EBS/77/100
Supplement 1

CONFIDENTIAL

April 27, 1977

To: Members of the Executive Board

From: The Acting Secretary

Subject: Portugal - Stand-By Arrangement

Attached for the records of the Executive Directors is the text of the stand-by arrangement for Portugal agreed at Executive Board Meeting 77/62, April 25, 1977.

Att: (1)

Stand-by Arrangement - Portugal

1. Annexed hereto is a letter dated April 12, 1977 from the Government of Portugal, setting forth the objectives and policies which the authorities of Portugal will pursue.

2. The International Monetary Fund grants this stand-by arrangement to support these objectives and policies.

3. Portugal will remain in close consultation with the Fund during the period of the stand-by arrangement and, in particular, will consult with the Fund in accordance with paragraph 12 of the annexed letter. These consultations may include correspondence and visits of officials of the Fund to Portugal or of representatives of Portugal to Washington, D.C. For the purpose of these consultations, Portugal will keep the Fund informed of developments in the exchange, trade, credit, and fiscal situations through reports at intervals or dates requested by the Fund.

4. For a period of one year from April 25, 1977, Portugal will have the right, after making full use of any gold tranche that it may have, to purchase from the Fund the currencies of other members in exchange for its own currency in an amount equivalent to SDR 42.4 million. The amounts available in accordance with this paragraph 4 shall be augmented by amounts equivalent to repurchases in respect of purchases under the stand-by arrangement, unless when any such repurchases are made, Portugal informs the Fund that it does not wish the stand-by arrangement to be augmented by the amount of that repurchase.

5. Portugal will pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

6. Portugal will have the right to engage in the transactions covered by this arrangement without further review by the Fund. This right can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally (under Article XIV, Section 1(a)(ii)) or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Portugal. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 6, purchases under this stand-by arrangement will be resumed only after consultation has taken place between the Fund and Portugal, and understandings have been reached regarding the circumstances in which such purchases can be resumed.

7. No later than three years after each purchase of exchange by Portugal under this arrangement Portugal shall repurchase an amount of the Fund's holdings of Portuguese escudos equivalent to the outstanding amount of the purchase. Repurchases shall be made with assets specified by the Fund at the time of the repurchase, in accordance with the Fund's policies and practices at the time of repurchase.

8. The rate of exchange at which Portugal will purchase currencies from the Fund in exchange for the currency of Portugal and at which the Fund will return the currency of Portugal in repurchase operations and made all other computations involving the currency of Portugal will be such rate as the Fund may from time to time determine under Article IV, Section 8, of the Fund agreement.

Annex to Stand-By Arrangement

Banco de Portugal
Lisbon, Portugal

April 12, 1977

Dear Mr. Witteveen:

1. The Government of Portugal hereby authorizes the Banco de Portugal to request of the International Monetary Fund a stand-by arrangement under which the Banco de Portugal will have, for a period of one year, the right to purchase from the Fund the currencies of other members in exchange for escudos up to an amount equivalent to SDR 42.4 million. Before making purchases under this stand-by arrangement, the Banco de Portugal will consult with the Managing Director on the particular currencies to be purchased.

2. The purpose of the request is to support the policies adopted by the Government of Portugal to strengthen the balance of payments position and to create the conditions for the development of the Portuguese economy on a sound basis beyond the program period.

3. In the second half of 1974 and in 1975, Portugal experienced serious economic difficulties caused mainly by the increase in energy prices and ensuing world recession, political and social changes, the granting of independence to its overseas territories, and the barriers erected in certain countries against the admission of Portuguese workers and exports. The decline in output and the sharp increase in the labor force resulted in unemployment which, at the end of 1975, exceeded 10 per cent of the total labor force. Large increases in labor costs and in import prices contributed to inflationary pressures, and the balance of payments, which had traditionally been in surplus, recorded sizable deficits in both 1974 and 1975. Some recovery of production took place in 1976, but the current account deficit of the balance of payments increased further to over US$1 billion and inflation accelerated despite a more moderate rise in wage rates. Unemployment continued to rise, and reached 14 per cent by the end of the year. Official reserves, which represented more than 12 months of imports in 1973, are now down to little more than gold holdings, of which 40 per cent has been pledged for various compensatory borrowings.

4. On December 30, 1976 the National Assembly of the Republic approved the 1977 budget and economic plan presented by the Government. The policies described in these documents, together with the action taken on February 25, to depreciate the escudo by 15 per cent are the mainstay of the Government's program for 1977. This program aims at reducing the deficit of the balance of payments for this year from about US$1 billion to about US$650 million by curbing the growth of consumption and imports and fostering exports. At the same time, a substantial effort is to be made to expand investment on which the country's employment and capacity to export will depend in the future.

5. The budget for 1977 provides for a reduction in the current deficit of the public sector to about three quarters of its 1976 level. A major increase has been provided in budgetary appropriations for public investment designed to arrest the decline in the country's capital stock and reduce

unemployment, and any increase in the overall deficit realized by the Central Government will be due to the growth of public investment. Increases in taxes and social security premiums, decided in 1976 and early 1977, will contribute to this result and the growth of total expenditures will be slowed; salary raises for the civil service will be limited and transfers and subsidies will be reduced. Moreover, in order to contain the financial impact of the budget, the authorities intend that no new expenditure appropriations will be authorized during 1977 unless offsetting tax increases are introduced within the calendar year, no funds will be transferred from the capital budget to the current budget, and no tax collections will be postponed from 1977 to 1978. The budget provides for borrowing Esc 16 billion from the private nonbank sector in 1977. The Social Security accounts will be kept in balance for the current fiscal year, and the autonomous funds will show an overall surplus for the year. The authorities intend to limit the growth of credit from the banking system to the public sector (Central Government, Social Security, autonomous funds and services, and local authorities) in the year ending December 31, 1977, to no more than the Esc 39 billion implied by the 1977 budget. This amount may be raised by Esc 3 billion to allow for the possible introduction of fiscal incentives for investment in the export sector.

6. The growth of money and credit was moderate in 1974 and 1975 as the demand for credit by the private sector remained abnormally low; the growth of credit showed signs of accelerating during 1976. The money stock broadly defined increased by 13 per cent and 18 per cent, respectively, during 1975 and 1976 compared with a growth of nominal GDP at factor cost of 12 per cent in 1975 and nearly 25 per cent in 1976. For 1977, monetary policy will aim at contributing to the improvement in the balance of payments and the price situation while allowing for the desired expansion of investment and exports. The targeted rate of increase of the money supply will be 23 per cent, which would be below that projected for nominal income. The authorities intend, therefore, to limit the increase in total domestic credit of the banking system in the year ending December 31, 1977, to no more than Esc 130 billion, consistent with the targeted improvement in the balance of payments. Furthermore, in order to avoid an excessive utilization of credit by nonviable enterprises, it is intended that the guarantees extended by the Central Government in 1977 will not bring the total amount of guarantees above Esc 70 billion, and that most of the increase would be in support of international borrowing. The authorities have recently increased interest rates for both loans and time deposits by an average of 1.5 percentage points.

7. The recent exchange rate adjustment, added to the effective depreciation of the escudo in the course of 1976 and early 1977, is expected to restore the competitive position of Portuguese products. This improvement will encourage the necessary reallocation of resources toward the export sector and promote import substitution. Together with the intensified effort to expand investment mentioned above and the steps taken to normalize labor relations, this action will provide the foundation for economic growth in the medium term consistent with a more balanced external position. In their efforts to achieve these objectives, the authorities intend to collaborate with the Fund in accordance with the provisions of Article IV, Section 4(a).

8. Real wages declined in 1976 as price controls and food subsidies did not prevent an acceleration of inflation. For 1977, the authorities intend to allow the exchange rate adjustment to produce its desired effect on international competitiveness and domestic employment. Accordingly, the Government has decided to limit increases in salaries to 15 per cent. It is also the intention to allow increases in import prices to be fully reflected in domestic prices with the exception of a few essential products, for which subsidies will be kept within the limits set by the budget. The system of price controls has been revised to allow greater flexibility in its application. As already indicated, budgetary expenditure for price subsidies will be reduced and this reduction will not be offset by allowing a deterioration in the financial position of the Supply Fund.

9. Portugal's external public debt (direct and guaranteed; excluding compensatory borrowings) increased by about 50 per cent from US$426 million at the end of 1973 to about US$640 million at the end of 1976. Obligations of public enterprises, including enterprises brought within the framework of the public sector since 1974, and of the private sector were estimated at around US$1.4 billion at end-1976. Debt service payments in 1977 (excluding any amortization of loans against gold collateral) are estimated at around US$600 million, about 25 per cent of receipts from exports of goods and services in 1976. Much of the debt is short- and medium-term; about three quarters of total repayments are due during the next five years. With the expected improvement in the balance of payments in the period ahead, the Government intends to slow the rate of increase of the external debt and to strengthen the maturity profile by reducing reliance on financing with maturity of five years or less, insofar as availability of longer-term official development loans and conditions in international financial markets allow. The authorities will therefore monitor carefully overall external debt developments and the Treasury will coordinate borrowing by public sector entities. The contracting of supplier credits will be subject to authorization by the Banco de Portugal so as to avoid excessive increases in such borrowing and bunching of maturities. The authorities are instituting a comprehensive debt registration system to be centralized in the Banco de Portugal.

10. Despite the deterioration of the external account since 1974, all bona fide payments and transfers for current international transactions have continued to be authorized. However, the standard travel allocation of foreign exchange has been progressively reduced. Importers of capital equipment goods are now required to arrange for foreign financing in order to qualify for domestic bank credit. Foreign exchange budgets are specified for transactions of the Central Government, and indicative exchange budgets for government agencies charged with importing essential foodstuffs, fuel, and raw materials. In May 1975, Portugal introduced a temporary import surcharge on about 30 per cent of total imports. Exemptions were provided for in cases of items essential for domestic production. In October 1976, in view of the further deterioration of the balance of payments, the rates of surcharge were raised to 60 per cent on about 1.3 per cent of imports and 30 per cent on about 28 per cent. A proposal currently before the Parliament would increase the coverage of the 60 per cent surcharge to about 2.3 per cent of total imports. An import deposit requirement of 50 per cent, to be blocked without interest for six months, was applied to about 7.5 per

cent of import items within the group already subject to the surcharge. In February 1977, Portugal introduced temporary value quotas on some 6 per cent of imports, including automobile components, household appliances, coffee, and bananas. The 1977 quotas are equal to average imports for the years 1975 and 1976, but may be enlarged by the amounts of increased exports of certain of the manufactured goods involved. The Portuguese authorities intend to eliminate the import deposit requirement and to review the quantitative restrictions with the Fund before the end of 1977. The import surcharge will be phased out gradually as soon as the balance of payments position permits.

11. During the period of the proposed stand-by arrangement, the Government does not intend to introduce any multiple currency practices or impose new or intensify existing restrictions on payments and transfers for current international transactions or enter into any bilateral payments arrangements with Fund members or to introduce new or intensify existing restrictions on imports for balance of payments reasons.

12. The Government believes that the policies set forth in this letter are adequate to achieve the objectives of the program but will take any further measures that may become appropriate for this purpose. During the period of the stand-by arrangement, Portugal will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of Portugal or whenever the Managing Director advises that consultation on the program is desirable. In any case, Portugal will consult with the Fund before the end of the program period.

Sincerely yours,

/s/

Dr. Medina Carreira
Minister of Finance

Dr. Jose da Silva Lopes
Governor
Banco de Portugal