IMMEDIATE ATTENTION

EB/CGATT/83/2

October 4, 1983

To : Members of the Committee on Liaison with the CONTRACTING PARTIES to the GATT

From : The Committee Secretary

Subject: Consultations with the CONTRACTING PARTIES to the GATT--Egypt, Korea, Portugal, and Sri Lanka

The attached memorandum from the staff concerning preparation for forthcoming consultations with the CONTRACTING PARTIES on their consultation with Portugal is submitted for consideration by the Committee. Consultations are also being held with Egypt, Korea, and Sri Lanka, but for these countries no statement by the Fund is expected because these are consultations under the simplified procedures agreed by the CONTRACTING PARTIES. The consultation with Israel has been postponed.

In the absence of objection from a member of the Committee by noon on Thursday, October 6, 1983, the memorandum will be deemed approved by the Committee for submission to the Executive Board for consideration on a lapse-of-time basis.

Att. (1)

Other Distribution:
Members of the Executive Board

October 4, 1983

To : The Chairman of the Committee on Liaison with the CONTRACTING PARTIES to the GATT

From : The Director
Exchange and Trade Relations Department

Subject: Consultations with the CONTRACTING PARTIES to the GATT

The Fund has been invited to consult with the CONTRACTING PARTIES in connection with their consultations with Egypt, Israel, Korea, Portugal, and Sri Lanka. However, the consultation with Israel has now been postponed. The Managing Director has recommended that this invitation be accepted and that Mr. Shailendra J. Anjaria, Chief, Trade and Payments Division, be designated to represent the Fund during the consultations to be held in Geneva during October 10-14, 1983. This recommendation was approved by the Executive Board on September 9, 1983 (EBD/83/230, 9/6/83).

In accordance with procedures set out in EBD/56/102 (8/29/56), it is intended to transmit to the CONTRACTING PARTIES the latest Recent Economic Developments papers on Egypt, Korea, Portugal, and Sri Lanka. It is expected that the CONTRACTING PARTIES will request the Fund's view with respect to Portugal. It is recommended that, in reply to such request, the Fund representative should be guided by the statement set forth below.

Portugal

Following some years of reasonably good performance, there has been a significant deterioration in Portugal's economic performance over the past three years. The restoration of external balance in 1979 encouraged the Portuguese authorities to relax the stance of financial policies in the following year, with the principal objectives of stimulating investment and of securing a recovery in real disposable income. The easier stance of financial policies that ensued, accommodated a rate of growth of real domestic demand in Portugal some 15 percentage points in excess of the OECD average over the period 1980-82. Moreover, the relative inflexibility of interest rate and exchange rate policies during that period reduced incentives for Portuguese residents to hold domestic financial assets, contributing to disguised capital outflows. The adverse impact of these policies on Portugal's external accounts was compounded by external factors. These included a 10 1/2 percent deterioration in the terms of trade between 1979 and 1982, the international recession, high interest rates abroad, and adverse weather conditions, which necessitated a sharp increase in energy and agricultural imports. As a result, the current account of the balance of payments shifted from near equilibrium in 1979 to deficits of US$1,250 million or 5 percent of GDP in 1980, US$2,850 million or 11.5 percent of GDP in 1981, and US$3,240 million or 13.2 percent of GDP in 1982. The growth of real GDP, which had averaged some 5 percent annually during 1976-80, fell to below 2 percent in 1981, but recovered to over 3 percent in 1982. The rate of annual price increase remained considerably above the OECD average, rising to 22 percent in 1982.

The current account deficits over the past three years were financed through substantial external borrowing, mainly by the public sector enterprises. By end-1982, Portugal's external debt had risen to US$13 1/2 billion, of which some US$4 billion was of short-term maturity. The debt service ratio (excluding the rollover of short-term debt) reached 27 1/2 percent in 1982. The deterioration in economic performance in 1982, together with political uncertainties, caused considerable uneasiness in international capital markets in the first half of 1983. Foreign exchange reserves of the Bank of Portugal (excluding gold) declined to less than two weeks' imports, forcing the Bank to request sizable BIS loans secured by gold collateral. During the first half of 1983, Portugal's net foreign assets declined by US$980 million to around US$8 1/2 billion at the end of June 1983, with gold valued at market prices.

Preliminary indications point to a significant improvement in the current account balance during the first half of 1983, with the deficit tentatively estimated at US$1,400 million as compared with US$2,200 million in the first half of 1982. The main factor underlying this improvement was a sharp drop in imports, particularly of oil and agricultural products, associated in part with the difficulties of the public sector enterprises in obtaining external financing. For the whole of 1983, the Fund staff is projecting that the current account deficit will be held at US$2,000 million or 9 percent of GDP, while for 1984 the deficit is projected to decline further to US$1,250 million or around 6 percent of GDP. These projections are based on both an expected recovery in foreign exchange earnings and the containment of import demand, as a consequence of the stabilization program on which the Portuguese authorities have embarked, and in support of which they have requested a stand-by arrangement from the Fund in the upper credit tranches.

The improvement in the external position at which the Portuguese authorities are aiming is to be achieved through a comprehensive policy effort designed to reduce domestic demand and to promote foreign exchange earnings. Steps already taken in this direction include a 12 percent effective devaluation of the escudo on June 22, 1983, a substantial cutback in the public investment program, a wide range of sharp increases in administered prices, including those of essential foodstuffs and of oil products, and the raising of interest rates in August by 2-2 1/2 percentage points following increases of 4-5 percentage points last March. The main contribution to the stabilization effort is to come from fiscal restraint with the combined position of the General Government and of the Supply Fund, which subsidizes essential commodities, targeted to move from a deficit equivalent to 12 1/2 percent of GDP in 1982 to a deficit of 9 1/4 percent in 1983, and to 6 percent in 1984. The improvement in the finances of the General Government is to be complemented by a comprehensive effort to contain the borrowing requirement of the public enterprises. At the same time, monetary policy is to be geared toward securing a scaling down in the rate of growth of the monetary and credit aggregates consistent with the targeted improvement in the balance of payments, and a deceleration of inflation. The rate of inflation is targeted to decline from a peak of 29 percent expected by end-1983 as a consequence of the recent sizable administered price adjustments and of the devaluation, to 20 percent by end-1984.

Faced with a sharp deterioration in the balance of payments in the previous two years, Portugal at the beginning of 1983 raised the 10 percent import surcharge initially introduced in 1975 to 30 percent, pending the introduction of more fundamental adjustment policies. There are also indications of some tightening of the administration of import licences over the past year. The import quota system introduced in 1976 for balance of payments reasons, and the 60 percent import surcharge on less essential products, were retained. The Portuguese authorities have recently embarked on a comprehensive program to bring about a lasting improvement in the external position. The Fund welcomes the commitment of the Portuguese authorities to an open trade and payments system, and in particular their undertaking to roll back the import surcharge to 10 percent, effective January 1, 1984. The Fund hopes that Portugal will reduce further its reliance on trade restrictions for balance of payments purposes as the current stabilization efforts begin to produce results.