EBS/78/228
Supplement 2

CONFIDENTIAL

June 6, 1978

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 78/81, June 5, 1978.

Att: (1)

Stand-By Arrangement - Portugal

1. Annexed hereto is a letter dated May 8, 1978 from the Minister of Finance and Planning and the Governor of the Bank of Portugal setting forth the objectives and policies which the Portuguese authorities 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 paragraphs 18 and 20 of the letter. These consultations may include correspondence and visits of officials of the Fund to Portugal or of representatives of Portugal to the Fund. For the purposes of these consultations, Portugal will provide the Fund, through reports at intervals on dates requested by the Fund, with such information as the Fund requests in connection with Portugal's objectives and policies set forth in the annexed letter.

4. For a period of one year from June 5, 1978, Portugal will have the right, after making full use of any reserve tranche that it may have at the time of making a request for a purchase under the stand-by arrangement, to make purchases from the Fund in an amount equivalent to SDR 57.35 million, provided that

(i) purchases under the stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 14.35 million until July 1, 1978; the equivalent of SDR 24.35 million until October 1, 1978; the equivalent of SDR 34.35 million until January 1, 1979; and the equivalent of SDR 44.35 million until April 1, 1979; and

(ii) the right of Portugal to make purchases under this stand-by arrangement shall be subject to paragraph 19 of the letter of intent to the extent that such purchases would increase the Fund's holdings of escudos beyond the first credit tranche.

If at any time any limit in (i) above would prevent a purchase under the stand-by arrangement that would not increase the Fund's holdings of escudos beyond the first credit tranche, the limit will not apply to that purchase.

5. Purchases under the stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in special drawing rights if, on the request of Portugal, the Fund agrees to provide them at the time of the purchase. Purchases shall be made in exchange for escudos.

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

7. Subject to paragraph 4 above, Portugal will have the right to engage in the transactions covered by this stand-by 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 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 7, 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.

8. (a) Repurchase of the outstanding amount of escudos that results from a purchase under this arrangement and is subject to charges under Article V, Section 8(b):

(i) may be made at any time;

(ii) will be expected normally as the balance of payments and reserve position of Portugal improves;

(iii) shall be made in accordance with the representation of the Fund if, after consultations with Portugal, the Fund represents that under its policies at the time of the repurchase Portugal should repurchase because of an improvement in its balance of payments and reserve position; and

(iv) shall be completed five years after the date of the purchase, provided that the repurchase shall be made in equal quarterly installments during the period beginning three years and ending five years after the date of the purchase unless the Fund approves a different schedule.

(b) Any reductions in escudos held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) Repurchase shall be made with special drawing rights, or with the currencies specified by the Fund at the time of the repurchase in accordance with the policies and procedures of the Fund at the time of the repurchase.

Annex to Stand-By Arrangement

Lisbon, Portugal
May 8, 1978

Dear Mr. Witteveen,

1. The pressures on Portugal's balance of payments have continued strong this past year, as internal and external disequilibria proved considerably more intractable than had earlier been expected, complicated as they are by serious structural maladjustments in the economy. In fact, it is mainly through a policy directed to overcome these structural problems of the economy that the external imbalance can be controlled on a more permanent basis. A medium-term strategy to restructure and increase productivity in industry and modernize agriculture will be implemented by the authorities to achieve that aim.

2. Meanwhile a substantial stabilization effort is clearly called for to provide a solid foundation for long-term economic reconstruction and development in Portugal. Accordingly, the Government of Portugal authorizes the Banco de Portugal to request a stand-by arrangement from the Fund, under which the Banco de Portugal will have for a period of one year the right, after making full use of any reserve tranche it may have, to purchase from the Fund the currencies of other members in exchange for escudos up to an amount equivalent to SDR 57.35 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.

3. The purpose of this request is to support the stabilization program recently adopted by the Government of Portugal, to strengthen the balance of payments and reduce inflationary pressures while maintaining a positive rate of growth of the economy to keep unemployment in check. These objectives are to be achieved through fiscal, monetary, and wage restraint combined with an exchange rate policy as outlined below. By these means the external current account deficit is to be reduced from about US$1,500 million in the period April 1977-March 1978 to about US$1,000 million in the period April 1978-March 1979. Net non-monetary capital inflows are expected to increase from US$150 million to US$200 million. This improvement in the external balance is to provide the main source of economic growth in the program period.

4. After a decline in real gross domestic product of nearly 4 per cent in 1975, the Portuguese economy recovered sharply in 1976, with real growth estimated at close to 6 per cent. It is estimated that a comparable expansion was achieved in 1977, despite a major decline in agricultural production. A shift of resources from consumption to investment and exports accompanied that expansion. Nevertheless, unemployment remained at about 7 per cent of the labor force at end-1977. At the same time, the rate of wage increases which moderated substantially in 1976 declined further in 1977, in line with the ceiling of 15 per cent placed upon it by law. Real wages appear to have been reduced in the course of 1977 by at least 7 per cent, as the rate of domestic price increases accelerated in late 1976, peaking at a very high level in May 1977 before moderating somewhat later in the year.

5. Despite the depreciation of the escudo in February 1977 and the maintenance of some import restrictions, a continued high rate of increase in domestic demand, due to the recovery of production and investment and the speculative accumulation of stocks, contributed to a further increase in the trade deficit to US$2,530 million in 1977. This deterioration was offset to some extent by significant increases in tourist receipts and emigrants' remittances, but not by enough to keep the current account deficit from rising from US$1,244 million or some 8 per cent of GDP in 1976, to US$1,495 million or about 9 per cent of GDP in 1977. The overall deficit rose from US$1,268 million to US$1,462 million, largely financed by compensatory borrowing and the use of gold reserves. As commercial banks also increased their foreign liabilities, the net foreign assets of the banking system turned negative in early 1977, if the official reserves of gold are valued at the traditional price.

6. The Government considered it appropriate, after an initial effective depreciation of 4 per cent in late August 1977, to move to a crawling peg system for the escudo. Thus, the effective rate depreciated by a total of 14.3 per cent in the 12 months through April 1978. A further adjustment of 7.0 per cent in the effective exchange rate was made in early May 1978. The authorities intend to continue the policy of the crawling peg. Exchange rate policy will in future be guided by the Government's decision not to allow the net foreign liabilities of the banking system, which stood at US$1,352 million on December 31, 1977, to exceed US$1,922 million on June 30, 1978; US$2,092 million on September 30, 1978; US$2,297 million on December 31, 1978; and US$2,457 million on March 31, 1979.

7. The authorities are determined to reduce inflationary pressures despite the prospective shift of resources to the external sector. Accordingly, to limit unnecessary pressure on the external value of the escudo, interest rates were raised in both February and August 1977. The Government decided on further substantial increases in May 1978, when the discount rate of the Banco de Portugal was raised from a range of 13-18 per cent to a range of 18-23 per cent. Interest rates on time deposits were raised by 4 percentage points to levels of 19 per cent and up on deposits of six months or more. Basic lending rates were raised 3.5 percentage points, but those for housing by only 1-2 percentage points, and those for agriculture, exports and priority investments by 2-3 percentage points, so as to minimize the impact of credit restraint on these vital sectors. The authorities consider these rates necessary for the present to check increases in the velocity of money, speculation in stocks, or adverse capital movements. They intend to raise or lower them in response to changing circumstances.

8. Monetary policy is designed to contribute substantially to the prospective improvement in the external balance and to the containment of inflation. By the close of 1977, the rate of domestic credit expansion had reached 34.5 per cent of the initial money stock, substantially exceeding the rate of growth in the money stock itself, before moderating to 32 per cent in the year ending March 1978. On average, the money stock grew by 22 per cent in 1977 compared with a 33 per cent growth in nominal GDP, but is expected to be reduced to about 18 per cent against an anticipated growth in nominal GDP of

about 27 per cent in the year to March 1979. Taking this into account along with the target for the balance of payments, net domestic credit of the banking system, the total of which amounted to Esc 654.0 billion on December 31, 1977, will not be permitted to exceed Esc 701.6 billion on or before June 30, 1978; Esc 738.6 billion on or before September 30, 1978; Esc 795.7 billion on or before December 31, 1978; and Esc 811.4 billion on or before March 31, 1979. The resulting increase in net domestic credit in the program year is estimated at about 23 per cent of money stock at the beginning of the period.

9. To give effect to these limits, the authorities have introduced indicative credit ceilings on individual banks and are prepared to make them mandatory should the need arise. To tighten credit control, domestic bank lending in escudos but denominated in foreign currencies has been included under the ceilings. More fundamentally, however, the monetary authorities intend to keep the development of the monetary base under close and continuous scrutiny and have set the following indicative targets for the program year: Esc 143.6 billion by June 30, 1978; Esc 143.6 billion by September 30, 1978; Esc 151.0 billion by December 31, 1978; and Esc 149.2 billion by March 31, 1979. To ensure that these limits are kept, the monetary authorities have gradually reduced rediscount quotas and introduced an uniform reserve requirement of 7 per cent on all monetary deposits, with the result that the banks' liquidity position has already become very tight. Finally, interest rates are being managed flexibly. Recent increases will help contain the demand for domestic credit and thus minimize the need for credit rationing.

10. A further contribution to domestic stabilization will come from fiscal restraint. A significant reduction in the deficit of the public sector was achieved in 1977, taking it down from 11 per cent of GDP in 1976 to 8 per cent in 1977, mainly in consequence of tax increases and the containment of public consumption. This improvement is to be consolidated in 1978 on the basis of the budget recently passed by Parliament. New tax measures have been authorized to raise revenues by the equivalent of 2 per cent of GDP over what they would otherwise have been. In addition, the administered price increases referred to in paragraph 12 below, will serve to limit the need for subsidies to state trading agencies and public utilities and corporations. After allowance for normal underspending, a surplus in the current account of the public sector will be achieved for the first time since 1974. There is still to be a rise in real capital expenditures, resulting mainly from an increase in equity capital subscriptions to public enterprises. Although the overall deficit of the public sector will thus remain unchanged in nominal terms, it will decline further in relation to GDP to 6 per cent in the year to March 1979.

11. The authorities intend to take every precaution to ensure that these budget outturns are realized. The revenue effort will be supplemented as necessary to make up for any revenues lost as a result of the phasing out of the import surcharge referred to in paragraph 15 below. Furthermore, any revenues from existing taxes that may exceed budgeted amounts will be used to reduce the public sector deficit and not to finance additional expenditures. Finally, during the period of the stand-by arrangement, the use of government securities to discharge tax obligations will be limited to arrears in direct taxes prior to 1977, as presently permitted by law. Thus, after allowing for other sources

of finance, the net claims of the banking system on the public sector, the total of which amounted to Esc 129.8 billion on December 31, 1977, will not be permitted to rise above Esc 143.8 billion on or before June 30, 1978; Esc 148.8 billion on or before September 30, 1978; Esc 166.8 billion on or before December 31, 1978; and Esc 183.8 billion on or before March 31, 1979.

12. To take account of increasing costs and to moderate the need for government subsidies, certain administered prices were increased substantially in April of this year. Utility rates for water, electricity and gas as well as transportation prices were raised by 35-50 per cent, while the prices of essential food products, which had been frozen since February 1977, were raised by more than 20 per cent. To ease the adjustment, the minimum wage, which had remained unchanged since January 1977, was raised by approximately 30 per cent, unemployment benefits were increased by about 25 per cent, and pensions were raised by up to 22 per cent. To help contain cost increases in the future, however, wage policy will have to remain firm, and legislation was therefore passed in April of this year limiting increases in contractual wages to 20 per cent in 1978, and requiring a minimum contract period of 12 months. Legislation was also passed in August 1977 allowing firms in financial distress to suspend wage contracts if their work force concurs.

13. Portugal's external medium and long-term debt, excluding obligations of the banking system, increased from US$1,125 million at the end of 1975 to US$1,469 million at the end of 1976 and further to US$1,848 million at the end of 1977. Most of this is either guaranteed by the Government or an obligation of public enterprises, including enterprises brought within the framework of the public sector since 1974, but not officially guaranteed. The ratio of debt service payments to exports of goods and services is estimated at 15 per cent in 1977 and is expected to rise to 19 per cent in 1978. In addition, short-term private debt has risen from US$145 million at the end of 1976 to US$717 million at the end of 1977. The Government will seek to avoid any further increase in such short-term debt during the program year. It will strengthen its efforts to avoid excessive external indebtedness and to improve the maturity profile, by continuing its policy of monitoring overall external debt developments and of coordinating foreign borrowing by public sector agencies and enterprises. Particular attention will be paid to limiting external borrowing to the financing of productive investment projects.

14. All imports are effected on the basis of import bulletins, which for imports not subject to quantitative restrictions serve a statistical purpose and enable the importer to obtain the necessary foreign exchange. For imports subject to restrictions, the bulletin is equivalent to an import license. Import bulletins are normally issued without delay. However, in late 1977 the process of authorizing import bulletins was subject to some delays, partly in conjunction with the introduction of new administrative procedures. As a result, a backlog of applications has been built up and the Government is seeking, in cooperation with private sector importers, to devise means of eliminating this problem. Already, the Government decided on May 2, 1978, that thenceforth all applications for imports of raw materials and intermediate goods would be

authorized automatically. It is the intention of the Government that this automatic procedure will be extended, no later than June 30, 1978, to all other categories of imports not subject to quantitative restrictions, and that by the same date, the backlog of import applications will have been fully eliminated.

15. The Government of Portugal abolished its import deposit requirement at the end of 1977, but still imposes an import surcharge of 30 per cent on the value of items covering about 29 per cent of total imports in 1976, and one of 60 per cent covering 2 per cent of 1976 imports. The 30 per cent surcharge will be phased out gradually: effective October 1, 1978 the rate will be reduced to 20 per cent; further to 10 per cent effective April 1, 1979; and fully abolished effective October 1, 1979. The 60 per cent import surcharge, applicable mostly to luxury goods, will be maintained temporarily, but the Government intends to study alternative domestic tax measures with a view to phasing it out beginning in 1979.

16. The temporary value quotas for certain consumer goods, applicable to about 4 per cent of 1976 imports, have been raised with effect from April 1, 1978 to an annual rate of Esc 3.405 billion, which is equivalent in foreign exchange terms to the value of these quotas in the year to March 1978. The value quotas for knocked-down automobiles, applicable to about 2.8 per cent of 1976 imports, remain unchanged in 1978 at their escudo level of 1977. All import quotas are strictly temporary and the Portuguese Government intends to review them with the Fund before the end of January 1979 with a view to reaching understandings with the Fund about steps to reduce or eliminate the restrictiveness of these quantitative import restrictions in 1979.

17. The Government establishes an annual foreign exchange budget for its own operations as well as foreign exchange budgets for the various state agencies in charge of monopoly imports of certain basic commodities, primarily foodstuffs. These budgets are, however, only indicative and the Government intends to amend these budgets from time to time so as to avoid restricting imports through rationing of foreign exchange. The Government of Portugal does not intend to introduce any multiple currency practices, or any new restrictions, or intensify existing ones, on payments and transfers for current international transactions, or to conclude any new bilateral payments agreements with the Fund members, or to introduce restrictions, or intensify existing ones on imports for balance of payments reasons.

18. Given the many uncertainties of the international and domestic economic situation, it is the intention of the Government to review the evolution of the program in January 1979 and on that occasion to reach such understandings with the Fund as may be necessary.

19. During any period of the stand-by arrangement in which the ceilings on net foreign liabilities of the banking system in paragraph 6, or the credit ceilings in paragraph 8, or the ceilings on government borrowing in paragraph 11 are not observed, or the intentions in the last sentence of paragraph 14, in the penultimate sentence of paragraph 15, and in the ultimate sentence of paragraph 17, are not carried out, or during any period after

January 1, 1979 in which understandings have not been reached with the Fund as indicated in the ultimate sentence of paragraph 16 and in paragraph 18, the Banco de Portugal will not request any purchases under the stand-by arrangement which would raise the Fund's holdings of its currency beyond the first credit tranche, except after reaching understandings with the Fund regarding the circumstances in which such purchases may be made.

20. The Government of Portugal 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, the Government will consult with the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 19 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the stand-by arrangement and while any Fund holdings of escudos above the first credit tranche include currency resulting from purchases under the stand-by arrangement, the Government will consult the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Portugal's balance of payments policies.

Sincerely yours,

Dr. Vitor Constancio
Minister of Finance
and Planning

Dr. Jose da Silva Lopes
Governor
Banco de Portugal