983 Article IV consultation with Portugal (EBM/83/84, 6/13/83), the Executive Directors had examined in detail the substantial problems facing the economy. His chair had concluded that, given the serious internal and external imbalances, the authorities should move quickly to implement decisive corrective measures, and he was pleased that the proposed program met that basic requirement. The proposed adjustment measures were comprehensive, and the program objectives were appropriate. If implemented with determination, the program would go a long way toward restoring a sustainable external position and should establish the foundation on which additional adjustment could be based. Continued decisive and comprehensive adjustment measures would be required in the coming years. The authorities should refrain from resuming stop-and-go policies; the striking success under the 1977/78 stabilization program had been offset by the subsequent inappropriate shift in financial policies.

A number of important policy measures had already been introduced, particularly in the area of taxation and subsidies, Mr. Grosche noted, and those encouraging steps underscored the authorities' determination. The adjustment program was correctly centered on budgetary restraint, complemented by measures to improve the financial position of public enterprises. Fiscal restraint was to be achieved both by increasing revenues and by reducing current expenditures, and the program would undoubtedly be painful for a significant part of the population and politically difficult to sustain. However, experience in a number of countries had shown that the alternative was likely to be even more painful, at least in the longer run.

The planned deceleration in the rate of growth of the monetary and credit aggregates, Mr. Grosche remarked, in conjunction with the present and prospective interest rate policy, appeared to support the adjustment process, and the quantitative performance criteria seemed to be appropriate. Externally, the devaluation of the escudo in June 1983 and the authorities' intention of continuing the policy of depreciating the exchange rate in order to maintain an adequate level of competitiveness were welcome. Their policy should help to reduce external borrowing and the debt service burden, which had recently reached unsustainable levels.

The import surcharge, which had been raised from 10 percent to 30 percent in January 1983, had been introduced mainly as a means of raising revenue, Mr. Grosche noted. That surcharge could be seen as a protectionist measure, however, and in maintaining it the authorities ran the risk of encouraging other countries to retaliate against Portuguese exports. He strongly supported the authorities in their intention to roll back the import surcharge in the 1984 budget year; it should be eliminated in 1985.

He agreed with the staff, Mr. Grosche said, that any increase in nominal wages in excess of the 20 percent target would seriously undermine the chances of achieving the inflation target and maintaining competitiveness. To keep the growth of nominal wages below 20 percent the authorities should maintain a firm policy on wages in the public sector, which could thus set the example for wage adjustments in the private sector.

The proposed legislation authorizing temporary layoffs of redundant labor, Mr. Grosche remarked, might be insufficient to raise profitability and create better conditions for investment. Because the legislation was temporary, it seemed merely to postpone the steps that would inevitably have to be taken to solve the underlying problem. Was the legislation designed to provide a temporary increase in competitiveness, or to avoid excessive tension between industry and labor?

Commenting on the request for compensatory financing, Mr. Grosche said that, while Portugal met the requirement of cooperation and had a balance of payments need to use the Fund's resources, the calculation of the export shortfall raised certain questions. The staff estimates were based on data covering receipts from travel, workers' remittances, and merchandise exports. On page 62 of SM/83/94 (5/25/83) it was mentioned that there had apparently been significant underreporting of travel receipts, especially in 1982, and he wondered why no mention of that matter was made in the present reports. Given the continued relatively poor competitiveness of the Portuguese tourist industry, the projected increase in earnings from travel in the postshortfall period seemed overoptimistic. As for workers' remittances, there was no certainty that the decline in the shortfall year was temporary in nature. There were a number of uncertainties; for instance, future remittances might be affected by the migration of relatives joining a worker in his host country. Moreover, the shortfall of workers' remittances in the past had been affected most seriously by the authorities' interest rate and exchange rate policies. However, the proposed purchase was much less than the calculated shortfall, and he could therefore accept the proposed decision.

Mr. Joyce observed that the authorities had made a significant effort in recent months to deal with the difficult economic problems that had become evident earlier in the year. The stabilization program addressed most of the major problems that had been identified during the 1983 Article IV consultation and the concerns that had been expressed by Executive Directors, particularly the rapid growth in domestic demand, the need to tighten monetary policy and budget controls, and the importance of shifting resources and directing new investment toward export-oriented sectors. The staff report outlined the detailed policy measures that the Government intended to implement during the program period, and the authorities had already taken a number of important steps in the fiscal, monetary, and exchange rate areas. Those measures and the proposed program appeared to be fully appropriate, and he had no difficulty in accepting the request for a stand-by arrangement.

The success of the program would depend upon the Government's making a determined effort to implement the new policies effectively, Mr. Joyce continued. Only then would the external position become more sustainable. In that connection, the mid-term review would be of critical importance, and he hoped that it would result in somewhat fuller clarification of, and more extensive reporting on, the fiscal, monetary, and wage policies, and the external position.

In the fiscal area, Mr. Joyce went on, the authorities were to be commended for their efforts to reduce the public sector deficit, particularly by streamlining the operations of the public enterprises. Given the magnitude of the adjustment required in the public sector finances, he agreed with the staff that investment should be concentrated on projects with the greatest impact on foreign exchange earnings, and that the projects to be cut should be the ones with the smallest adverse effect on employment. The other element of the fiscal adjustment that would be critical was the reform of the tax system, which must, inter alia, try to eliminate the present bias against wage and salary earners. The authorities felt that the scope for further increases in the tax burden in the short run was limited, and that judgment was obviously one that the authorities themselves were best able to make. It was clear, however, that the full burden of the fiscal adjustment could not be placed solely on expenditures, and that at a minimum the administration of the present tax system needed to be tightened to deal with the large incidence of tax avoidance and tax evasion. The authorities planned to submit the 1984 budget to Parliament later in October, and he hoped that the tax system would be thoroughly examined at the time of the scheduled review of performance under the proposed program.

As for monetary policy, Mr. Joyce continued, the proposed program called for a tightening of total domestic credit growth throughout the period of the stand-by arrangement, an objective that seemed wholly appropriate. The rate of growth in real terms was expected to be negative in 1983 and only marginally positive in 1984. The authorities had already moved to increase interest rates, and lending rates were substantially positive in real terms. During the scheduled review, he would be looking to see whether the authorities had remained vigilant and had kept real interest rates positive, especially if, as seemed likely, the recent sharp increases in administrative prices started to likely, the recent sharp increases in administrative prices started to feed through the system and increase inflationary pressures. Keeping real interest rates positive would help to encourage domestic savings and assist the authorities in meeting the program credit targets. He hoped that the staff would be able to report positively on the steps that the authorities had taken to streamline the system of interest rate subsidies and to reduce the subsidies themselves. During the 1983 Article IV consultation, the staff had noted that the system had grown rapidly and covered nearly 40 percent of all credit transactions. Reducing the subsidies would improve resource allocation.

Commenting on wage policy, Mr. Joyce said that at the time of the review he would be looking for greater clarification of the means that the authorities expected to use to continue moderating the growth in nominal wages in order to keep it below the rate of inflation. The authorities apparently planned to restrain wages primarily by insisting on wage restraint in the public sector, including the state enterprises, in the hope that the private sector would follow the example. Successful implementation of the wage policy would certainly require restraint of public sector wage growth, but it was not clear that the level of public sector wage settlements would necessarily have a determining influence on private sector wages. Wage developments would have to be carefully monitored, and he hoped that in its report for the review the staff would be able to elaborate on the link between the private and public sector labor markets. The importance of monitoring those developments should be stressed because it was in the wage area that the authorities' commitment was likely to be severely tested during the program period, particularly as the purchasing power of workers was expected to decline. Although the new program had recently received parliamentary approval, the Government had encountered strong opposition by some of the political parties, and there had been protests by nearly every major economic group in the country.

On the external side, Mr. Joyce remarked, the export projections seemed overoptimistic, despite the 12 percent devaluation of the escudo in June 1983. Similarly, given the weakness of the recovery in Europe, the projections for tourist receipts and workers' remittances might not prove to be attainable. If, at the time of the review, export performance appeared to be falling short of the projections, it would be necessary for the authorities to introduce further measures to achieve the program objectives. Looking further ahead, he was deeply concerned about the high level of the debt service ratio, which was not expected to fall below 50 percent until 1990. Were the external accounts likely to be sustainable at the end of the program period? Much would depend not only on strict adherence to the program, but also on the extent and timing of the world recovery and on the willingness of the international banking community to finance the recovery of the Portuguese economy. Portugal might well need support from the Fund in the longer run, but that possibility underscored the importance of the successful implementation of the adjustment plan under the proposed stand-by arrangement.

The proposed purchase under the compensatory financing facility was acceptable, Mr. Joyce stated. It seemed to meet fully all the relevant criteria. Moreover, the export shortfall in the 12 months ended March 1983 had been considerably larger than the proposed purchase.

Mr. de Maulde recalled that during the 1983 Article IV consultation a number of Executive Directors had indicated their hope that the Portuguese authorities would promptly enter into discussions with the staff to define the adjustment program that was obviously needed. They had also expressed their full confidence in the ability of the authorities to address the relevant issues. The proposed program appeared to be fully in line with the Executive Board's expectations, and he warmly supported it, together with the proposed purchase under the compensatory financing facility.

Under the program, Mr. de Maulde commented, the current account deficit was to be reduced from the equivalent of 13 percent of GDP in 1982 to 9 percent in 1983 and 6 percent in 1984, and the fiscal deficit was to decline from 12 percent of GDP in 1982 to 10 percent in 1983 and 7.3 percent in 1984. In other words, the authorities were committed to roughly halving the two most serious imbalances in just 18 months. Such an effort should certainly receive all the necessary support from the international community.

Fiscal restraint was the core of the proposed adjustment, Mr. de Maulde noted, and it was expected to result from a combination of measures designed to increase receipts and control expenditures. Although the adjustment would therefore affect a broad spectrum of the population, much of the burden apparently would fall on wage earners, who were on average taxed more heavily than nonwage earners. Wage restraint and reduced cost of living adjustments for pensioners would account for a large portion of the decline in expenditure. The main fiscal objective--to narrow the sizable gap between receipts and expenditures as a percentage of GDP--was obviously correct. Whether it could be accomplished in a short period was somewhat doubtful. The experience of other countries in achieving that objective was mixed, even when the authorities had been as clearly committed to the reduction as those of Portugal. Increasing taxes would appear to be a more practical route in Portugal, but the tax system did not seem to be sufficiently flexible, and the short-term contribution of additional tax measures might not be as large as expected.

Nevertheless, Mr. de Maulde continued, there was no reason to delay overhauling the tax system, and the progress made toward introducing a value-added tax was welcome. Still, at least over the period of the proposed program, expenditure restraint might well prove to be a more efficient tool--if not the most equitable one. In that connection, he wished to hear a further comment on the decision to roll back all interest rates on government securities held by the Bank of Portugal to the rate prevailing at the time of issue of each security, instead of continuing the practice of adjusting such rates in line with movements in the discount rate. The practice was of course a rather dramatic, although efficient, way of making interest payments easier at a time of rising interest rates, but its merits on purely financial grounds were questionable. He wondered whether the scheme was not partly cosmetic; after all, the savings on the expenditure side would be offset by the lower receipts due to the reduced profits of the Bank of Portugal.

On the external side, Mr. de Maulde commented, much of the expected adjustment would hinge upon the pace of the expansion of exports and in that area, unlike the fiscal adjustment, only a portion of the factors involved could be considered to be safely within the control of the authorities. Portuguese exporters, and especially medium-sized and small private firms, had done relatively well, as evidenced by gains in market shares. The recent adjustment in the exchange rate of the escudo should provide some further assurance that those gains would not be lost and could possibly be enhanced. At the same time, Portuguese exports tended to fluctuate significantly, and the recovery in the industrial world would play an essential role in the country's export performance. Portugal's main trading partners might not prove to be those enjoying the most rapid rates of growth, at least over the program period. Such factors were important in terms of the evolution of the external debt, and he fully endorsed the program targets for the levels of foreign assets and liabilities in the period up to the March 1984 review.

He was fully convinced, Mr. de Maulde said, that the proposed course of action in Portugal deserved the Executive Board's support. The proposed adjustment should certainly go a long way toward reducing the imbalances in the economy. However, it was clear that much would remain to be done at the conclusion of the program period, and he hoped that the uncertainties about the Fund's capacity to provide financial support whenever it was needed would not prevent the Fund from assisting Portugal.

Mr. Erb stated that the proposed decisions were acceptable, although certain factors behind the export shortfall had clearly been within the control of the authorities. During the shortfall period, interest rates in Portugal had been kept below foreign rates, and an overvalued exchange rate had been maintained, thereby discouraging workers' remittances and accurate invoicing of exports. However, the proposed drawing under the compensatory financing facility was acceptable, as it was exceeded by the export shortfall by a comfortable margin and the decline in economic activity abroad was the major reason for the shortfall.

Commenting on the stand-by arrangement, Mr. Erb said that he was pleased with the authorities' commitment to the stabilization program, as evidenced by the adjustment measures already introduced and by the authorities' stated policy intentions. The Government had clearly embraced the program as its own; there had been no pretense in public statements by the authorities that the program had been imposed upon Portugal by the Fund. The public attitude of the authorities in any country was a crucial factor in the success or failure of a stabilization program, and the Portuguese authorities' clear commitment to their program greatly increased its chances of success.

It was clear, Mr. Erb continued, that a reduction in the public sector deficit was to be relied upon heavily to achieve the desired external adjustment; therefore, it was imperative that the Government fully meet its fiscal objectives by continuing to adjust administered prices, improve the tax system and, most important, maintain expenditure restraint. The authorities should be vigilant in remaining within the limits on expenditures, even if revenues were somewhat better than projected. It was his understanding that expenditures might be higher than had been recently anticipated, and he wondered whether the staff was worried about that possibility. In the longer run, it would be beneficial for the authorities to reduce the fiscal deficit by even more than the target amount. The provision of Fund technical assistance on both the expenditure and revenue sides might well be worth exploring.

Commenting on the external sector, Mr. Erb said that the exchange rate policy was broadly appropriate. For it to remain so, the authorities would have to make certain that nominal wage increases were contained as planned, and that the financial policies were fully implemented. He agreed with the staff that competitiveness would have to be kept under review. The table on the projections for the balance of payments and external debt for the period 1982-90 was particularly useful. It showed that the reduction in the current account deficit to $1.25 billion in 1984 and its maintenance at about that level over the projection period would permit a slow reduction in the debt service ratio and moderate growth of imports. Under that scenario, the medium-term balance of payments position seemed sustainable. However, the scenario clearly showed that there was little margin for policy mistakes, and he agreed with Mr. Grosche that it would be vital for the authorities to avoid reversing their policy course. The medium-term scenario also suggested that the authorities should consider creating a plan for lengthening the structure of the external debt. The total debt service ratio would still be high--about 50 percent--even by 1990, although a large portion of the debt was short term; even excluding the amortization of the short-term debt, the debt service ratio would be some 25 percent.

The framework of the proposed stand-by arrangement and the clarity of the explanation in the staff report should serve as a model for future papers, Mr. Erb considered. In particular, the staff had made an explicit judgment about the time path of the balance of payments adjustment and the key assumptions underlying its judgment.

Mr. Schneider said that he fully supported the proposed decisions. He agreed with the staff that the request for compensatory financing met all the requirements.

Following a period of reasonable growth rates and a marked improvement in the balance of payments, Mr. Schneider continued, the authorities had relaxed the stance of financial policies in 1980 in order to stimulate investment and to secure a recovery of real disposable income. However, that action, together with exogenous factors, had resulted in a rapid deterioration in both the domestic and external accounts; the current account had moved from equilibrium to a deficit equivalent to about 13 percent at end-1982. The authorities' policy of financing the current account deficit by external borrowing had naturally had a negative effect on the external debt position. At present, the Government's main goal was to reduce the current account deficit and the debt service burden in the medium term. In that connection, the most critical factor would be the determination of the authorities in implementing the proposed program.

On a first look, Mr. Schneider remarked, the main targets seemed ambitious and harsh, particularly when the period of the stand-by arrangement--just 16 months--was taken into account. Reducing the external current account deficit from the equivalent of 13.2 percent of GDP in 1982 to 6 percent in 1984 and the combined deficit of the general government and the Supply Fund from 12.6 percent of GDP in 1982 to 6 percent in 1984 would require both determination and political courage; the implications of the reductions for the majority of the Portuguese people should not be overlooked.

Commenting on fiscal policy, Mr. Schneider said that he agreed with the authorities that the short-run increase in the tax burden in relation to GDP should be a limited one, and that the fiscal effort would therefore have to be focused mainly on restructuring the tax system, improving the administration of taxes, reducing public spending, and strengthening the financial position of the public enterprises. A cut in public investment and the choice of a public sector investment strategy were the main steps to be taken toward substantially reducing the fiscal deficit. He agreed with previous speakers that the burden of the fiscal adjustment could not be placed entirely on expenditures.

The authorities' interest rate and exchange rate policies had already produced encouraging results, Mr. Schneider commented. The effective devaluation of the escudo by 12 percent in June 1983, the increase in interest rates in August 1983 to positive levels in real terms, and the authorities' intention to use a flexible approach to interest rate policy and to maintain a competitive exchange rate should help to restore competitiveness and improve resource allocation in the economy as a whole, particularly by increasing the value of workers' remittances and tourism receipts, and also by shifting resources into the export sector.

Substantial losses of international reserves, owing mainly to gold sales, Mr. Schneider observed, had reduced the usable foreign assets available to the economy to the equivalent of less than two weeks' imports in mid-1983. Despite the high level of the revalued gold assets, the present level of reserves excluding gold gave the authorities little room for maneuver in their attempt to implement their economic policies.

Even if the authorities succeeded in fully implementing the proposed program, Mr. Schneider noted, the current account as well as the general government and Supply Fund deficits would still be relatively large--about 6 percent of GDP--by the end of 1984, and the rate of inflation would remain at about 20 percent. The ratio of private domestic savings to GDP was expected to continue to decline, public savings were forecast to remain at negative levels, and the total debt service ratio was projected to stay at about 70 percent in 1983/84. In the circumstances, the Portuguese economy would need still further improvement before a sustainable rate of growth of output and employment could be resumed. Accordingly, he would not exclude the possibility of a new arrangement with the Fund at the end of the present program period in order to maintain and support the momentum of the courageous adjustment efforts of the Portuguese authorities.

Mr. Robalino said that both draft decisions were acceptable. The case for compensatory financing was self-evident: the purchase was much less than the estimated shortfall, and all the relevant criteria had been met.

The proposed stand-by arrangement, Mr. Robalino noted, was centered on a substantial improvement in public finances, and he was pleased that the authorities intended to introduce a comprehensive reform of the tax system. That move would not only help to increase support for the stand-by arrangement, but would also broaden the tax base and simplify the administrative procedures for tax collection when Portugal became a full member of the European Communities.

The authorities' flexible approach to the interest rate and exchange rate policy was welcome, Mr. Robalino said, and he was pleased that the proposed program was not excessively harsh. The reduction in the fiscal and external deficits was to be about one third--in terms of GDP--rather than the 50 percent decline that had been typical of many previous programs. Public savings were expected to decline slowly, and public investment was projected to increase only moderately during the program period. Gradual adjustment, combined with the authorities' full determination to introduce the necessary measures to correct the economic imbalances, constituted a good scenario for the coming year.

Mr. Feito stated that he strongly supported the proposed decisions. He agreed with Mr. Lovato that the staff had clearly shown that all the relevant criteria with respect to compensatory financing had been met. Foreign shocks, beyond the control of the authorities, had obviously harmed Portugal's exports, and the efforts that the authorities were making to reduce the external imbalance were clearly appropriate.

The proposed economic program, Mr. Feito commented, was the second Fund-supported stabilization program for Portugal in five years. It was useful to analyze the differences and similarities between the economic problems confronting the country and the policy packages implemented to solve them, to note the reasons for the equilibrium that had been achieved under the 1977/79 program, and to estimate whether or not the position at the end of the proposed stand-by arrangement would be sustainable.

One of the most striking aspects of the economic situation in Portugal, Mr. Feito said, was the large size of the external imbalance. The current account deficit was equivalent to 13.2 percent of GDP at end-1982, compared with about 5 percent in 1980. Another striking feature was the authorities' commitment to rapidly achieving a sustainable balance of payments position under the proposed program. The current external deficit was projected to be halved, to less than 6 percent of GDP in 1984. Portugal's economy was obviously a particularly open one, and the present trend in the external sector was not sustainable; it had been constraining the capacity level of the economy, and the financing of essential imports had become increasingly difficult. There was little doubt that a major stabilization effort was needed to strengthen the confidence of international lenders and to restore the import capacity of the economy.

The rate of growth of real domestic demand in Portugal had been well in excess of that of its main competitors, Mr. Feito commented, and had been rightly identified as one of the major factors responsible for the deterioration in the balance of payments. The program placed heavy emphasis on bringing the rate of growth of domestic demand in line with that of Portugal's major trading partners, mainly through a substantial improvement in public sector financing. Indeed, the public sector would shoulder practically the entire burden of the stabilization effort: the cash deficit of the general government as a ratio of GDP, adjusted by the changes in the arrears of the Supply Fund, was supposed to decline from 12.6 percent in 1982 to about 6 percent in 1984. Since the propensity to invest and to save in the private sector was projected to decline by approximately equal amounts, the 6 percentage points of fiscal adjustment would account for the targeted reduction of about 6 percentage points in the current account deficit relative to GDP by end-1984.

The task facing the authorities was difficult, Mr. Feito observed. The fiscal performance had been one of the most disappointing features of economic developments in Portugal in the previous five years. Indeed, the fiscal targets under the 1977/79 stand-by arrangement had not been met, although the balance of payments outcome had nevertheless been better than projected. That the authorities were well aware of the need for fiscal discipline was encouraging. They should be strongly commended for the important reforms that they were planning to implement in tax collection and the management of public enterprises.

Correction of the public sector finances was certainly the centerpiece of the proposed program, Mr. Feito said, and if the nominal values of the main variables, such as interest rates, exchange rates and wages, evolved as projected, the desired improvement in the external balance at the end of the program period should be attainable. Still, he wondered whether the external position would be sustainable and would lay the foundation for a resumption of growth, or whether, as had happened under the program for 1979, the equilibrium would be unstable and highly vulnerable to any domestic or external shock. It could obviously be argued that any equilibrium would turn out to be unstable if the rate of growth of domestic demand were very rapid, or if the country faced a severe external shock, or both. However, it could also be argued that the negative effects of an acceleration in the growth of domestic demand or of an external shock could be amplified by built-in rigidities in the structure of the economy, the correction of which could considerably reduce the trade-off between improvements in the internal and external balances. Some of the structural weaknesses tended to constitute a permanent balance of payments constraint on capacity growth.

Probably as a result of low productivity in agriculture, Mr. Feito went on, imports still accounted for a high proportion of food consumption, thereby considerably reducing the elasticity of imports and making it harder for wage earners to accept the reduction in real income resulting from domestic price increases following the devaluations. The relatively sizable dependence on imported energy was another rigidity on the real side of the economy that could not be corrected by monetary measures alone. During the previous several months, there had been a decline in imports of oil and agricultural products associated with the difficulty that public enterprises had had in obtaining external financing. It was therefore possible that, at the end of the program, after the external situation had improved and the ceiling on access to external sources of finance had become inoperative, the high propensity to import oil and agricultural products would again bring the balance of payments under pressure.

The persistence of the external imbalance over the previous nine years was further evidence of the need for structural adjustment on the supply side of the economy, Mr. Feito commented. With the exception of 1979, the external current account imbalance as a percentage of GDP had been more than minus 5 percent since 1974. That level of absorption of external savings was excessively high for an economy as developed as Portugal's and underscored the need for substantial structural reform. The temporary success of the 1979 financial program seemed to have been due to inordinate cuts in real wages and to substantial increases in real interest rates. However, the short-term improvement had rapidly disappeared, leaving the country to face a situation in which the overall competitiveness of the economy was not sufficient to encourage adequate employment without intensifying the external pressures.

He wondered, Mr. Feito went on, whether the Government was contemplating structural reforms beyond the scope of the proposed program, particularly in the areas of energy and agricultural production. Would it not have been more convenient to tackle the external imbalance within the framework of an extended arrangement? Had the authorities or the staff considered the possibility of an extended arrangement either as an alternative to the proposed stand-by arrangement or as a follow-on arrangement upon the conclusion of the proposed arrangement? Whatever the answer to the questions that he had raised might be, he was confident that the demand restraint to be achieved under the program was, at the least, a necessary condition for the attainment of a stable balance of payments structure.

Mr. Tvedt commented that the staff report for the 1983 Article IV consultation with Portugal and the present reports clearly indicated that the problems facing the economy were due to both exogenous factors and inappropriate domestic policies. Lax financial policies had caused a rapid deterioration in the external balance as well as serious domestic financial imbalances, which, in turn, had caused a decline in confidence abroad. A wide-ranging policy effort had clearly been needed to restore balanced growth and a sustainable external position.

The Government's policies were appropriate and addressed in a determined fashion the major problem areas, Mr. Tvedt considered. He particularly welcomed the efforts that had been made to correct the imbalance in the public sector, as the government deficit had clearly been a major cause of the present difficulties. The effort to rationalize the operations of the public enterprises was important in that respect.

During the discussion on the 1983 Article IV consultation, Mr. Tvedt recalled, he had expressed some concern about the exchange rate policy. Experience showed that, in maintaining a system of preannounced exchange rate changes, a government always ran the danger that the system would become too rigid and would not adequately bridge the gap created by foreign and domestic price differentials. Hence, he welcomed the Government's intention of closely monitoring the real exchange rate and of adjusting the rate of nominal depreciation, if necessary. The experience of recent years further underscored the importance of maintaining an appropriate real effective exchange rate.

He also welcomed the Government's effort to strengthen monetary policy, Mr. Tvedt said. He wondered what the prospects were for increased nonbank financing of the government deficit.

The area where the uncertainty seemed to be greatest was wage policy, Mr. Tvedt commented. What were the prospects for limiting the wage increases to the extent needed to achieve the program objectives? Much would probably depend on the confidence of the Portuguese people in the Government's policy stance. Were there any indications that the program was acceptable and credible in the eyes of the public? Finally, the request to draw on the compensatory financing facility met all the relevant criteria, and he fully supported both proposed decisions.

Mr. Wicks said both proposals were fully acceptable. The authorities were to be commended for having undertaken the stand-by arrangement. The new Government had used its political credit well to make a number of politically courageous decisions designed to achieve budgetary and monetary restraint and to make an important contribution to achieving a better economic balance.

His position was similar to that of Mr. Joyce and Mr. Grosche, Mr. Wicks continued, and he wished to concentrate his comments on the external accounts, and particularly the data provided in the valuable table for which Mr. Erb had rightly commended the staff. He agreed with Mr. Joyce that the projection of export growth seemed somewhat overoptimistic, and a further comment would be welcome. In any event, even if the projected increase were realized, the external current account would still record a deficit of about $1.25 billion cumulatively until 1990.

His doubts about the projection for export earnings, Mr. Wicks went on, together with the continued current account deficit caused him to be uncertain whether the projected increase in foreign debt to 40 percent in the period 1983-90 would be sustainable. What additional room was available to reduce imports and otherwise improve the external current account, thereby reducing the financial requirement to a level that the international banking community might find more acceptable? It would be useful to have additional information on the measures that were to be introduced to accelerate export growth.

The medium-term balance of payments and debt projections were cause for some concern, Mr. Wicks continued, as they implied a degree of strain through the rest of the 1980s. The projected increase in gross debt was based on the assumptions that the international financial markets would continue to provide increasing amounts of medium-term and long-term debt and that the short-term debt could be rolled over from year to year. Both of those assumptions were rather bold, particularly in the light of the debt service ratio, which, although improving, would still be at nearly 50 percent by 1990. Moreover, the proportion of short-term debt would continue to leave Portugal vulnerable to changes in confidence abroad.

Although Portugal's holdings of gold were large, Mr. Wicks noted, the foreign exchange element of the reserves was precariously small--about $500 million at end-May 1983. He wondered whether the authorities might not adopt a longer-term policy of switching out of gold and into more liquid and remunerative currency assets.

That the program included only a reduction--rather than the elimination--of the import surcharge was regrettable, Mr. Wicks said. The prolonged application of such trade restrictions was difficult to reconcile with Portugal's reliance on imports of many items, including energy. He recognized that cutting imports helped to reduce the balance of payments deficit in the short term, but continued import stringency would be inconsistent with the recovery effort in the medium term.

An extended arrangement should normally be approved for a country only if it had a good track record of implementation of policies under a stand-by arrangement, Mr. Wicks remarked. The proposed stand-by arrangement should be successfully implemented before the Executive Board considered an extended arrangement for Portugal. He would certainly not rule out an extended arrangement for the country in the longer term.

He looked forward to hearing the staff's responses to the questions posed by previous speakers about the proposed compensatory financing, Mr. Wicks commented. During the discussion on Costa Rica's request for compensatory financing (EBM/83/132, 9/7/83), he had mentioned that it was regrettable that the request was based to a large extent on a shortfall of manufactured exports. In the present case, one third of the shortfall was attributable to manufactures, and the overvalued exchange rate had probably been an important cause of that portion of the shortfall.

Mr. Suraisry said that he generally agreed with the staff appraisal. Both draft decisions should be approved. The request for compensatory financing seemed to be straightforward and fully in line with the requirements of the relevant Executive Board decisions. However, as Portugal was a relatively developed country, the size of the statistical lag was surprising; the data for the final three months of the shortfall year--which were in fact the first three months of 1983--were estimates.

It was clear, Mr. Suraisry went on, that the economic and financial situation in Portugal had deteriorated markedly since 1979: real economic growth was depressed, the rate of inflation had risen to more than 20 percent, and serious imbalances in the fiscal and external accounts had emerged. Those problems could be traced in part to factors beyond the authorities' control, but the overexpansionary financial policies had caused the growth of domestic demand in Portugal to exceed significantly that of its major trading partners. The comprehensive measures that the authorities were now introducing to stabilize the economy and to shift resources into productive sectors were therefore welcome.

He agreed with the staff, Mr. Suraisry said, that a strong fiscal policy would be essential both forthwith and in the medium term and that, to that end, the recent tax increases were an important step.

The scope for a further tax increase was quite limited, and he hoped that the authorities could carry out their plans to reform the tax structure and strengthen tax administration. A lasting improvement in public sector finances would also require effective control over expenditures, particularly transfers to the local authorities and the the state enterprises, which had recorded major overruns. The new monitoring procedures that the authorities had outlined in their letter of intent and their other efforts to reduce current spending and bring capital expenditure more in line with available resources were commendable. Given the urgent need to increase public sector savings, the recent decisions cutting the investment programs of the state enterprises and permitting them to adopt more flexible pricing policies were appropriate.

The authorities should be encouraged to maintain their firm stance on public sector wage increases, Mr. Suraisry considered. Adhering to a limit of about 17 percent was particularly important in the present circumstances, as it would help to reduce the budget deficit and to preserve resources for repaying the foreign debt. That limit could also set an example for private sector wage settlements, thereby helping to bring inflation and inflationary expectations under control.

To be effective, the fiscal restraint would have to be accompanied by tighter monetary and credit policies, Mr. Suraisry continued. The proposed ceilings on domestic credit expansion--which implied a significant deceleration in monetary growth--appeared to be consistent with the aims of reducing inflation and improving the balance of payments. The intention of enforcing the quantitative credit controls more effectively was welcome. In the medium term, the authorities should develop and broaden the domestic financial markets to make it easier to finance a larger proportion of the public sector deficit by nonmonetary means.

Externally, Mr. Suraisry commented, the room for maneuver was limited by the need to reduce the current account deficit and the foreign borrowing requirement to more sustainable levels. The 12 percent devaluation of the escudo in June 1983 and the present flexible exchange rate policy had improved Portugal's competitive position, but the policy would have to be kept under close review in the coming months.

The authorities' decision to reduce the import surcharge in the 1984 budget year was encouraging, Mr. Suraisry remarked, and the firm steps that had been taken to monitor external borrowing by the public sector and to limit the increase of short-term debt should help to restore Portugal's creditworthiness. The proposed program as a whole provided a sound framework for stabilizing the economy in the short run, but adjustment would have to be sustained for some time, as Portugal faced a number of difficult structural problems. Comprehensive supply-side measures were needed to modernize the agricultural sector and to diversify the export base if Portugal was to benefit fully from membership in the European Communities. He hoped that the authorities would use the opportunity provided by the stabilization program to plan ahead in those areas.

Mr. Polak said that the proposed stand-by arrangement conformed precisely with the hope that Executive Directors had expressed during the 1983 Article IV consultation discussion that the Government would work with the Fund to create and implement a comprehensive stabilization program. He fully agreed with the staff and Mr. Lovato that the new program was a clear signal that the authorities were making a serious effort to deal with the external and internal imbalances. Of course, there had been important reasons for adopting such measures: after the courageous adjustment program of 1977-78, Portugal's economy had slipped back into an unsustainable position, and corrective action was urgently required. In addition, the long-term development and growth of the economy required the elimination of distortions and resource misallocation, and the proposed program constituted the first steps in that direction. Moreover, as Portugal aimed to become a member of the European Communities, it would have to bring the management of its economy up to a level at which the convergence of its policies with those of other EC members could be achieved. For all those reasons, the authorities were to be complimented for introducing the new stabilization program. He was pleased that, as a result of the recent discussion on the Fund's usable resources (EBM/83/145 and EBM/83/146, 10/3/83), the Fund was able to go ahead with its support of Portugal's stand-by arrangement. It would have been most unfortunate if the Fund had had to withdraw or reduce its financial assistance to Portugal.

The most essential element of the proposed program, Mr. Polak considered, was a large improvement in the external current account position. The present deficit was clearly unsustainable, and the planned reduction would require the full implementation of the program; in that connection, the targets were the minimum required, and some additional measures might be needed. The debt service was projected to rise in 1983 to over 30 percent of exports, and that figure excluded the amortization of the short-term debt. In that context, he doubted whether the symmetrical flexibility of the target for domestic credit to the Government was wise. He fully understood that, if additional credit could be obtained abroad, it would be reasonable to cut domestic credit to the Government. However, given Portugal's tenuous balance of payments position, he was not confident that, if the amount of credit that could be obtained abroad was significantly less than the authorities hoped, the logical conclusion would be to provide more domestic credit to the Government.

In the longer run, Mr. Polak remarked, sustained improvement of the economy could not be achieved without structural improvement in the efficiency, profitability, and export performance of the public enterprises. Curtailing investment and reducing real wages would be helpful in the short run, but additional efforts were needed to improve the long-term outlook, and the authorities' intention of monitoring the improvement in the financial position of the public enterprises was certainly welcome. He attached particular importance to the target for domestic credit expansion to the public enterprises that was to be set during the scheduled review. The target should provide for a sharp decline in comparison with the 1982 financing requirement, which was relatively large, at 12 percent of GDP.

The discussion in the staff report on the exchange rate policy, Mr. Polak noted, seemed to emphasize the need to stick to the policy of a monthly rate of depreciation that roughly offset the inflation differential between Portugal and its main trading partners, thereby preserving for Portugal the small head start that it had been given by the devaluation of the escudo in June 1983. The staff had indicated that if the rate of inflation was greater than anticipated, the monthly rate of depreciation would be adjusted accordingly. That policy stance was the inevitable one for the immediate future, but in the longer run--and in that context he had in mind Portugal's potential membership in the European Communities--the authorities must deal directly with the inflation, and not merely compensate for its effects.

On balance, in the light of all the factors reported by the staff, the proposed use of the compensatory financing facility was fully justified, Mr. Polak remarked. However, in a footnote on page 13 of EBS/83/197 it was noted that assurance had been received from France "at the highest level" that Portuguese emigrant workers seeking to transfer funds would be exempted from certain restrictions. He wished to receive assurance that the French Government did not maintain a special regulation for Portuguese emigrants.

Mr. de Maulde explained that the text in question gave the inaccurate impression that Portuguese workers would be granted preferential treatment by the French Government, and that transfers by workers in France to any other country were subject to restrictions. In fact, transfers by expatriate workers were completely free.

Mr. Prowse commented that it was evident that the new program had come quite late in the day for the Portuguese economy and was therefore particularly important; if it was not fully implemented, the prospects for the economy would be grim. The Fund should support the program, but it should be noted that the program was not designed to correct all the problems facing the economy, and he looked forward to an ongoing relationship between Portugal and the Fund. The present discussion seemed to have sown the seed of a possible agreement some time in the future on a cooperation requirement for the approval of extended arrangements. He hoped that such a requirement would not be brought forward.

The difficult economic situation in Portugal reflected mainly the problems of the public sector and public finances, Mr. Prowse continued, and restoring proper balance in those areas would be essential for the long-term success of the Government's policy stance. The measures already introduced were welcome, and the proposed package was comprehensive, although in some respects it seemed to be lacking in intensity. As Mr. Robalino had noted, although the program was appropriate in relation to the amount of Fund assistance that was to be given, it constituted a modest effort in comparison to the problems facing the economy that would have to be solved in the coming period. For instance, it was clear that the external accounts and the domestic finances of the public sector would not be viable at the end of the program period. In comparison with the ideal targets, the proposed targets were moderate, although the difficulty in obtaining public acceptance of even those moderate targets was admittedly sizable. He wished to underscore the importance that he attached to the scheduled mid-term review. At that time, he would not be surprised if there were a clear need for further action.

Given the problems facing the economy, Mr. Prowse went on, the credit ceilings were not particularly stringent. Similarly, the wage objectives were welcome, but were not especially severe; indeed, there was no clear indication that there would be any reduction in real terms in public sector wages in the coming year. The external situation was particularly worrying. The balance of payments deficit at the end of the program period would apparently be unsustainable, and there was some question about the financing of the deficit. Even if financing could be arranged, the external debt position would remain a cause for serious concern, as the debt service ratio would be 30 percent in 1984, compared with 28 percent in 1983, and the share of short-term debt in total debt was large. Moreover, the debt service ratio in 1983 excluded the amortization of the short-term debt; such debt should be included in the assessment of the overall debt situation. In any event, the total external debt was expected to continue to grow throughout the 1980s. The objectives with respect to the external debt should be re-examined with a view to achieving a larger and more rapid improvement than was presently planned. Even on the basis of the most favorable scenario, the debt service ratio would be as high as 25 percent in 1990.

The adjustments in the exchange rate that had been made were welcome, and the intention to maintain competitiveness was commendable, Mr. Prowse remarked. The staff had correctly stressed that a mechanistic approach to exchange rate policy was merely a second-best solution, and he was pleased that the authorities had indicated their willingness to make adjustments beyond the planned levels if such action proved to be warranted.

Commenting on the public finances, Mr. Prowse said that he agreed with previous speakers that adjustments in the prices and charges of public sector enterprises were required. A more stringent budget deficit objective was also needed. Although the ratio of revenues to GDP was expected to increase, the tax structure should be reviewed to ensure an even better performance. The authorities might wish to attempt to introduce the value-added tax (VAT) earlier than the planned target date of end-1985.

The private sector savings ratio, Mr. Prowse noted, was expected to decline in 1984, and public sector savings were expected to continue to be negative. The level of private domestic savings was already relatively high, but he wondered why it was not expected to respond to the positive real interest rates.

He was pleased to support the proposed use of the compensatory financing facility, Mr. Prowse commented, although the normal six-month lag between the end of the shortfall period and the formal request for assistance seemed to have been exceeded. Nevertheless, the proposed stand-by arrangement clearly satisfied the cooperation requirement for compensatory financing; Portugal obviously had a balance of payments need to use the Fund's resources, and the proposed purchase was less than the estimated shortfall. Hence, he had no difficulty in accepting the purchase request. However, he, like previous speakers, harbored some doubt about the projection for workers' remittances. The relevant calculation was based on the assumptions that employment opportunities and wage levels abroad would grow and that certain adjustments in interest rates and exchange rates would be made. On the other hand, some factors would have a negative influence on workers' remittances. For instance, the movement of workers' families between Portugal and the host countries might affect the inflow of remittances. His points were however minor ones and did not at all detract from his support for the proposed purchase.

Mr. Teijeiro stated that the proposed decisions were acceptable. The economic situation in Portugal had deteriorated considerably in the past few years as a result of both domestic and external developments. In many respects, particularly the foreign debt, public sector, and external current account positions, the situation in Portugal was similar to that in a number of Latin American countries.

The proposed program was a good start toward adjustment, Mr. Teijeiro commented. However, given the magnitude of the current disequilibria, he wondered whether the program was sufficiently strong. In two areas in particular--the exchange rate policy and the fiscal policy--the adjustment seemed to be on the slow side.

There were two issues in the exchange rate policy area, Mr. Teijeiro commented. The first had to do with the appropriateness of the starting point of the new policy. Apparently the present real effective exchange rate would result in a large current account deficit, equivalent to 6 percent of GDP. The second issue had to do with future adjustments of the exchange rate. Given the expected behavior of domestic wages and prices, and the planned rollback of the import surcharge and credit subsidies for exports, the planned 1 percent monthly devaluation might prove to be insufficient. The authorities had stated that they were prepared to reconsider their exchange rate policy if Portugal's competitive position began to deteriorate. However, it would be much better to start with a higher rate of devaluation than to resort to significant jumps in the exchange rate that could have damaging effects on capital movements.

The proposed adjustment effort in the general government sector was a good first step, Mr. Teijeiro considered. However, the fact that most of the adjustment was to come from tax increases was regrettable, as the tax system was inefficient and promoted serious distortions in resource allocation. He wondered whether the planned increase in the corporate income tax was consistent with the present profitability situation in the private sector. In any event, the general government deficit would continue to be substantial. The particularly worrying aspect of the fiscal adjustment was that the definition of the public sector deficit excluded the deficit of the public enterprises. The problems in the public sector were due largely to the behavior of public enterprises, and it would have been advisable to incorporate their deficit in the new targets. The planned reduction in foreign financing was only a partial guarantee that the behavior of the public enterprises would be significantly improved. The enterprises still had access to domestic credit sources and were therefore able to avoid major adjustments. What assurances did the staff expect to receive that the public enterprises would play an appropriate role in the fiscal adjustment? A ceiling on domestic credit to the public enterprises might well have been a useful element of the program.

The relatively moderate pace of adjustment under the proposed program, Mr. Teijeiro commented, was probably traceable to the fact that the Bank of Portugal's reserves included $8.5 billion in gold. That cushion had enabled Portugal to avoid the kind of crisis that faced a number of heavily indebted countries. The ample gold holdings could also explain why the proposed adjustment program could be considered to be sufficient. At the same time, it was natural to wonder whether the existence of the ample reserves would guarantee a continuous flow of external financing. In any event, the present level of reserves was not an argument for providing a smaller volume of Fund resources than would have been provided if Portugal's reserves had been very low. Finally, his support for the proposed decisions was based largely on the authorities' commitment to be flexible if the need to do so arose.

Mr. Salehkhou commented that the Executive Board discussion on the 1983 Article IV consultation with Portugal had been timely, as it had coincided with the formation of a new Government and the preparation of an adjustment program. The consultation had given the Executive Board a good opportunity to express its concerns about the deterioration of the domestic and external position of the Portuguese economy and to describe the main features of a stabilization program that could be supported by the Fund. It was encouraging to see that the Portuguese authorities largely agreed with the staff analysis of the problems facing the economy, and in particular that they recognized the adverse effects of the inadequate domestic policies--including excessively accommodating financial and monetary policies--and of the continued postponement of meaningful adjustment. It was noteworthy that the authorities had implemented some strong stabilization measures along the lines of the Executive Directors' recommendations prior to the commencement of the negotiations that had led to the proposed stand-by arrangement.

The proposed program was a strong and comprehensive one, Mr. Salehkhou considered. Although the magnitude of the imbalances in Portugal's economy would remain large and would hardly be sustainable at the end of 1984, the projected improvement was substantial, and the policies that had been implemented or were to be introduced were generally consistent with the program targets. Furthermore, all of the various branches of economic policy would be contributing to the stabilization effort. In particular, the authorities intended to maintain a flexible exchange rate policy that would ensure continued adjustment to maintain the competitiveness of Portugal's exports and that would take into account developments in domestic inflation and interest rates abroad. The authorities also intended to strengthen the financial position of the public enterprises; substantially increase the tax burden in 1983; significantly raise administered prices in 1983 and 1984; maintain control over wages and salaries, especially in the public sector; significantly curtail the general government investment program; and enforce the credit ceilings more effectively.

While he supported the proposed stand-by arrangement, Mr. Salehkhou said, he wished to stress the importance of certain aspects of the adjustment program. The Portuguese economy had been allowed to deteriorate dangerously in the past few years, and the successful implementation of the new program constituted only a first step in a long process of adjustment. The imbalances were projected to decline markedly, but additional measures and a tightening of the current policies would be required even after 1984--particularly for tackling inflation, which should be reduced to 20 percent in 1984, and for reducing the general government budget deficit and the external current account deficit. The authorities should closely monitor the implementation of the various program measures and developments that had a bearing on the assumptions on which the targets were based.

A significant contraction of domestic demand was clearly necessary, Mr. Salehkhou continued, but it was important to bear in mind that the new measures and policies were expected to result in further declines in real GDP in both 1983 and 1984 and would inevitably cause a further increase in unemployment. While the new policies were crucial to preserve Portugal's competitiveness, to correct the domestic distortions, and to maintain economic growth in the medium run, the authorities were rightly concerned about the significant political and social costs of the program and should try to alleviate somewhat the short-term adverse effects on the economy to ensure the continued support for the stabilization effort. He welcomed their intention to seek the advice of the World Bank on the cuts in public investment; the authorities intended to concentrate the cuts on the projects that would have the least adverse impact on employment.

The external policies, Mr. Salehkhou went on, were largely consistent with the program objective of significantly reducing the current account deficit while maintaining Portugal's competitiveness. The large devaluation in June 1983, as well as the system of a crawling depreciation of the exchange rate, should play a major role in maintaining the country's competitive position. However, the impact of the exchange rate depreciation on exports and imports might be at least partially offset by the effects of other planned measures, including the elimination of interest rate subsidies on imports and the reduction in the import surcharge from 30 percent to 10 percent. Further comments from the staff on how realistic the program's assumptions were would be appreciated, particularly those related to the increase in foreign exchange receipts and to the decline in imports.

On the request for compensatory financing, Mr. Salehkhou said that, although the shortfall in earnings from exports and tourism and in workers' remittances was undoubtedly related to some extent to Portugal's inadequate policies in the period preceding the national elections in April 1983, the staff had clearly shown that the main cause was the economic recession in Portugal's trading partners. The proposed request met all the relevant criteria.

Mr. Malhotra stated that the proposed requests were acceptable. The Portuguese economy was suffering from serious external and internal imbalances that were both short term and medium term. While the proposed program seemed to be appropriate for the next year or two, the prospects for the economy over the rest of the decade were not bright.

Externally, Mr. Malhotra continued, the measures already taken with regard to the exchange rate and the intention of the authorities to maintain a flexible exchange rate policy by monthly depreciations of the escudo, seemed appropriate for the time being. However, the policy seemed rather mechanistic, and in the light of the high rate of inflation it might have to be re-examined; it should certainly be an important subject of discussion during the scheduled mid-term review. There had been important corrections in interest rate policy. The large interest subsidies were to be phased out.

The major areas of concern were fiscal policy and the external debt, Mr. Malhotra said. He was pleased that the overall budget deficit was likely to be reduced from some 12 percent of GDP in 1982 to about 6 percent in 1984, but it appeared that the reduction would result mainly from a decline in capital inflows. It was unclear what the net impact of the domestic actions would be on revenue and expenditure. If the reduction in the budget deficit was essentially a reflection of reduced foreign borrowing and capital inflows, Executive Directors' opinions of the extent of the planned fiscal adjustment might well be affected. In any event, the tax system was clearly inadequate, and the authorities should pay close attention to the need to improve tax administration; in that connection, Fund technical assistance would be useful. In the short run, positive fiscal adjustment efforts were more likely to result from expenditure control than from revenue-raising measures. Although to some extent reductions in expenditure would be related to the decline in the inflow of foreign capital, it would be essential for the cuts in expenditure in general, and in development project financing in particular, to be sensible, and to that end the assistance of the World Bank would be useful.

Portugal's debt situation would probably continue to be serious all through the 1980s owing to the large debt service burden, Mr. Malhotra remarked. As Mr. Prowse had stressed, the amortization of the short-term debt should be included in the assessment of the overall debt service burden, and Mr. Erb had usefully suggested that one way of alleviating the debt problem was to lengthen the maturities of the short-term liabilities. The debt situation was not expected to be sustainable in 1984 or 1985, and he wondered whether the assumption that there would be a further increase in debt in the second half of the 1980s was thought to be appropriate.

The fiscal and external imbalances could not be corrected in just one or two years, Mr. Malhotra commented. In the period after Portugal's previous stabilization program, exogenous factors--as well as some domestic policy decisions--had made the economic situation difficult. In the coming period, some of the corrective steps might be difficult to take, as the authorities would have to make a serious effort to contain wages and inflation. It was not clear how all the various pressures arising from wage and tax policies would affect the implementation of the adjustment program. The public sector would be the key to improving the overall economic situation and, in that connection, both efficiency measures and price adjustments would be important, as the revenue system would take some time to improve and as expenditure cuts would cause some disruption. There might well be constraints on the extent to which wages could be contained, and therefore improved functioning of the public sector could make an important difference to the outcome.

Mr. Zhang stated that he fully supported the proposed decisions and merely wished to pose a question. On page 25 of EBS/83/196, it was stated that "this projection assumes a recovery in export market shares on the basis of an improved competitive position...." To that end, the authorities presumably would have to lower export prices and could do so through the continuous depreciation of the escudo. However, on page 5 of EBS/83/197, it was stated that "the shortfall in Portugal's earnings from merchandise exports was due solely to lower prices." He wondered whether the two statements were consistent.

Mr. Hirao said that he broadly agreed with the staff appraisals and accepted the proposed decisions. Portugal's economic difficulties stemmed from various factors, some of which were clearly attributable to external developments beyond the control of the authorities. However, a greater role had been played by domestic factors, particularly by the stance of financial policies since 1980. The rate of growth of domestic demand had been higher in Portugal in 1980-82 than the average rate for the OECD, and the external current account deficit, which had widened substantially after the near-equilibrium position of 1979, had been financed through substantial external borrowing. The relatively inflexible interest rate and exchange rate policies had also contributed to the capital outflows by reducing the incentive to hold domestic financial assets. The authorities' main objective under the proposed program was to correct the severe external imbalance, and they had appropriately given highest priority to budgetary restraint complemented by measures to improve the financial position of public enterprises.

On the revenue side, Mr. Hirao continued, the authorities' decision to strengthen tax revenues was welcome. The major adjustments in administered prices should make a significant contribution to improving the financial position of the Supply Fund. A further small increase in the tax burden was envisaged under the 1984 budget. The staff had noted that, while the tax ratio in Portugal was somewhat in line with that of other European countries, the tax burden remained unevenly distributed, the tax system seemed to be overly complex, and the tax base had been eroded by the large number of exemptions. He hoped that the comprehensive restructuring of the tax system as well as the strengthening of the tax administration that the authorities intended to undertake would help to improve the public finances in the medium term. The authorities also intended to tighten expenditure control, and to that end the planned restraint in public sector hiring and wages seemed appropriate. The growth of capital spending was also to be strictly contained, and the careful scrutiny of projects in the public sector investment plan was welcome.

The restraint on external borrowing, Mr. Hirao commented, should make an important contribution to the adjustment efforts. The authorities' intention of containing the short-term element of the debt would be of crucial importance. Finally, the proposal to use the compensatory financing facility met all the relevant requirements, and he had no difficulty in accepting it.

Mr. Erb noted that a number of Executive Directors had suggested that a follow-on program for Portugal--perhaps in the form of an extended arrangement--might be appropriate. He did not wish to prejudge the matter at the present stage, but important issues would have to be dealt with before the Executive Board could handle a request from Portugal for an extended arrangement. Some of the issues had been raised by Mr. Feito. He himself wondered whether there were not structural adjustments that would increase domestic economic activity and employment opportunities without necessarily harming the balance of payments. Were there structural adjustments that might result in an immediate improvement in the balance of payments either by encouraging import substitution, export growth, or foreign direct investment? At present, foreign direct investment in Portugal was nearly nonexistent. One of the problems facing both foreign and domestic investors was the rigidities in Portugal's labor force. Another question that would eventually need an answer was whether there were structural adjustments that would result in a temporary balance of payments financing requirement. Were there structural adjustments that would help to improve the economy's ability to service temporary financing beyond the period of adjustment?

The staff representative from the European Department commented that the question of the adequacy of the adjustment effort envisaged under the proposed program had a short-term and medium-term dimension. In the short run, the adjustment effort would be sizable: if the targets were met, the external current account deficit would be reduced by the equivalent of more than 7 percentage points of GDP; in dollar terms, the deficit was to decline to less than 40 percent of its level in 1982. The staff was nearly certain that the program targets would be met and, in fact, exceeded in 1983; if the present policies were kept on course, the targets would most likely be met in 1984. The staff's confidence stemmed from the fact that the assumptions underlying the program were conservative. The burden of the adjustment in the short run was almost entirely on the public sector. The borrowing requirement of the public enterprises had tentatively been projected to improve by the equivalent of 4 percentage points of GDP. That effort, when seen in the context of the envisaged adjustment in the balance of payments, clearly suggested that there was room for a sharp fall in private sector savings. In fact, however, the decline was unlikely to occur, particularly after the considerable increase in real interest rates. The preliminary indications were that the external current account had been in virtual equilibrium in the third quarter of 1983. That quarter was of course a seasonally strong one, but in the same quarter in 1982 the external current account had registered a deficit of $500 million. Hence, the improvement since then had clearly been substantial.

The staff agreed with Executive Directors who felt that the adjustment of the economy in the medium term, on the basis of the scenario in Table 6 of EBS/83/196, was minimal, the staff representative stated. A debt service ratio that remained at about 25 percent, including short-term amortization, was obviously not a cause for comfort, since the ratio would undoubtedly move to an even higher level if any of the assumptions in the scenario proved to be too optimistic. The main task at the present stage was to identify the steps that could be taken to improve the medium-term balance of payments prospects while maintaining some room for the growth of output and employment needed to bolster Portugal's per capita income, which was only about one quarter the average of Europe's.

There were a number of areas in which structural adjustments should be made, the staff representative went on, and it was the staff's understanding that the Government was committed to making them. There was clearly room for improvement in import substitution, particularly for agricultural and energy imports. The World Bank had long recommended that certain measures--which would not involve relatively large outlays--should be introduced to improve extension services and farming techniques. Better use of seeds and fertilizers would dramatically improve yields in Portugal, which, at present, were low in comparison with those of other Southern European countries. There was also scope for improving energy conservation and for substituting other energy sources. The Government had prepared an energy plan that would probably have to be re-examined in the light of the necessary cuts in the electric company's energy investment program. Furthermore, pricing policies governing agricultural commodities and energy products had become more realistic and the Government intended to maintain appropriate prices, thereby helping to reduce the country's dependence on imports of those items.

There were a number of other rigidities in the Portuguese economy that could be reduced, a change that would improve the prospects for growth without making the external imbalance unsustainable, the staff representative remarked. The authorities could take steps to attract foreign capital--including direct investment and portfolio investment--and to encourage a reflow of capital that had been kept abroad for long periods. The Government intended to take steps, in collaboration with the IFC, to develop the domestic capital market and to diversify the range of financial instruments available in Portugal. Direct foreign and domestic investment would be greatly encouraged by a reduction in the rigidities in the labor force. It was true that layoffs for a two-year period were planned. It would have been difficult for the Government to retain political and popular support if it favored legislation providing for layoffs for an indefinite period. However, the coming two years could be used to retrain members of the labor force to take advantage of new employment opportunities created by the development of export-oriented enterprises. The authorities had indicated that they intended to introduce appropriate training programs. The rate of unemployment was relatively high, and there were bottlenecks of skilled labor in certain sectors. Hence, some investment in manpower training could be quite fruitful, even in the short run.

The Fund could play a role, together with the World Bank, in supporting the structural adjustment effort in Portugal, the staff representative commented. The precise form of the Fund's support would depend on a number of factors, including the availability of Fund resources and the commitment of the Government to prepare and undertake a medium-term program. It was the staff's understanding that the authorities intended to prepare a three-year program in 1984 for the following three years that would address the areas of structural weakness. If progress in that area were made, the staff would consider at the appropriate time the kind of Fund support that could be provided.

Commenting on the proposed program, the staff representative said that fiscal policy was the centerpiece of the adjustment program, and she agreed with Executive Directors who had stressed that the first order of business for the authorities was to improve the antiquated tax system by consolidating the existing schedule of income taxes into a global income tax, introducing a value-added tax (VAT), and making tax collection and other administrative improvements. Some progress in those areas had already been made, and the staff would continue to encourage the authorities to accelerate the pace. The draft legislation for the VAT had been prepared, and the authorities intended to introduce it in 1985. No steps had yet been taken to introduce a personal income tax, but the staff planned to encourage the authorities to establish a task force within the Ministry of Finance to study the matter; Fund technical assistance might well prove to be useful. The progress in the tax area that had been made was reflected in the strong increase in tax receipts in recent years, but it was clear that much remained to be done. Improvements in the tax area were crucial to maintaining a feeling among the public that the adjustment burden was being fairly distributed. The staff and the authorities hoped that it would not be necessary to resort again in 1984 to the extraordinary tax on incomes introduced in 1983, which had fallen largely on labor income.

There were short-term and longer-term dimensions to the expenditure control effort, the staff representative explained. In 1983, the staff expected that there would be some expenditure overruns compared with the amounts estimated in the program. However, the tax receipts from the package of measures introduced in September 1983 were likely to be at least Esc 6 billion in excess of the initially estimated amount. Still, the slippages in expenditure in 1983 strongly suggested the need to tighten expenditure control in 1984. The 1984 budget had not yet been finalized, but indications were that the expenditure estimates were less than those contained in the staff report, while the estimates for tax receipts were broadly in line with those mentioned in the staff paper. Hence, the authorities seemed to be aiming in the initial budget document for a deficit somewhat smaller than the one indicated in the projections reported by the staff. Given the record of performance in the budget area, the staff felt that it was desirable to make the initial budget somewhat more ambitious than the targets in the program. The staff would certainly insist on the adoption of measures to improve implementation of budgetary measures in 1984.

The staff had agreed with the change in the treatment of interest payments to the Bank of Portugal, the staff representative commented, because the new practice was more in line with practices prevailing in other countries. In no other country was the interest rate on the stock of debt at the end of each year automatically raised to the prevailing discount rate. The practice in Portugal had led to a level and rate of growth of interest payments that had been artificially inflated in comparison with the experience of other countries. Despite the adjustment, however, the average interest rate on government debt held by the Bank of Portugal was well in excess of 20 percent, and interest payments to the Bank of Portugal were expected to increase by 43 percent in 1984, the equivalent of 1 percentage point of GDP.

Hence, the change was not merely a cosmetic one, and transfers by the Bank of Portugal to the budget were expected to increase sharply in 1983 and 1984.

The projected improvement in the borrowing requirement of the public sector enterprises was due to a sharp cut in the investment program and to measures designed to improve the self-financing of the enterprises, particularly price adjustments and wage restraint, the staff representative explained. Thus far, wage settlements in the public enterprises had been kept on average to approximately 20 percent, compared with an average rate of inflation of at least 24 percent in 1983, thereby implying a sizable cut in real terms. At the same time, the increase in wages of civil servants had been kept at 17 percent, implying an even sharper decline in real terms. The Government intended to constrain the rate of increase in wages in nominal terms in 1984 to no more than the rate recorded in 1983; the constraint would imply a cut in wages in real terms similar to that of 1983, as the rate of inflation on average was unlikely to decelerate significantly. The rate of inflation would however fall substantially during the year.

Interest rates in Portugal, particularly on the lending side, were substantially positive in real terms, the staff representative remarked, and the authorities intended to maintain a flexible policy, taking into account developments in domestic inflation and real interest rates abroad. They were also determined to fulfill their commitment to eliminate interest rate subsidies to exporters by the end of 1983. They believed that the exchange rate was competitive, and that the time was ripe to remove those particular subsidies. They also intended to review other interest rate subsidies, which had become pervasive, with a view to reducing their scope substantially.

Responding to the question on the symmetrical nature of the ceiling on domestic credit to the public sector, the staff representative said that she agreed that the degree of flexibility provided in that area should be limited and, indeed, the amount involved was equivalent to more than $100 million. At the time of the negotiations, there had been genuine uncertainty about the ability of the authorities to raise sufficient external financing. The preliminary indications were that the loan being negotiated for the republic would provide financing in excess of the amount that had been expected at the time of the preparation of the program, so that the ceiling would, in effect, operate in the right direction.

All the indications with respect to wage policy were positive thus far, the staff representative commented. In general, wage increases had been held to less than 20 percent in both the public and private sectors, although it was difficult to say at the present stage whether the wage objective for the coming year would be achieved, given the acceleration in the rate of inflation toward the end of 1983 resulting from the increases in administered prices. However, the Government was clearly determined to maintain its policy of restraint.

In presenting the initial government program, the authorities had publicly stated that real wages would have to decline, and instructions to that effect had already been given in the public enterprise sector, which had tended to be the leading sector in wage negotiations. If wage restraint were achieved in the public sector, it was therefore likely to have a good demonstration effect for the private sector. In that connection, there was a fear of growing unemployment resulting from the modification of the legislation on layoffs and the crisis that had been emerging in the construction sector. The staff was therefore confident that if the Government could hold the line on wage adjustments in public sector enterprises, the adjustments in the private sector would not significantly exceed the target.

In judging the appropriateness of the exchange rate, the staff representative explained, the staff had made calculations based on the standard indices of competitiveness, the shortcomings of which were well known. But the calculations did suggest that, after the June 1983 devaluation, the competitive position had improved significantly over the previous peak in 1979, when the volume of exports had grown by 29 percent and the balance of payments had been in equilibrium. Of course, economic conditions had changed since 1979, and it had therefore been appropriate for the authorities to aim at a level of competitiveness above the peak in that year. It was difficult to say at the present stage what the precise level of competitiveness should be, and the staff and the authorities planned to keep the competitive position under close review. The performance of exports thus far in 1983 had exceeded the original expectations; the staff had projected a 10 percent increase in exports in the first half of 1983, and the actual increase had been 12 percent. The authorities had been fully prepared to discuss the question of competitiveness with the staff and had indicated that they were also prepared to step up the rate of the monthly depreciation if their expectations about wage moderation--the crucial factor in competitiveness--were not met. In the longer run, the staff agreed with Mr. Polak that the authorities should aim at reducing the rate of inflation in order to ensure Portugal's successful integration into the European Communities. Meanwhile, however, it would be crucial to maintain the policy of a crawling peg that enabled Portugal to compensate for the existing inflation differential.

The staff certainly agreed with the Executive Directors who felt that the foreign debt in general, and the debt profile in particular, was uncomfortable, the staff representative said, and that every effort should be made to consolidate the short-term debt. The authorities shared that view, and their aim was to reduce the share of short-term debt to no more than 20 percent of total debt. However, having witnessed the difficulties experienced by others in negotiating medium-term financing, and given the continued uneasiness in the capital markets about the prospects for Portugal's economy, the staff was not optimistic that a major consolidation of the short-term debt would be achieved within the program period. However, the debt should not be allowed to rise significantly, if at all, and it was the staff's intention to encourage the authorities to revise downward the indicative target for 1984. In fact, the short-term debt had declined significantly in the first half of 1983, and the starting position at the time of the scheduled review, when the staff hoped that the relevant target would be reduced, would be favorable.

The staff agreed with Executive Directors that the share of gold in Portugal's total reserves was disproportionately large, the staff representative remarked. At the present stage, however, sales of gold would be interpreted largely as a sign of weakness in the balance of payments. As a result, the desired shift in the composition of reserves would have to await an improvement in the balance of payments, so that the sale of gold would be interpreted merely as a form of diversifying the country's reserve holdings, rather than as a way of financing a balance of payments deficit that could not be covered through the capital markets.

As for the apparent inconsistency between the staff statements on the recovery of market shares and the increase in the volume of exports, the staff representative from the European Department said, it was important to note that the growth in market shares had continued in 1982, although the thrust of the improved export performance in 1982 had been provided by new exports--such as petrochemicals, gearboxes and automobile equipment--that were not expected to grow at the same rapid rate in 1983 and 1984.

The Deputy Director of the Exchange and Trade Relations Department, commenting on the adequacy of the adjustment effort in Portugal, noted that that effort compared favorably with arrangements approved in recent months of similar duration and amount. Indeed, the targeted reduction in the budget deficit and the external current account deficit was subtantially larger than in the recent cases of Korea, the Philippines, and Thailand.

The staff representative from the Research Department recalled that Executive Directors had noted that the export shortfall had been due to a number of factors, including the underreporting of travel receipts, the underinvoicing of exports, the effect of the relatively low interest rates in Portugal on workers' remittances, and the effect of the exchange rate. The underreporting and underinvoicing had existed for some time; the underinvoicing in particular had been a problem since approximately 1980, when pressures on the exchange rate had begun to intensify. Those problems had not been featured in EBS/83/197, because recent discussions with the authorities and a staff assessment had suggested that the role of underinvoicing and underreporting had probably been exaggerated in the previous staff reports. The analysis of both the staff and the authorities strongly indicated that the main factor behind the export shortfall had been the weak external demand rather than an intensification of the underinvoicing and underreporting.

The underinvoicing, the staff representative went on, had apparently affected one major export item, namely, textiles. As a result, the unit values of textile imports seemed to have declined more sharply than was justified by market prices. In that connection, it should be noted that textile exports from Portugal had recorded a sharp increase in volume that had been facilitated by an easing of the EC quotas, even though in the period under review world demand had generally been depressed. To the extent that the main portion of the increased export volume had consisted of lower-priced products, it had had a depressing effect on aggregate unit values. For that reason, at least part of the decline in the prices of textiles had been due to the shift in the composition of textile exports during a period of weak demand.

The decline in workers' remittances, the staff representative continued, was traceable largely to the political uncertainty, rather than to the Government's interest rate policy or other financial factors. For instance, the latest data suggested that even though interest rates had been raised in March 1983 to positive real levels, workers' remittances had not recovered in the second quarter of 1983. That development was perhaps explained by the uncertainty about the course of economic policy until the new Government had taken office in June 1983.

It had been suggested, the staff representative recalled, that the overvalued exchange rate had contributed to the export shortfall. The aggregate volume of exports had in fact increased by 15 percent, largely in response to the adjustment of the exchange rate in mid-1982, the early part of the shortfall year; in other words, the substantial increase in volume had followed the improvement in competitiveness. At a time of weak foreign demand, Portugal had done well in gaining market shares. It was for the same reason--the improvement in competitiveness--that the volume of exports was projected to increase by 6 percent in each of the coming two years, a much lower rate than that recorded during the shortfall year. Export prices were projected to increase by 4 percent, which was roughly in line with world inflation. As for travel receipts, they were projected to increase by 10 percent a year in nominal terms and 5 percent in real terms. The preliminary data suggested that travel receipts, unlike workers' remittances, had risen sharply in the second quarter of 1983. There was some feeling among Executive Directors that the projected increase in workers' remittances in the coming two years might well be overoptimistic. The staff had projected a 4 percent increase in nominal SDR terms. Assuming an increase in both employment and in real wages stemming from the expected economic recovery in the host countries, the projected value increase implied a reduction in the number of workers making remittances.

As for the six-month limit from the end of the export shortfall year to the date of purchase, it had been exceeded by a week in the case of Portugal, the staff representative from the Research Department explained. There had been other cases in which the six-month limit had been exceeded by a longer period, but they were all exceptional. The limit had not been applied rigidly, and from time to time delay in the distribution of the relevant staff report had been unavoidable. Finally, the staff had received preliminary data for the first six months of 1983, which covered not only the final quarter of the shortfall year--the figures for which had been estimated--but also the first three months of the postshortfall year. The staff expected to be able to finalize the shortfall calculations shortly and believed that calculations would not show any overcompensation.

Mr. Lovato said that his authorities greatly appreciated the advice and cooperation of the staff in the formulation of the proposed adjustment program. During the present discussion, Executive Directors had encouraged the authorities to remain firm in their determination to implement the program, and some of them had said that they harbored doubts about the pace and stringency of the adjustment process under the proposed stand-by arrangement. During the discussion for the 1983 Article IV consultation with Portugal, he had noted that in 1982 and the first half of 1983, the badly needed adjustment had been hindered by the weakness of the Government, which had not had sufficient strength and determination to introduce the necessary but politically difficult measures, and by the institutional and legal framework that had evolved after the revolution, which had not permitted adjustment to take place in either the public or the private sectors. Since then, the situation in Portugal had changed: the new Government enjoyed widespread support in Parliament, thereby enhancing its chances of maintaining political and social stability, and it was committed to taking every needed and possible step to reverse the trends of the previous several years.

The new Prime Minister, Mr. Lovato commented, had demonstrated the Government's courage and determination by talking, even during the election campaign, about the many unpopular measures that would be needed. The Government, convinced that the basic economic problems were deep-seated and structural, had already begun preliminary work on two medium-term programs and a project to open up to private capital several key sectors of the economy, including banking, insurance, and cement and fertilizer manufacturing. The authorities believed that there was no alternative to a strong and lengthy effort aimed at restructuring the economy; only such a program would establish the foundation for a sound recovery and further development, while preserving and strengthening the young democratic system in Portugal.

Some Executive Directors, Mr. Lovato noted, apparently felt that the adjustment objectives were not sufficiently ambitious. However, it would be unwise to aim to do too much in a short period. Experience had shown that guidelines for determining adjustment programs should be based on steps that had to be taken to achieve economic objectives but that were also politically and socially feasible. It would be useless, and even counterproductive, for the country and the Fund to establish goals that were so ambitious that they simply could not be achieved. In any event, actual adjustment results and the Government's determination to improve upon them were more important than initial objectives themselves. Preliminary data showed that the achievements in Portugal had thus far been better than expected, and the authorities had expressed their willingness to discuss and review the performance criteria within the framework outlined in their letter of intent.

In attempting to reduce the public sector deficit, Mr. Lovato commented, the authorities had little room for maneuver on the revenue side, and they intended to concentrate their efforts on reducing tax evasion, strengthening the collection structure, and, in the medium term, reforming the excessively complex and relatively inelastic tax system. The Fund staff mission that had visited Portugal toward the end of 1981 had reported in March 1982 that the impressive number of preliminary studies made by the ad hoc Commission should pave the way for a smooth introduction of the VAT in Portugal, and the introduction of the tax was therefore merely a matter of time. Much more could be done on the expenditure side, but he was confident that the increases in taxes and the new taxes already introduced, together with the effort to improve control of the highly rigid structure of public construction, would help the authorities to meet the performance criterion for the reduction in the budget deficit in the short run. More time would be required to achieve the difficult objective of reducing the transfers to the local entities, in part because new legislation would have to be enacted.

Most speakers had rightly stressed the need to improve the performance of the public enterprises, Mr. Lovato remarked. The public enterprise sector was a cause for great concern among the Portuguese authorities, who believed that the sector's inefficiency ought to be reduced, but who were worried that the effort to control expenditure - might well increase the already high rate of unemployment. The Prime Minister and the Minister of Finance were fully aware of the problems facing the sector and of the implications of possible solutions, and they were clearly determined to make every possible effort to improve the selffinancing of the enterprises. In that connection, they did not intend to confine the efforts to maintaining realistic prices and to keeping wage increases below the rate of inflation; they also intended to reduce the capacity and work forces of the enterprises.

Reform of the agricultural sector was clearly required, but it was also a sensitive issue to which previous governments had turned a blind eye, Mr. Lovato explained. The new Government had taken some steps in the agricultural sector to prepare the country for membership in the European Communities. For instance, the Government had already decided to allow private enterprise access to the agricultural purchasing area and had decreed that all public concerns dealing with agriculture and foodstuffs had to be reconstructed. As a result, market forces would govern import policy. Technical assistance to farmers was to be increased, and a training school for young farmers was to be established. The most politically sensitive measure was likely to be the decision to review the so-called agrarian reform in some of the provinces where the present situation ranged from what the Prime Minister had called "unclear to illegal" and where a new legal and economic structure should help to improve efficiency and to encourage investment. Finally, the Portuguese authorities were determined to meet their commitments and to continue to cooperate with the Fund.

The Chairman commented that the overall public sector deficit of Portugal was clearly unsustainable. Since 1981, it had exceeded 20 percent of GDP. The public sector enterprises accounted for about half of the overall deficit and were therefore clearly a major question mark in terms of the likely success of the proposed program. There had been a large effort in 1983 to reduce the deficit of the public sector enterprises, especially by reducing certain investments and by adjusting prices. During the mid-term review, it would be important to see whether the target for 1984 could not be reduced. The staff should receive specific indications of the steps that were to be taken to rein in the public sector enterprises; the proposed program contained relatively little information in that respect.

The fiscal targets under the program were perhaps on the easy side, the Chairman said, and in implementing the program the authorities would have to adhere to them fully and, if possible, to overperform. The expenditure side was one of the weak points of the program, and a close look at it would have to be taken during the scheduled review. Much of the boost in current expenditure was accounted for by the servicing of the interest on the debt, which in turn was a reflection of the enormous overall public sector deficit as a proportion of GDP. As much as 25 percent of current expenditure was absorbed by the servicing of the debt, and the burden had been increasing rapidly in recent years. The public sector deficit, including that of the public enterprises, was the main problem facing the economy, and attention would have to be concentrated on the effort to control public expenditure.

The new program was clearly not an anti-inflation program, the Chairman remarked. The rate of credit expansion of 21 percent was to be broadly in line with the increase in the consumer price index of 20 percent. The authorities obviously were not trying to reduce the rate of inflation significantly. The staff had given some reasons why the program was not aimed primarily at combating inflation, but a somewhat stronger effort at inflation control would have been welcome. In any event, the various aspects of the program and the medium-term problems mentioned during the present discussion would certainly be important topics of the major review scheduled for March 1984.

The staff representative from the European Department said that it was important to note that the projections for the public enterprises for 1983, and especially those for 1984, were preliminary. The staff and the authorities had not wished to include an explicit commitment because the major decisions on the investment program of the public enterprises in 1984 had not yet been taken; it would have been premature for the authorities to commit themselves in that area. In connection with price performance, it was the unwinding of repressed inflation in the past that had caused the rate of inflation to accelerate at the present stage. The underlying rate of inflation would certainly be lower than the recorded rate in both 1983 and 1984, and a further improvement was expected in the period after the termination of the program, when Portugal and the Fund were expected to continue their present close relationship.

The Executive Board then approved the following decisions:

Stand-By Arrangement

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

2. The Fund approves the stand-by arrangement attached to EBS/83/196, Supplement 1.

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

Decision No. 7546-(83/148), adopted
October 7, 1983

Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request by the Government of Portugal for a purchase of SDR 258 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979).

2. The Fund notes the representation of Portugal and approves the purchase in accordance with the request.

Decision No. 7547-(83/148), adopted
October 7, 1983

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/83/147 (10/5/83) and EBM/83/148 (10/7/83).

2. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to an Executive Director, as set forth in EBAP/83/242 (10/3/83), and travel by Executive Directors, as set forth in EBAP/83/244 (10/4/83) and EBAP/83/245 (10/5/83), is approved.

APPROVED: March 19, 1984

LEO VAN HOUTVEN
Secretary