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IMF Concludes Article IV Consultation with Portugal

The IMF Executive Board on October 17, 1997 concluded the 1997 Article IV consultation[1] with Portugal.

Background

The performance of the Portuguese economy in recent years has been distinctly positive, characterized by accelerating growth, lower inflation, and a beneficial rebalancing of the policy mix through a reduction in the fiscal deficit and an easing of interest rates. The economy is clearly reaping the benefits of stability-oriented policies, in the form of noninflationary growth and good chances of meeting the Maastricht criteria.

The process of real convergence, that raised GDP per capita from half of the EU average in 1985 to some 70 percent in 1996, has resumed. The recovery has been gathering momentum, and forecasts for GDP growth in 1997 have been revised upward, to around 3½ percent. Activity is benefitting from rapid capital accumulation, spurred by lower financing costs, profitability gains, improved business confidence, and a number of large infrastructure projects. Increased real disposable income and a pickup in employment since 1996 have supported consumer demand. Nominal convergence is also proceeding, aided by exchange rate stability and a decline in wage awards. The rate of inflation is now within the Maastricht reference value. The recovery has also brought a long-awaited reduction in unemployment (to an average of 6.8 percent in the first three quarters of 1997). This attests to a continued flexibility of the Portuguese labor market, stemming primarily from real wage flexibility. Rigid employment protection regulations, however, remain on the books.

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[1]Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. In this PIN, the main features of the Board's discussion are described.

While the comparatively stronger cyclical upswing has been associated with some widening of the external current account deficit (to 2½ percent of GDP in 1996), gains in export market shares have been sustained, driven by a structural shift toward higher value-added exports, linked to large foreign investments. The current account deficit is expected to narrow slightly in 1997.

Monetary policy continues to be geared toward maintaining exchange rate stability. The escudo's relative strength within the ERM and declining inflation have allowed the Bank of Portugal to progressively reduce official interest rates over the past year, with the three-month interest rate differential against Germany narrowing to some 150 basis points. Bond yields have fallen even more markedly, bringing the long-term differential against Germany to new lows, of under 40 basis points.

The government has characterized its approach to fiscal consolidation as one of "rigor with a social conscience." The two budgets (1996–97) enacted since it took office and the newly drafted 1998 budget, therefore, have pursued a common strategy of relying on improved tax administration to raise revenues, of emphasizing sustained social (especially for education) and infrastructure spending, and of implementing a bold privatization program whose substantial proceeds will help reduce the debt–to–GDP ratio to a projected 63 percent by end–1997. This strategy, in conjunction with the strong cyclical upswing and declining interest rates, contributed to a considerably larger improvement in the general government deficit in 1996 (to 3.2 percent of GDP) than originally budgeted. It has also brought the deficit target of 2.9 percent of GDP well within reach for 1997, albeit with a somewhat different evolution of several budget items than anticipated (including the incorporation of a previously unbudgeted capital transfer from *Banco Nacional Ultramarino*). In spite of the restraint on spending on goods and services and the noteworthy improvement in tax administration, the improvement in the structural primary balance has nonetheless remained modest and current primary spending has continued to rise (by ½ percentage point of GDP in both 1996 and 1997, and a further rise is envisaged for 1998). The root cause of this increase lies in the dynamics of transfer payments, notably for health and civil service pensions.

The convergence program for 1998-2000 recognizes the need for continued fiscal adjustment and structural reforms. The fiscal deficit is targeted to be halved to 1½ percent of GDP by 2000. Public spending will continue to be reoriented toward education, poverty alleviation, and infrastructure investment. The weight of primary expenditures in GDP would be marginally reduced by the end of the convergence program period, based on intended reforms in the health and social security systems. In the latter area, an ad hoc Commission is to present its reform proposals by end-year. The program also envisages the enactment of tax reform, focused on broadening the tax base, with the aim of reducing direct taxes in the medium term. The macroeconomic scenario assumes a continuation of Portugal's catch-up process: output growth is expected to peak in 1998, due to the effects of the Lisbon World Expo, and moderate to 3.3 percent in subsequent years. Inflation is projected to equal the EU average as of 1998. This scenario does not differ significantly from the IMF staff's own projections.

Executive Board Assessment

Executive Directors commended the authorities for their consistent pursuit of stability-oriented policies which had yielded tangible benefits. Growth had picked up, inflation had declined, interest rate differentials had narrowed significantly, and prospects for EMU participation were bright. Directors agreed that the immediate policy agenda was to safeguard exchange rate stability and inflationary gains, and to secure the 1997 fiscal target. Looking forward, the policy requirement was to build on the achievements to date through further fiscal adjustment and progress with structural reforms to meet the challenges and maximize the benefits of economic and monetary union.

Directors welcomed the likely achievement of the targeted general government deficit of 2.9 percent of GDP in 1997, sustained by a buoyant revenue performance and lower interest payments—a reflection of the success in reducing inflation. They noted, however, the presence of expenditure overruns, particularly with respect to health. Some Directors regretted that the capital transfer from Banco Nacional Ultramarino had not been used to improve the 1997 budget deficit outcome. Directors urged the authorities to make decisive efforts to curtail health expenditure overruns, which were a chronic source of budget pressures, and to maintain a tight monitoring of budget execution in other spending areas.

Looking to 1998 and over the medium term, Directors stressed the need for a strong fiscal position, given Portugal's relatively high degree of output volatility and to provide room for the operation of automatic stabilizers. In that context, a number of Directors felt that, with stronger growth and lower interest payments, the opportunity could have been seized to accelerate the pace of fiscal adjustment in the 1998 budget and over the medium term, consistent with the Stability and Growth Pact. Directors stressed that ongoing efforts to improve tax administration would need to be complemented by measures to curb current primary spending. Consolidation based on the containment of such spending would allow the public sector to carry out its sizable investment program and create room for the intended reduction in direct taxation toward the end of the convergence program period.

In that connection, Directors stressed the importance of containing transfer payments through reforms of the health and social security systems. Controlling health expenditure was considered to be a priority, and Directors saw scope for strengthened cost control incentives and a greater use of copayments. Reform of the social security system, for its part, would need to address both the longer-term problems of the general pension system, as well as the more immediate pressures stemming from the regime governing civil servants. Directors encouraged the authorities to move promptly once the recommendations of the Commission for Social Security Reform were finalized later this year. Some Directors also advised that the treatment accorded to civil servants' pensions be brought in line with that of the private sector.

Directors commended the authorities for their firm conduct of monetary policy, based on a credible commitment to exchange rate stability, that had brought the Bank of Portugal's final objective of medium-term price stability within reach. Such progress was providing welcome scope for a decline in short-term interest rate premia, which was being judiciously taken up by the central bank.

While noting that unemployment had declined in 1997 and continued to be appreciably below the EU average, Directors called for vigilance against the possible emergence of some of the structural rigidities that had led to high and persistent unemployment elsewhere in Europe. Labor market flexibility was essential to Portugal's successful performance within the monetary union. To that end, Directors felt it important that the traditional flexibility of real wages be supplemented by an easing of the comparatively rigid formal employment regulations.

Directors welcomed the continued success of the privatization program that had enhanced efficiency, attracted foreign investment, and contributed significantly to reducing the public debt. They saw further scope to improve the economy's efficiency by removing distortions in the real estate market, strengthening competition policy, and expediting the judicial process. The maintenance of competitiveness under EMU would also require an enhancement of human capital to sustain productivity growth, and Directors supported the priority accorded to improving education and training.

Finally, Portugal's recent subscription to the IMF's Special Data Dissemination Standard was welcomed.

Press Information Notices (PINs) are a new series of IMF press notices (see Press Release 97/21). PINs are issued, at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies.

Portugal: Selected Economic Indicators

	1994	1995	1996	1997 1/	1998 1/
Real economy			*Change in percent 2/*		
Real GDP	0.5	2.3	3.3	3.3	3.5
Domestic demand	1.4	2.3	3.3	3.5	3.1
CPI (year average)	5.2	4.1	3.1	2.2	2.3
Unemployment rate (in percent)	6.8	7.2	7.3	6.8	6.6
Gross national saving (percent of GDP)	22.5	24.0	22.7	24.1	24.9
Gross domestic investment (percent of GDP)	25.1	24.7	25.2	26.4	26.9
Public finance			*Percent of GDP*		
Central government balance 3/	-5.1	-4.2	-3.6	-2.7	-2.6
General government balance 3/	-6.1	-5.8	-3.2	-2.9	-2.5
Public debt	64.5	66.6	65.4	63.2	62.5
Money and credit (end-period)			*Change in percent*		
Total domestic credit 4/	11.9	11.9	11.4	15.0	...
L- (M2 + treasury bills held by the nonbank public) 4/	9.5	8.2	9.0	7.4	...
Interest rates (period averages)			*Percent*		
Three-month treasury bill rate 5/	10.5	9.7	7.2	5.4	...
Ten-year government bond yield 5/	11.5	11.5	8.6	6.1	...
Balance of payments			*Percent of GDP 2/*		
Trade balance	-9.5	-8.7	-9.0	-9.0	-9.1
Current account	-2.6	-0.7	-2.5	-2.3	-2.0
Gross official reserves (in US$ billions) 4/ 6/	20.7	21.0	20.8	18.7	...
Reserve cover (months of imports of GNFS) 4/	7.2	5.8	5.3	4.3	...
External debt (US$ billions)	9.5	11.8	11.6	12.0	...
Exchange rates					
Exchange rate regime			Member of ERM		
Present rate (October 22, 1997)			Esc 181.5 per US$		
Nominal effective rate (1990 = 100) 4/	94.7	96.3	96.9	93.4	...
Real effective rate (1990 = 100) 4/	111.4	114.6	115.5	111.9	...

1/ IMF staff projections; unless otherwise noted.

2/ Unless noted otherwise.

3/ Data for 1998 correspond to the draft budget.

4/ July 1997.

5/ Mid-October 1997.

6/ Gold valued at constant prices.