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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/153

10:00 a.m., October 26, 1990

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
M. Al-Jasser	Z. Iqbal, Temporary
G. K. Arora	
C. S. Clark	G. C. Noonan
	Chen M., Temporary
T. C. Dawson	S. B. Creane, Temporary
J. de Groote	
E. T. El Kogali	L. B. Monyake
E. A. Evans	S.-W. Kwon
	M. Hepp, Temporary
L. Filardo	R. Marino, Temporary
R. Filosa	
M. Finaish	
M. Fogelholm	I. H. Thorláksson
	O. Kabbaj
G. Grosche	
J. E. Ismael	
A. Kafka	
J.-P. Landau	J.-F. Cirelli
Mawakani Samba	C. V. Santos
	P. Wright
	G. P. J. Hogeweg
K. Yamazaki	S. Yoshikuni

C. Brachet, Acting Secretary
C. P. Clarke, Assistant

Also Present

IBRD: K. Ikram, Asia Regional Office. African Department: E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; E. M. Taha. Asian Department: P. R. Narvekar, Director; K. H. Lee. European Department: M. Guitián, Deputy Director; C. Cottarelli, T. Krueger, L. E. Molho, G. C. Pastor, E. Spitäller. Exchange and Trade Relations Department: J. T. Boorman Director; E. Brau, Deputy Director, J. Pujol. Legal Department: P. L. Francotte, R. B. Leckow. Middle Eastern Department: I. H. Lee. Research Department: J. A. Frenkel, Economic Counsellor and Director. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; K. S. Friedman, B. R. Hughes, M. J. Papin, S. L. Yeager. Western Hemisphere Department: S. T. Beza, Counsellor and Director. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. O. Aderibigbe, M. B. Chatah, A. Gronn, J. M. Jones, J.-L. Menda, P. O. Montórfano, A. Napky, P. Péterfalvy, F. A. Quirós, A. Raza, H.-J. Scheid, S. P. Shrestha, A. M. Tanase. Assistants to Executive Directors: H. S. Binay, G. Bindley-Taylor, C. Björklund, T. T. Do, S. K. Fayyad, B. R. Fuleihan, O. A. Himani, K. Ichikawa, M. E. F. Jones, G. Montiel, F. Moss, M. Mrakovcic, M. Nakagawa, D. Saha, C. Schioppa, M. J. Shaffrey, C. M. Towe.

1. PORTUGAL - 1990 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1990 Article IV consultation with Portugal (SM/90/168, 8/20/90). They also had before them a background paper on recent economic developments in Portugal (SM/90/179, 9/7/90).

The Deputy Managing Director was in the chair.

The staff representative from the European Department commented that apparently economic activity was even stronger in 1990 than was shown in Table 1 of the staff report; it was easily possible that growth in demand might exceed 5 percent, and GDP growth might exceed 4 percent. Inflation was also stronger, owing to the oil price effect. The current rate of inflation was approximately 13.5 percent, although it was expected to slow to 13 percent by the end of the year, leading to an expected average for 1990 of roughly 13 percent.

Under the 1991 budget, the targeted reduction of the fiscal deficit to 6.5 percent was consistent, in the view of the authorities, with the 6 percent deficit that they targeted as a first step in the realization of their medium-term objective to reduce the deficit to 3 percent by 1995, the staff representative continued. The differential of half a point was attributable to the effect of the oil price increase on real growth and the GDP deflator. Consequently, while the authorities had not accommodated the oil price increase--both expenditures and revenues remained unchanged relative to their levels before the oil price increase--and given the effect of the oil price increase on nominal GDP, the deficit would likely widen to 6.5 percent in 1991. For 1990, the deficit was expected to be smaller than the 7.5 percent shown in Table 1.

On incomes policy, the authorities planned to take into account recent developments on the inflation front, the staff representative noted. The inflation objective that was to be the guiding rate for agreement on contractual wage increases would be adjusted in line with revisions to the inflation forecasts for the year as a whole.

The transition to indirect monetary control was discussed in the staff report, the staff representative from the European Department said. In that connection, efforts were underway to ensure that the transition would begin in early 1991.

Mr. Filosa made the following statement:

> First of all, I would like to express my deep appreciation for the quality of the staff's analysis and advice. Indeed, the staff report clearly highlights the striking progress achieved by the

Portuguese economy since our last consultation, as well as the challenges to be faced in view of my authorities' determination to contribute significantly to the ongoing process of European integration.

I will now comment on the progress that has been made, beginning with macroeconomic performance. During the last two years, Portugal has continued to out-perform its European partners on a number of fronts. The rate of growth in 1989 exceeded the average rate of growth in the EEC by more than 2 percentage points. Even more noticeable are the results achieved in the field of employment. Here, Portugal has managed to achieve a rate of unemployment which, at only 5 percent of the labor force in 1989, is almost half the EEC average rate. Furthermore, the good performance on the front of employment has not prevented Portugal from achieving substantial productivity gains; in fact, over the 1980s productivity has increased in excess of 20 percent. Nor has the declining rate of unemployment caused undue pressure on wages, which have shown a good degree of flexibility in real terms and only moderate increases in nominal terms.

But what is most noticeable in the case of Portugal is the establishment of a sort of virtuous circle between improvements in the internal economic conditions of the country and its increasing integration into the world economy. In fact, the positive effects of the dwindling productivity gap with its main trade partners, and the favorable evolution of real wages have allowed Portugal to achieve consistent gains in world market shares and to fully exploit the opportunities offered by participation in the EEC.

Of course, the substantial increase in productivity could not have been achieved without the increased flow of foreign direct investment, which in 1989 was almost nine times as large as the flow recorded in 1984. In turn, such a large increase in foreign investment could not have taken place in the absence of the favorable evolution of real wages, the wide-ranging process of structural reforms undertaken by the authorities, and the generally good climate in industrial relations prevailing in the country.

It is important to note that the large flow of foreign direct investment will exert positive effects not only on real variables, but also on the structure of the external position of Portugal. In fact, the large inflow of foreign direct investment, which occurred in 1989 has played a major role in allowing Portugal to finance its current account deficit, to secure a substantial accumulation of foreign exchange reserves, and to prepay large amounts of external debt--the ratio to GDP of which has declined from the peak of 80 percent reached in 1985 to the value of 39 percent in 1989. Also, the increase in external assets and the reduced external financial liabilities will allow Portugal to obtain much better terms on its foreign borrowing, and the higher share of foreign direct investment in total external liabilities will decrease the vulnerability of Portugal to external financial shocks, while increasing the flexibility of its balance of payments in the event of real downturns.

Progress in the macroeconomic field has gone in parallel with substantial progress in the implementation of a wide-ranging program of structural reforms. Important structural reforms have been undertaken in four main fields, namely, public enterprises restructuring and privatization, tax system, budgeting procedures of the state, and liberalization of the exchange system.

Regarding privatization, it must be recalled that since 1987 the Ministry of Industry has been implementing a strategy of industrial restructuring for the enterprises under its own supervision. In this mainstream, the authorities, under the centralized supervision of the Ministry of Finance, initiated in 1989 an ambitious privatization program to be completed by 1994. The program, which will affect most public enterprises, aims at restructuring the enterprises concerned, reducing the role of the State in the economy, and developing a modern capital market. The gross proceeds of the whole privatization program have been calculated to exceed Esc 1 trillion at current prices, which will be devoted to withdrawing public debt and to recapitalizing the remaining public enterprises. The initial phases of the privatization program have been successfully concluded, and Esc 70 billion worth of shares have been sold to the public so far. Much of the success must be ascribed to the well-defined rules and procedures set for the operations, as well as to the general political consensus on the program. In 1990, the program will be carried out with five more privatizations, which should yield another Esc 70 billion.

The important tax reform and the reform of the budgeting procedures for the state and public accounting, undertaken in 1989 and in 1990, respectively, will significantly contribute to improving the management of fiscal policy. The tax reform has introduced a new comprehensive system of personal income taxation, which has widened the tax basis and reduced the possibilities of evasion. The reform of the budgeting procedures for the state and public accounting has instituted the requirement of non-negative primary balances, and will make possible a more flexible use of budget funds at the level of each ministry. In this light, a Treasury Reform Commission was appointed in June with the responsibility of proposing and implementing the necessary measures. The reform, by concentrating the responsibility for all public debt issues under the Treasury's administration, will contribute to improving the management of public debt and reducing the overall cost of borrowing.

Finally, in the framework of the European monetary unification process, Portugal has accelerated the pace of dismantling controls on capital outflows. The recent controls on inflows should be seen only as a temporary measure.

I will now address the challenges facing my authorities, starting with the macroeconomic goals. My authorities have set three major medium-term goals for Portugal. First of all, they intend to achieve a more balanced fiscal situation. Secondly, they are determined to reduce inflation and, thirdly, they intend to participate in the exchange rate mechanism of the European Monetary System (EMS) as soon as possible. To achieve these important goals my authorities are already implementing a new mix of fiscal, monetary, and exchange rate policies, which duly takes into account the need to absorb, rather than accommodate, the negative effects on prices of the recent oil shock.

Regarding fiscal policy, estimates of the fiscal outturn for 1990 indicate that some improvement in the public accounts has already taken place. In fact, the estimated consolidated primary surplus and the consolidated deficit--1.3 percent and -7.5 percent of GDP, respectively--have improved compared with the values indicated in the 1990 budget--1.2 percent and -7.8 percent of GDP, respectively.

For 1991, the authorities intend to accelerate this trend. On the basis of a rate of growth of GDP equal to 3.5 percent and an inflation rate of 10.5 percent, the 1991 budget aims at achieving a primary surplus of 2.5 percent of GDP and a consolidated deficit of -6.5 percent. On the revenue side, the budget envisages an increase in excise taxes on tobacco and alcohol, the reduction in the number of items subject to a zero value-added tax (VAT) rate, but no increases in personal tax rates. Therefore, the increase in the direct tax to GDP ratio from 8.4 percent to 9.4 percent will come from improved tax administration after the 1989 reform, as well as from higher revenues from the capital income tax. On the expenditure side, a decrease in absolute terms of subsidies and an increase in capital expenditure have been programmed. The increase in current expenditure due to the implementation of the new salary scheme for the Civil Service will not compromise the effort of containing the public deficit. The general improvement in the fiscal situation will be reflected in lower financing needs of the consolidated public sector, which will decline from 9.6 percent in 1990 to 7.2 percent of GDP in 1991, thus facilitating the task of monetary policy.

Regarding monetary policy, my authorities intend to rely increasingly on indirect methods of monetary control. In this light, credit ceilings were abandoned in March in favor of an indicative system for the expansion of bank credit. This new, transitional system will be soon replaced by a system more fully based on the use of indirect instruments. My authorities are fully aware that the efforts to sterilize the effect on liquidity of the massive inflow of capital from abroad are having unwanted effects on the profits of the Central Bank. In order to address this problem, they envisage absorbing the excess liquidity of the banking system by selling Esc 855 billion of public debt to the banking system. With the proceeds of this sale, the Government will prepay the old public debt owned by the Bank of Portugal. My authorities will also place with the credit institutions an additional ESC 211 billion worth of public debt. The proceeds will finance the prepayment of external public debt.

It is clear, however, that the problem of excessive capital inflows cannot be resolved without revising the policy of allowing a constant depreciation of the exchange rate. In fact, the imposition of restrictions on capital inflows cannot be but a temporary measure. The new exchange rate policy envisages that the fluctuation of the escudo would take place within a band defined in terms of a basket of European currencies. It should be noted that the width of the band will not be announced to the public and that the authorities are ready to accept some temporary appreciation, also in nominal terms, of the escudo. Apart from the obvious advantage of increasing the scope for an independent interest rate policy, the new exchange rate policy will prepare the ground for the participation of Portugal in the exchange rate mechanism of the EMs. In fact, the new policy will greatly facilitate the task of setting the bilateral rates in the ERM. Furthermore, under the new policy, the exchange rate might be used as an anti-inflationary weapon, thus favoring the convergence of inflation toward the European average. My Portuguese authorities share the European view that the exchange rate is capable of exerting substantial discipline on price and wage setting. In this last regard, I would like to stress that the objective of achieving an average inflation rate of 10.5 percent in 1991 should not be regarded as overambitious, as the objective is duly supported by an appropriate mix of fiscal, monetary, and exchange rate policies. Nor is the pact between the Government, the trade unions and the industrialists, achieved last week on wages and pensions, inconsistent with the inflation objective. In fact, the increase in real wages brought about by the 13.5 percent average increase in nominal wages will be offset by productivity gains.

The efforts of the authorities in the field of structural reforms will be basically devoted to completing the various reforms undertaken in the past. The privatization program will continue in 1991 with an estimated amount of sales equal to Esc 290 billion. Similarly, the implementation of the Second EEC Banking Directive will be completed by January 1, 1993. The authorities will also seek more flexibility in the use of EEC funds.

Mr. de Groote made the following statement:

Let me first commend the Portuguese authorities for the outstanding economic results achieved last year: an even more rapid real GDP growth than in 1988, with a better balance between consumption and investment and with the foreign sector contributing positively; the current account deficit halved, despite the terms of trade deterioration; and a declining unemployment rate combined with strong productivity gains and a general wage moderation. It goes without saying that accession to the EC has had an important bearing on this outcome. In this regard, I would like to stress that the Portuguese experience suggests that the peripheral areas of a common market should not fear becoming marginalized, but instead have the opportunity to catch up, provided of course that the necessary policy adjustments are put in place and sufficient financing is made available. Portugal offers a fine example in this context.

This does not mean, though, that all problems have been taken care of, or that an unchanged policy stance will result in a smooth narrowing of the gap in living standards between Portugal and its EC neighbors. On the contrary, constant vigilance is being called for, and at this very moment this is clearly the case on the inflation front. The inflation target will most probably not be met for the third consecutive year, the inflation rate itself has been on the rise for the last three years, and, more importantly, the inflation differential with the EC partners is widening again. This points to a deeper-rooted problem, which a tight monetary policy has not been able to address on its own. The staff rightly stresses the importance of fiscal restraint and even suggests some further help from incomes policies.

Together with the staff, I am convinced of the necessity of a tighter fiscal policy stance to address the problem of inflation in Portugal. It is a pity that the way toward a withdrawal of fiscal stimulus, on which the authorities now agree, could not have been prepared in 1990 by a neutral fiscal stance. Instead, the 1990 budget has imparted a considerable stimulus to the Portuguese economy, with a deficit increase--resulting solely from the expenditure side--of almost 3 percentage points in terms of GDP. Reversing this situation will call for budget revenue- increasing, as well as expenditure-reducing, measures. While accepting that there is room for indirect tax increases, I would like to caution against a too outspoken use of this instrument. Indeed, not only will it give rise to further inflationary pressures, albeit only in 1991, but it will also fail to bring the composition of budget revenues more in line with the EC average. I would like to recall here that Portugal already draws relatively higher receipts from indirect taxes than its EC partners, whereas receipts from social security contributions and from direct taxes are significantly below the European average. In the same vein, I am somewhat surprised to find that the staff's medium-term adjustment scenario seems to hinge on a deficit reduction arrived at primarily by way of increasing indirect taxes. I would like the staff to comment on this, as well as on another aspect of their medium-term scenario, namely, the slower real growth rate of exports in the non-adjustment scenario compared with the adjustment scenario. This is the opposite of what the Quantum scenario generates, where one finds a higher real growth rate of exports under conditions of nonadjustment.

Turning back to the fiscal policy issue, I believe deficit reduction should be brought about equally by expenditure restraint, and I am reinforced in this belief by a number of arguments. First, there is the fact that interest payments on public debt will continue to rise, which implies that other expenditures need to be contained if the total is to be held constant. This rise in interest payments was masked in 1989 by a fortunate combination of a declining implicit nominal interest rate on domestic debt and increasing inflation, yielding a negative real rate. The withholding tax on treasury bills now having risen to 20 percent, and the greater awareness of inflation being on the rise again, will increase the interest payments bill for the government. I am wondering in this context if the move toward a higher withholding tax, which is, moreover, diverging from the EC average, will not have negative repercussions, since depositors are not being compensated for this by higher gross offered rates and private creditors continue to look abroad for loans. What will happen if private Portuguese investors are finally allowed to look for the best opportunities in Europe once the EC capital market liberalization directive is fully adhered to by Portugal?

A second reason why I would urge for more government expenditure restraint is that it could create an appropriate climate for more moderate civil service wage increases. If my interpretation of the facts is right, it seems that public sector wage settlements in the past have, moreover, had a clear demonstration effect on private sector wage demands, contributing to further inflationary pressures as well as creating tensions in the Tripartite Council of Social Bargaining. These tensions in turn have restrained the room for maneuver for an effective incomes policy. It is clear that incomes policy cannot be done away with if one wants to realize a rapid and durable reduction of inflation in Portugal.

A third reason for restraining government expenditure growth is that it will force a scaling back of public investment not related to EC transfers. In this way it could be better assured that the EC-related public investment program, which will remain substantial over the medium term, does not surpass the absorptive capacity of the Portuguese economy and that investment will be directed to projects which offer a reasonable rate of return. Apart from fiscal policy restraint, which needs to be complemented with incomes policy, a subject which I have already touched upon, the fight against inflation will have to be supported by nonaccommodative monetary and exchange rate policies. I do not plan to go over this part at very great length, since this issue and the problems that it involves for Portugal have been exposed so clearly by the staff. Allow me to touch upon just two themes relating to monetary and exchange rate policy, respectively.

Concerning monetary policy, it is worth stressing that indirect monetary control procedures require swift reactions from agents acting in well organized competitive markets of a sufficient size. The removal of direct controls in Portugal should, therefore, be followed by structural policy measures to arrive at the establishment of such a financial market environment. This will ensure, for instance, that a tight monetary policy is also reflected in deposit rates, whereas now in Portugal it has contributed only to a rise in lending rates, yielding an unwarranted large spread and sizable profits for the commercial banking sector.

Concerning exchange rate policy, it seems that Portugal is in a rather enviable position of being able to pursue a nonaccommodative exchange rate policy, which will inevitably drive up the real effective exchange rate in the short run, but which should contribute to bringing down inflation over the medium run. The downward flexibility of real wages, strong productivity growth, as well as the fact that minor losses of price competitiveness do not seem to affect the buoyancy of Portuguese exports, stand to underline this. Of course, such an exchange rate policy stance has also been applied by other European countries in the past, more specifically within the context of the exchange rate mechanism of the EMS, with the deutsche mark acting as the credible anchor. The Portuguese authorities have for the time being opted for a similar strategy outside of the EMs. The most positive aspect of this recently made choice, to me at least, is that it has introduced more exchange rate risk, which should influence capital flows. As Mr. Filosa's statement indicates, the fact that the width of the band within which the escudo will fluctuate is not being made public is highly useful in this regard. The only question I have in this context is why the Portuguese authorities have chosen to stabilize their currency only in terms of the main EMS currencies and not in terms of the ECU, like Norway has done. This choice is all the more surprising in that the previous basket against which the escudo was pegged in a crawling way did contain such currencies as the Netherlands guilder and the Belgian franc, which are part of the ECU but not of the new Portuguese basket. After all, recent foreign trade data for Portugal indicate an increasing share of EC exports and imports, of which the Benelux countries are not a negligible part.

I would like to express my interest in hearing the opinion of the staff and of Mr. Filosa regarding the timing of the future entry of the escudo in the EMS exchange rate mechanism. More specifically, are the authorities planning to wait until the inflation rate in Portugal has come down to within reach of the EC average, or do they intend to follow the UK reasoning and enter when inflationary expectations are felt to have peaked?

Mr. Noonan made the following statement:

The Portuguese economy has recorded an enviable rate of output growth in recent years. That growth largely reflects Portugal's competitive advantages within the European Community and, particularly, its relatively low cost base of 1986. Future output capacity is also growing, based on an impressive investment performance. However, that investment performance has contributed to a rate of growth of domestic demand which has been greater than that of output. The result has been a weakening of the current external account and, more seriously, a strengthening of inflationary pressures.

Financing the excess of domestic demand over output does not seem to pose an immediate problem. The staff points out, in Appendix VII of the background paper on recent economic developments, that "there is no evidence of a structural savings deficit in Portugal as regards the needs to fund investment and to safeguard external balance." Mr. Filosa's statement makes much the same point, noting that the inflow of foreign direct investment and transfers had been more than sufficient to finance the current deficit. While short-term capital inflows have been large, they have simply financed an increase in foreign reserves, though at a cost to the profits of the central bank, as Mr. Filosa points out.

Nonetheless, the absence of any immediate financing problem should not induce complacency with respect to either the sustainability of the balance of payments, or the consequences of a continuing high rate of inflation. In that context, direct foreign investment also requires to be remunerated, and the repatriation of future profits will pre-empt a significant element of prospective output growth. It is therefore important not to allow expectations to build up, because, if unchecked, excessive domestic demand will ultimately and inevitably threaten both the balance of the external account and the competitive advantages that have contributed so much to Portugal's recent growth and investment performance.

I would, therefore, agree with the staff that, given the strength of aggregate demand over recent years, the authorities' fiscal response has been insufficient. If investment is perceived to be desirable, then the appropriate fiscal response should be to make room for it, particularly where inflationary hot-spots can be identified, for instance in the construction sector. Instead, the authorities seem to have exacerbated domestic demand growth through a substantial increase in the public sector borrowing requirement, as well as by an increase in fiscal expenditures as a share of GDP.

We would agree with the staff that without a substantial fiscal adjustment, the objectives of convergence of the inflation rate to EC norms and entry into the exchange rate mechanism of the EMS, will be seriously undermined. It was, therefore, encouraging to note that the authorities' own adjustment scenario for 1991 calls for containing the growth of civil service employment to 1 percent, real nonpay cuts in public consumption of 4 percent, and substantial increases in direct and indirect tax receipts compared with nonadjustment receipts.

We wonder if the staff could comment on how the 1991 budget measures compare with this scenario, and whether, in their view, the 1991 measures represent a credible step toward the medium-term adjustment required. We note, in that context, that the official projections had assumed a world oil price of $20 per barrel. Finally, on fiscal policy, could the staff comment on the implications of the recent wage and pension pact on progress toward addressing the substantial cash flow deficits that are projected for the social security system by the mid-1990s?

As regards monetary and exchange rate policies, I would suggest that the authorities' attempts to use interest rate and administrative means to contain excess demand were misplaced. The likely outcome of those attempts, if they were to be successful, would seem to me to be the maintenance of the public sector element of domestic demand at the expense of the private sector, particularly private sector investment. As already indicated, the appropriate response should have been on the fiscal front.

In any event, given the peg of the escudo and conditions of increasing capital mobility, the effectiveness of the policy was likely to be questionable. It is generally understood that, in such circumstances, attempts to restrain demand through increases in interest rates will be confounded by short-term capital inflows. It is also unlikely that administrative controls over domestic credit and capital controls will be effective, except perhaps in the short run, especially given the strong evidence of disintermediation.

As regards incomes policy, I understand that the authorities have recently negotiated a centralized wage settlement with the trade unions and business organizations that would accommodate cost of living adjustments of 14.5 percent, allowing for wage drift of 1 percent. As I noted during our discussion of Spain's Article IV consultation, and as was concluded in a recent IMF working paper, centralized pay agreements that are based on a strong consensus can have significant macroeconomic benefits, without introducing structural rigidities.

However, in my view, the success of such agreements depends in large part on a consensus regarding the importance of containing inflationary pressure. Even if wage increases were limited to 14.5 percent over the next year, which is not at all certain, I feel it is appropriate to express that a negotiated settlement of this magnitude runs the risk of reinforcing inflationary expectations and pressures, rather than abating them.

In concluding, and wishing the authorities well, I hope that the threats that I have touched upon could be avoided, and the gap between Portuguese living standards and those elsewhere in Europe will be narrowed.

Mr. Grosche made the following statement:

I should like first of all to commend the authorities for the remarkable growth performance in recent years. It is particularly encouraging that the growth process has led to substantial employment gains. Obviously, the ongoing integration into the European Community has played a major role in boosting Portugal's economic prospects. In turn, the country has been quite successful in catching up to the EC partners.

But this rather bright picture is seriously clouded by a high rate of inflation. The excellent staff report, with which I can fully concur, rightly puts the emphasis on inflation as the main challenge to Portugal's economic policymakers. If unabated, inflation would not only seriously undermine the prospects for sustainable economic growth, but also jeopardize the large potential benefits of further economic and financial integration into the European Community. Information about recent price developments is therefore a matter of serious concern. I found it worrisome not only that inflation has accelerated further in recent months, but also that only a slight reduction is expected for next year.

Given the overriding need to fight inflation, the staff report draws attention to the scope for monetary policy. Attempts to bring liquidity growth under control have been frustrated by the circumvention of direct credit controls and, maybe even more importantly, by capital imports. Capital could be imported almost without risk, since the interest differential quite substantially exceeded the announced rate of exchange rate depreciation. In line with the staff's recommendations, recent changes in the exchange arrangement are aiming at increasing the exchange rate risk, as well as allowing for some real appreciation of the exchange rate. These measures, aimed at discouraging capital imports, seem to be largely appropriate. They should help to better control the creation of money. In addition, the authorities have reintroduced some capital controls. This certainly appears to be somewhat unfortunate within the context of the ongoing liberalization of capital movements in the EC. But perhaps the earlier liberalization came at an unfortunate time, when a firm anti-inflationary macroeconomic policy stance had not yet been put in place.

The recent measures seem to work quite well in discouraging capital imports. Like the staff, I should like to stress, however, that the approach chosen by the authorities can only provide temporary relief, as it is by no means a substitute for tighter financial policies.

Fiscal policy, in particular, appears to be of critical importance. I also think that temporarily switching to a fully floating exchange rate would not be a lasting solution. At first glance, this seems to be an easy way out. Such a step would definitely not replace the need for a more appropriate domestic policy mix; it would rather distract from it.

I would therefore urge the authorities to use the temporary relief provided by the measures now taken by the authorities, first, to increase the effectiveness of monetary policy and, second, to put an appropriate mix of tight macroeconomic policies in place.

As regards the first point--monetary policies--I think the staff paper very clearly describes the deficiencies of direct credit controls. The envisaged measures paving the way toward indirect monetary control are, therefore, most welcome steps in the right direction. They should be complemented by measures aimed at strengthening Portugal's banking sector. Competition in this sector appears to be far from what it should be. Also, efficiency and capital standards need to be improved. One way to do this would be to invite foreign banks to participate; therefore, I find it quite unfortunate that the authorities intend to exclude foreign investors from the envisaged privatization of public banks.

With respect to the second point, fiscal policy should take the lead in the stabilization effort, easing substantially the burden for monetary policy. I would agree with the staff that the expansionary fiscal policy stance in 1990 is "highly inappropriate under the current circumstances" and incompatible with the objective of reducing inflation. Although the budget deficit for 1990 might now turn out to be somewhat lower than previously expected by the staff, it will still be highly expansionary compared with the previous year. Even more worrisome, perhaps, is that the budget for 1991 obviously does not envisage a major adjustment effort. I found it rather disappointing that earlier attempts to restrain expenditure have been completely offset by the salary increase in the public sector. Without going into detail, I would strongly urge the authorities to reconsider the stance of fiscal policy along the lines recommended by the staff. I think the medium-term scenarios clearly underline the urgency and the potential benefits of a tighter fiscal policy.

Before concluding, let me add that within an appropriate mix of anti-inflationary policies, incomes policy has an important role to play. Although a moderate wage policy in the past has prevented a cost push, which would have made the liquidity expansion even more explosive, this cannot be taken as granted for the future. The recent wage agreement for 1991 appears to be on the high side, entailing the clear risk that inflationary expectations are being kept on a level which is much too high.

Mr. Wright made the following statement:

There can be no doubt that, on most indicators, the Portuguese economy has performed well since the last full Article IV consultation, with strong growth, falling unemployment, and rising shares of diversifying export markets. The strength of inward direct investment is testimony to the cost advantages Portugal has over its EC partners. There may be some way to go before Portuguese incomes catch up with levels in other EC countries, but once structural reforms really take hold, the prospects for such gains are encouraging.

However, I share the concern of other speakers that a shadow of doubt has fallen across the sustainability of growth, as inflationary pressures have built up. These are perhaps most evident in the labor market where, despite rapid productivity growth, unit labor costs have been rising at a rate well into double figures. Part of the solution to this in the long term is improvement in the functioning of the market. But, in addition and more immediately, some alleviation of demand pressure is clearly required. My concern about such pressures arises in particular out of the recent trend in the real effective exchange rate shown in Chart 3. In this context, I think the staff understates the case when they say that the continued absence of cost pressures on inflation cannot be taken for granted.

These developments should set alarm bells ringing about the prospects for domestic inflation and for international competitiveness. It is not sufficient to judge the adequacy of competitiveness by recent experience with shares of export markets, which must in part reflect the impact of accession to the EC. The absolute cost advantage, in which the authorities seem to place such faith, may quickly be whittled away.

To lessen demand pressures, it is essential that the stance of fiscal policy be appropriately tight. The staff have clearly identified the issues involved, and Mr. Filosa's statement is reassuring on this matter. I would emphasize only one aspect--longer-term developments in Portugal depend critically on structural change and priority must be given to the domestic appropriations required to accompany EC funds for this purpose. This places a constraint on government spending for other purposes: there must be sufficient resource headroom to absorb these inflows. More generally, I endorse the staff report's identification of the increased role for fiscal and structural policies in fighting inflation as the economy becomes increasingly open.

This brings me to what I see as the central issue--the mix and structure of monetary policy. The first concern is that monetary conditions should be sufficiently tight to bear down on inflation. Here I have to say that I cannot accept the view that the crawling peg depreciation of the exchange rate favored until recently represented a nonaccommodating policy stance. Automatic adjustments of this kind are, to my mind, a pernicious procedure, which immediately validate domestic inflation, to the tune of 3 percent a year in Portugal's case.

This unwelcome effect has been compounded in Portugal by the influence of recent exchange arrangements on inflows. By removing exchange uncertainty, it has encouraged both short-term liquid inflows, and foreign borrowing by residents to avoid domestic controls and high interest rates. These inflows, together with direct investment and remittances, are contributing to inflationary pressures through domestic liquidity conditions. The means of sterilization available to the authorities has, as Mr. Filosa has pointed out, cut into central bank profitability and have had doubtful effectiveness.

The dilemma faced by the authorities is therefore how to maintain tight domestic monetary conditions while curbing either the monetary effects of the foreign exchange inflows or the inflows themselves. One method is to resort to direct controls in the domestic markets and on the exchanges, and the authorities have taken some steps in this direction. It cannot be a long-term solution within the EC framework. Nor do I think it is very effective even in the short term. Direct controls, in both the domestic and international markets, are increasingly seen as a challenge to those who wish to circumvent them. It is instructive to note, for example, how recent domestic borrowing constraints have succeeded only in pushing borrowers offshore.

As the authorities have recognized in the recent change to exchange rate policy, one way of discouraging the external flows in response to interest rate differentials is to introduce uncertainty--or at least to reduce the degree of certainty--in the market. These considerations are reflected in the measures described in Mr. Filosa's statement, which are intended to alleviate the somewhat paradoxical conditions observed recently. One, fairly extreme, way to achieve this would be the classic squeeze of a large once-off devaluation, which may be quickly reversed. I do not offer this as a policy prescription in Portugal's circumstances. Neither do I think that a banded form of the crawling peg would be the answer. Rather, uncertainty would effectively be introduced by ceasing to state explicitly any exchange rate policy. In addition, it would be appropriate not to resist upward pressure. This would remove the accommodating aspect of policy and achieve tighter monetary conditions overall.

The risks of such a policy producing perverse results--lower direct investment, but higher short-term inflows--cannot be discounted. But overall, such a policy should itself enable the stance of monetary policy to be tightened. If inflows result in a stronger exchange rate, this would permit some reduction in short-term interest rates. If, on the other hand, the greater uncertainty produces downward pressure on the exchanges, this would allow the authorities greater latitude in raising interest rates. Either way, the objective of allowing monetary policy to bear down more effectively on inflation would be achieved.

I would also urge the authorities to take the opportunity provided by tighter fiscal policy to increase the degree of domestic sterilization--and foreign debt prepayment by the government--to absorb domestic liquidity. Again, Mr. Filosa's statement indicates the authorities intend to move in this direction. The spin-off effect of deepening the official debt market will be important in enhancing indirect monetary control, which, together with general restructuring of the financial system, will make rates more effective in curbing credit expansion. I will not comment in detail on the Byzantine complexity of the financial system. Suffice it to say that it is a matter of the utmost urgency that the conditions for indirect market-based control are quickly achieved, and I welcome the authorities' intentions in this area.

The end result of the measures I have suggested, which, I think, are on much the same lines as those outlined by Mr. Filosa, should be tighter domestic monetary conditions, reduced inflationary pressures, and an overall policy mix which is better balanced and more sustainable. Taking the plunge on such a course would, I recognize, be a courageous political act, given the possible difficulties in the short term. But I have no doubt that in the absence of action, the advantages to Portugal of EC membership will quickly be diminished. In addition, Portugal's intention to place the escudo in the exchange rate mechanism of the EMS will require a clear view of what the appropriate central rate should be. The present arrangements provide no guide as to what that might be.

Could I close by welcoming, very much after the event, Portugal's acceptance of the obligations of Article VIII.

The staff representative from the European Department noted that most speakers had stressed the problem of inflation and the need for an appropriately tight fiscal policy. With respect to the 1989/90 fiscal deficit, there had been a significant narrowing of the deficit in 1989 for reasons that were in part incidental: the coincidence of taxation that was still being carried out under the old system and taxation under the new personal income tax system, which had replaced the old schedular system, had significantly raised tax pressure in that year. Inevitably, that coincidence could not be repeated in 1990. In addition, there were indications at the time the 1990 budget was prepared that inflation had decelerated; indeed, it had been decelerating quite significantly toward the end of the year. For those reasons, the authorities had been somewhat more sanguine than the subsequent revival of inflation would have warranted; believing that inflation was under control, they were perhaps not as restrictive on fiscal policy as they might have been. Furthermore, as inflation had exceeded the target, as Mr. de Groote had pointed out, the authorities felt that in the circumstances it would be appropriate to return to the taxpayers some of the fiscal drag from which they had suffered. It was worth noting in that respect that 1991 was to be an election year, which had had some effect on the budget.

It was also important to mention the wage reform that had been introduced, the staff representative remarked. The wage reform, and the consequent adjustment in wage levels, was felt to be necessary because of the lagging competitiveness of public sector wages with those of the private sector. The wage reform had, of course, very pronounced effects on fiscal expenditure.

It was the combination of those effects that had made for a rather conspicuous widening of the deficit in 1990: an unwarrantedly optimistic view of the deceleration of inflation, a return of the fiscal drag, the coincidence of taxation under the old and new systems in 1989, and the wage reform in 1990, the staff representative noted. The authorities were quite aware that the stance of fiscal policy was inappropriate--a situation which they also explained in terms of those effects.

With respect to 1991, the fiscal deficit was programmed to narrow to about 6.5 percent of GDP, although the authorities considered that one half of 1 percentage point of that deficit could be attributed to the effect of the oil price increase, which would have an adverse effect on real growth and would dampen the rise in the GDP deflator, the staff representative continued. That effect was not to be confused with an accommodative stance that the authorities might be taking with regard to the oil price increase. On the contrary, they were insisting that the increase would not be accommodated; indeed, they had not revised expenditures or revenues in response to the oil price increase. All the same, it might turn out that the fiscal impulse was at best broadly neutral relative to 1990. If one considered that the likely outturn for 1990 was a fiscal deficit below 7 percent, and that the projected fiscal deficit for 1991 was of the order of 6.5 percent, the resulting fiscal adjustment might not be regarded as sufficient.

Responding to a point made by Mr. Grosche and Mr. Noonan, the staff representative suggested that it was debatable whether the incomes policy arrangement was sending the right anti-inflationary signal. It was true that contractual wage increases of the order of 13 percent--plus one point wage drift--would make for fairly sustained wage increases; in fact, an inflation target for the following year of the order of 11 percent was expected, and there would, therefore, be considerable real wage gain. At the same time, inflation was currently running at a rate of about 13.5 percent, and the authorities believed, therefore, that the incomes policy agreement would have a restraining effect. They also believed that it would improve industrial relations, in that it was understood that there should be no resort to strike activity in 1991.

It was also true that, as mentioned by Mr. Noonan, there had been a number of arrangements that were perhaps not obviously measures that would dampen inflation, such as the adjustment of minimum pensions and wages, and some reduction of fiscal drag, the staff representative went on. The authorities felt, however, that the budgetary effects of those arrangements had been offset by the adjustment of indirect taxes and excise taxes on alcohol and tobacco, and by strict restraint of current expenditure in ministries other than education and social security. It was absolutely correct that there was a significant need for expenditure restraint, and in that context interest payments were likely--as Mr. de Groote had pointed out--to constitute a considerable drag on the budget. Indeed, in the process of transition to indirect monetary control, the interest burden on the budget would rise, and that burden would have to be distributed over time; it was currently foreseen that it would be distributed over a number of years.

It was envisaged that the government would issue securities at variable rates, sufficiently attractive to induce commercial banks to switch out of deposits held with the central bank and into the new government paper, the staff representative continued. The government, in turn, would use the proceeds to retire government debt held by the central bank. In that way, the total balance sheet of the central bank would be scaled down. The problem of differential rates paid on central bank liabilities and assets would also be reduced, and, hence, the central bank's profitability would be restored. At the same time, of course, there would be the effect of higher interest rates on the government paper that would need to be issued. The interest payments on that paper were not expected to show up in 1990; that was so, simply because an administrative arrangement between the central bank and the government would spread interest costs over subsequent years. In any event, owing to rising interest payments over time, it was all the more necessary that the government should exercise primary expenditure restraint.

Several Directors had mentioned the need to complement fiscal restraint with nonaccommodating monetary and exchange rate policies, the staff representative observed. The point had been made in the staff report that under the old system of the crawling peg, monetary policy and--with capital movements largely liberalized--exchange rate policy had become inconsistent. The recent change in capital controls, namely, the partial rollback of earlier liberalization, and the change in the exchange rate system leading to increased uncertainty, did restore that consistency to a certain extent. It was true, and the authorities were perfectly aware, that controls could not be relied on to work forever; hence, they were regarded only as a temporary expedient.

As to Mr. de Groote's point on the basket for the new exchange rate system, the staff representative said, the new basket contained the deutsche mark, which carried the weight not only of the German economy, but also of the economies of Belgium and the Netherlands. It was in that sense that the role of the Belgian and Netherlands currencies was taken into account. Other currencies in the basket were the French franc, the Italian lira, the Spanish peseta, and the pound sterling.

With respect to the timing of entry into the exchange rate mechanism of the EMS, there had been two instances when the market had believed that entry was imminent, the staff representative stated; indeed, that belief was reflected in the movements of the escudo/DM rate, which had appreciated on those occasions. One such instance had been in the summer of 1990, and the other was when the pound sterling had entered the exchange rate mechanism of the EMS, and when there had been expectations that the escudo might follow suit. While the authorities believed, and had said so repeatedly, that they would join the exchange rate mechanism of the EMS shortly, they still wanted to make more progress on inflation convergence. Much would also depend on the next stage of the Delors plan for economic and monetary union, and whether in fact it was to start in January of 1993 or 1994. Under the earlier exchange rate system, as was pointed out in the staff report, the authorities had felt that they should be in the exchange rate band by the end of 1992. That move was subject to change, however, depending on what would be decided at the December 1990 intergovernmental conference.

It had been suggested by Mr. Wright that letting the exchange rate go might have been a better way to proceed, the staff representative recalled. The staff had explored that alternative and had decided against it, as there were likely to be adverse effects on the real exchange rate, the fluctuations might be too pronounced, and there might be permanent effects of temporary adjustments. As it was the intention of the authorities to move into the exchange rate mechanism of the EMS, they had adopted the approach that they felt was best. The new system was intended to work with an informal rule of an annual 3 percent effective nominal depreciation of the escudo--previously the rule had been a formal one--and there would be a band around the exchange rate. The authorities considered that that implied a somewhat stronger escudo than would have corresponded to the prescribed 3 percent effective nominal depreciation. In fact, that had already proved to be the case, as during the previous few months the escudo had been stronger than it would have been under the old system of a rigid 0.25 percent monthly effective nominal depreciation. The evidence seemed to suggest that the introduction of the new exchange rate regime and the partial rollback of capital liberalization had been successful; while the situation had been barely sustainable in June and July 1990, when large flows of money had rushed into Portugal and caused problems of liquidity control and pressure on the central bank's balance sheet, it was currently perceived to be under control.

With respect to the authorities' fiscal program and, specifically, Mr. de Groote's comments concerning the extent of reliance on indirect tax increases, the staff representative said that the adjustment of public finances considered would involve not only indirect tax increases, but also measures to raise direct tax revenues through improved efforts at tax administration, which was in accordance with the authorities' plans. In its own scenario, the staff had assumed that government consumption would be constrained and that, notwithstanding the recent wage reform and its implications for government expenditures, government expenditure would in future be strictly controlled. Hence, there was no exclusive reliance on the increase of indirect taxes.

As to Mr. Wright's observations on competitiveness, it was true that the real exchange rate had been increasing in Portugal, albeit from a very low level, the staff representative observed. There was no question that under appropriate pressure, exporters could reduce their profit margins, which had been quite ample. Under the new exchange rate system, the escudo would be relatively stronger than it had been in the past; that strength could be expected to force companies to exercise more discipline in pricing behavior and so narrow profit margins. In addition, it appeared that the composition of Portuguese exports had changed in a way that strengthened overall exports and furthered market penetration. That was not reflected in an index such as the one for real exchange rates, but was nevertheless a development that had improved overall competitiveness. When that development was added to the generally strong and comfortable profit position and the increasing investment activity, which would continue to modernize and improve the production structure of the country, competitiveness should not pose a serious problem in the short run, although the real exchange rate could not be expected to rise indefinitely without having adverse effects.

On the question of the accuracy of price and unit labor cost statistics, the authorities were of the view that both measures overstated the effective increases involved, the staff representative from the European Department concluded. Nonetheless, it was true that there had been a real appreciation, and the staff assumed that the pressure from the new exchange rate system on the enterprise sector would be a salutary one, and that enterprises would be able to tolerate the situation in their export markets, even while further raising market shares.

Mr. Wright observed that questions of terminology had hampered earlier Board discussions on exchange rates. He wished to clarify his views on what had been characterized as his position that the authorities should let the exchange rate go. He had made two points in his intervention, one of which he had raised and then dismissed, while the other was more substantive. With respect to the former, he had noted that there was a well-tried market tactic one could use to create uncertainty, which involved manipulation of the rate itself. That move was not to be taken lightly, and for that reason he had not pursued it.

On the second point, Mr. Wright continued, it was not his intention to imply that the authorities should adopt a completely permissive approach toward the exchange rate. On the contrary, he had suggested that in determining the overall package of monetary tightness, one could conceive of domestic monetary conditions in terms of both the exchange rate and interest rates, which, together, would deliver an overall level of monetary tightness. It appeared that the managed depreciation--to which considerable certainty had been attached--combined with the level of interest rates in the economy, produced an overall package of monetary tightness that was not appropriate under the circumstances. Consequently, the argument that he had attempted to make was that the exchange rate should certainly be more clearly determined by market forces, but not that it would be neglected--its level should be carefully monitored. The process that would determine the stance of interest rates was iterative.

He remained a little unhappy with the notion that the exchange rate was still expected to depreciate, albeit in a way which had less certainty attached to it, in terms of both the amount and timing of depreciation, Mr. Wright concluded. Indeed, he was not persuaded that any depreciation was actually called for, given the experience of competitiveness in the real exchange rate.

Mr. de Groote said that he wondered how it was possible that the authorities had developed a scenario whereby exports would increase faster under nonadjustment than under adjustment. Were there good reasons for holding such a view?

Mr. Noonan observed that no allowance had been made for increases in budgetary allocations following the recent increase in oil prices and the consequent inflationary pressures. Moreover, many of the budgetary allocations were of a nondiscretionary nature. How were the authorities actually going to control public expenditures to conform with those allocations? If there was no mechanism whereby the authorities could control nondiscretionary expenditures, it seemed that the fiscal deficit targets were unlikely to be achieved in 1991, which was not very reassuring.

The staff representative from the European Department said that there was a risk in that regard; however, two points were worth noting. First, elections were to be held next year in either June, July, or October. If the elections were held early, it was the staff's understanding that the authorities would have to resubmit the 1991 budget once the new Government took office, and at that time the authorities would make efforts to tighten fiscal policy more convincingly than was the case at the moment.

The second point was that there was currently the possibility of greater flexibility in expenditure control than had been the case previously, the staff representative from the European Department noted. Certain expenditure appropriations could now be carried forward, so that if the Minister of Finance urged restraint in expenditures, ministries would not risk losing appropriations that they had not already spent by the end of the year. Furthermore, there was also a much tighter administration of below-the-line Treasury operations than in the past.

Mr. Yoshikuni said that he was very interested in the discussion between Mr. Wright and the staff representative from the European Department on the exchange rate and monetary policy, and in that connection was generally sympathetic with the views expressed by Mr. Wright. There was some question as to the details of the new exchange system that had been described by the staff; it seemed that the staff was still thinking in terms of continuing the current crawling peg system, albeit with a band. He did not see any rationale for continuing the crawling peg, particularly in light of the fact that the actual real exchange rate was appreciating while, simultaneously, substantial capital inflows were continuing. Therefore, it was difficult to envisage how a narrow band could stem the flow of capital and make monetary policy independent. He was inclined to think that there was some room for a one-time adjustment of the exchange rate, followed by some form of a hard currency scheme supported by strengthened financial policies. On the other hand, the staff representative from the European Department had noted that capital inflows had slowed since July, and, if that were the case, perhaps such an adjustment would be unnecessary. He was concerned that the easing of capital inflows might have been the result of the introduction of the direct capital controls, which was perhaps not a movement in the right direction with respect to possible membership in the ERM. Similarly, he wondered whether there was any room to further liberalize capital outflows--which was discussed in the staff paper--and if such a liberalization could help to offset capital inflows.

The staff representative from the European Department replied that capital controls had indeed played an important role, but the authorities did not intend to maintain them indefinitely, as they knew that they would be circumvented. The authorities had experienced circumvention of direct controls in the domestic area, and they had no reason to think that their experience with capital controls would be any different. In any event, the greater exchange rate flexibility under the new system had also succeeded in stemming the inflow of capital. In particular, it appeared from the path of daily exchange rate movements--of the escudo/deutsche mark rate, for example--that when sterling had joined the exchange rate mechanism of the EMS, there were market expectations that the escudo would follow suit, and, consequently, there were relatively strong pressures for the currency to appreciate. Instead of simply allowing the money to enter, as would have happened under the old system, the authorities had permitted the escudo to appreciate quite significantly at the time. Furthermore, it was the intention of the authorities to join the exchange rate mechanism of the EMS at an early date, and the current exchange rate policy was not seen as an indefinite solution.

With respect to the liberalization of outflows, Portugal had advanced those liberalization measures that had been agreed with the EC, the staff representative from the European Department remarked.

Mr. Filosa observed that the change in the exchange rate system had attracted the attention of all speakers, a fact that had been anticipated during an earlier informal discussion on exchange rate developments. There were two points worth noting on the nature of the changes: the continuous crawl that had characterized the previous system had been discontinued; and the question of flexibility meant that, while there was an intention to have some depreciation in nominal terms--because a stable nominal exchange rate would have implied a very strong appreciation in real terms--that could not be achieved in the transitional stage in which Portugal found itself. While recognizing that an accommodative exchange rate might not induce inflation to fall to the desired level--a point that was correctly made by Mr. Wright--the authorities saw scope for tightening that policy somewhat and could therefore conceive of some lower average level of depreciation.

In the very short term, Mr. Filosa added, the introduction of a band around the exchange rate--the width of which was not to be announced--provided flexibility in two senses: capital inflows might be resisted through some appreciation of the exchange rate; and it allowed for more flexible monetary policy. Thus, the band was expected to discourage very short-term capital movements through the introduction of some exchange rate risk, and to limit the need for the sterilization of inflows, as the central bank would no longer be compelled to intervene on each occasion.

He agreed with Mr. Wright's characterization of the authorities' intentions concerning the stance of monetary policy, Mr. Filosa continued. In assessing the stance of monetary policy--interest rate levels and the exchange rate--it was important to remember that a delicate balance must be maintained, because sudden increases in interest rates would jeopardize the reduction of the fiscal deficit. Accordingly, it was the intention of his authorities to have a blend of monetary policy--interest rates with a compatible exchange rate--while allowing market forces to determine the exchange rate in the short run, in order to provide monetary policy with the option of sterilizing capital inflows. It was obvious that such a policy alone could not be successful in achieving price and wage settlement discipline--the second main objective of exchange rate policy--because of the current high level of inflation. Capital controls, which were regarded as a temporary measure, were needed to accompany the projected deceleration of inflation in order to ensure an orderly path toward convergence with the average level of inflation in the EC.

The question of consistency between the new exchange rate approach--which implied a certain role for the exchange rate as an anchor, at least in the medium term--and the package of fiscal and incomes policies had attracted the attention of most speakers, Mr. Filosa commented. In the view of his authorities, the combination of policies was appropriate. The target level of inflation, which was 11 percent on average for 1991, implied a lower inflation level at the end of that year; that in turn implied a deceleration of 3 percent, which was very much faster than in any other country and, in particular, the EC. On the more general question of reducing the substantial level of inflation--in light of the current trend in all countries, including those of the EC, for inflation to accelerate because of oil price increases, and the desired convergence toward the EC-average rate of inflation--a number of speakers had indicated that the level of wages envisaged in the package was not consistent with the objective. In considering the adequacy of nominal increases in wages, one needed to take into account increases in productivity; when that was done, the unit labor costs, which were implicit in the projection, were consistent with the 11 percent inflation objective. That matter touched on another feature of the package that he had not fully explored in his statement: the current incomes policy package was consistent with no change in the distribution of income. Greater restraint on wages would have implied a shift in income distribution toward profits, but, as was made clear in the staff paper, profits were already high. Therefore, a more stringent incomes policy would have been unwarranted if productivity increases were accounted for and, in any event, would have encountered some difficulties with respect to income distribution, because of the current high level of profits. Furthermore, the package, if fully implemented, was fully consistent with one of the Fund's principal recommendations to all member countries in the current circumstances: maintenance of nonaccommodative policies and, in particular, the full pass-through of oil price increases in order to avoid second round inflationary effects. The budget was very clear on that point. It was equally clear that the authorities' wage policy provided no automatic mechanism for accounting for oil price increases in wage settlements.

While there was room--perhaps even a need--to further restrain government expenditure, as a few speakers had suggested, it should be noted that the 1991 budget would call for no nominal increase in expenditure associated with the functioning of the state; purchases of capital goods and services for the state sector were not to increase in nominal terms, Mr. Filosa stated. On the revenue side, the proposed increases in indirect taxation--affecting only alcohol and tobacco--would be in compliance with the EC objective of harmonization of indirect taxation. The two additional items that would be affected--the VAT and the withholding tax--were themselves under discussion in the EC and ultimately would be reconciled with the conclusions of those discussions.

On the question of how privatization revenue would be employed, he could assure Mr. Grosche that part of that revenue would be devoted to recapitalization of banks that had developed weak capital bases, Mr. Filosa said. With respect to the terms for participation of foreign capital in the privatization effort, there had been a limit to such participation in the past, but it would not remain indefinitely, and, in any event, it would be determined on a case-by-case basis. It was possible to conceive of a limit different from that of the current 10 percent: higher levels of participation of foreign capital would be allowed in certain instances--one could not exclude a level of 15 percent, for example--but it was also quite reasonable that some lower limit would apply in enterprises in which the Portuguese authorities had certain strategic interests; that was clearly a judgment that the Portuguese authorities would have to make according to their own judgment of their strategic interests.

Mr. Noonan recalled that Mr. Filosa had said that the 14.5 percent pay increase, which seemed to be a minimum, would be consistent with an inflation rate of 11 percent, as the difference was accounted for by the increase in productivity. However he would distinguish between productivity in the manufacturing sector and productivity in the whole economy; the latter tended to be much smaller than the former. Table 15 of the background paper on recent economic developments indicated that the increase in productivity in the manufacturing sector had not been all that striking--of the order of 1 percent between 1988 and 1989. Consequently, he had difficulty in reconciling an economy-wide increase of 3.5 percent--which was implicit with the 14.5 percent pay increase and the 11 percent inflation target--with what had actually been experienced.

Mr. Filosa replied that the increase in wages would be much higher in the public sector than in the manufacturing sector, and that he had referred earlier to an average level of wage increases without perhaps looking too carefully at the sectoral components of that average. It was possible that Mr. Noonan had been correct with respect to the expected increases in productivity, but on average it seemed that there would be no major changes in income distribution, which went to the heart of what was essentially a political agreement. Nevertheless, the wage increase did appear somewhat on the high side; it was likely that there was no uniform view in Portugal that the present result was the best that could be achieved, but negotiations often produced such outcomes.

The staff representative from the European Department added that the incomes policy agreement was not a priori inconsistent with no change in income distribution. If one allowed for a contractual wage increase of 13 percent, and 1 percent wage drift, the implied real wage increase would be 3 percent, assuming a level of inflation of 11 percent. If real GDP were to increase on the order of 4 percent in 1991, and if employment were to increase by approximately 1 percent, then the increase in real wages would equal the productivity increases in the overall economy. Consequently, while that was not necessarily a fully developed analysis, it was true that the incomes policy as such was not a priori inconsistent with neutrality of income distribution. It was also true--as mentioned by Mr. Filosa--that the authorities did not want the inflationary effect of the oil price increase to be taken into consideration in wage adjustments.

The authorities intended to incorporate into wage settlements the observed price developments over the previous period, the staff representative from the European Department said. As contractual negotiations were held every quarter--the length of a contract was one year--the Government would negotiate in the first quarter on the assumption of the current inflation target--10.75 percent to 11 percent, for example. If, in the second quarter the overall inflation target had to be revised, then future wage increases would be correspondingly adjusted; the authorities were not, therefore, locked in to a particular wage increase. As a result, if there were to be success in bringing down inflation, wage increases would be brought down correspondingly. Of course, there was also the risk that if there was no progress on the inflation front, wages would go the other way, but that would not in itself change the real wage. If there was approximately 4 percent real GDP growth and some growth in employment, wage increases could be kept in line with productivity and profit margins would not change.

Mr. Hogeweg stated that he agreed with much of what had been said by previous speakers. The main lesson to be learned from the discussion was that the mix of fiscal and monetary policies was inconsistent with certainty in the exchange rate. It was therefore understandable that some control on capital inflows had been re-established to cope with that situation. As he had in an earlier informal discussion on exchange rate developments, he welcomed the change in exchange rate policy that tried to deal with that issue. Of course, the degree of uncertainty created by the new system depended on the margin--which he understood would not be disclosed--within which the exchange rate was effectively allowed to move. In that connection, the wide fluctuation band employed by two members of the exchange rate mechanism of the EMS might have given some guidance. Most importantly, however, the present movement in Europe toward monetary union was, of course, in the opposite direction--no capital controls, and no fluctuation in the exchange rate--and the Fund should keep that in mind when advising the Portuguese authorities. The movement toward monetary union in Europe clearly pointed to the need for a different policy mix and, in particular, more attention to fiscal restraint; it was in that way that Portugal could truly join the European club.

He interpreted the fact that the Dutch and Belgian weights had been added to that of the deutsche mark as a tribute to the credibility of Dutch and Belgian exchange rate policy, Mr. Hogeweg remarked. He also welcomed the explanations offered by Mr. Filosa and the staff of the restructuring of the central bank balance sheet to restore its profitability and establish a base for indirect monetary control. There was no doubt that the restructuring would increase the weight of interest payments in the budget, as the costs of absorbing bank liquidity would have to be borne somewhere, but he welcomed the move in the direction of removing the burden from the central bank.

The staff report mentioned that no monthly or quarterly data were reported on government finance for publication in IFS, Mr. Hogeweg noted. He wondered whether the authorities could be pressed to improve their record in that respect.

The Acting Chairman commented that it was interesting to compare what Directors had said on exchange rate policy during the discussion at EBM/90/151 on Sri Lanka with their remarks during the present discussion. He sensed that there were differences--although that might have been because it was difficult to reconcile all of the underlying assumptions that were associated with those two cases--even though, in both cases, Directors had suggested that underlying fiscal and monetary policies were not consistent with the need to stabilize the exchange rate and reduce inflation. For example, in Sri Lanka, there was a band system without an explicit announcement of the width of the band, which had been sharply criticized by Mr. Goos in particular. In Portugal, too, the introduction of a band without announcing its width had created some uncertainty.

At the present discussion, Mr. Yoshikuni had suggested that perhaps a devaluation followed by stabilization would be a way to achieve the exchange rate objective, the Acting Chairman recalled. Indeed, that was in effect what Sri Lanka had done in 1989 through a large devaluation at the end of the year, with the exchange rate subsequently stabilized but with a large loss of competitiveness. In the case of Sri Lanka, the staff had pressed for a more market-oriented approach to the exchange rate, which was consistent with Mr. Wright's position on Portugal's policy stance. However, that position had been strongly criticized during the discussion on Sri Lanka by Directors who felt that more emphasis should have been placed on the exchange rate as an anchor.

It would be useful to compare the differing views expressed on cases that were similar in character, in order to see what conclusions could be drawn about the complex issues that arose, the Acting Chairman said.

Mr. Cirelli made the following statement:

Let me first welcome the remarkable economic performance of Portugal during the past few years. As noted by the staff, the accession to the European Communities in 1986 has induced sustained economic growth. When looking at today's main policy issue, namely, the reduction of inflation, one must remember that the remarkable buoyancy of domestic activity proved compatible with further progress in bringing financial variables more in line with average developments in Europe.

To fight inflationary pressures, I agree with previous speakers that efforts should be made to ensure that capital inflows do not undermine the anti-inflationary stance of monetary policy. I agree with the staff that the more efficient way to help to address the present situation is to implement fiscal restraint. The fiscal impulse in 1990 intervened at a quite inappropriate time and certainly added to the excess of demand. A more restrictive stance for the 1991 budget appears to be of the utmost priority.

I can agree with other speakers that such a policy must be accompanied by an incomes policy, which should play an important role in the process of disinflation. The situation certainly requires a better policy mix. I will not discuss this necessity at length, as my colleagues have eloquently made the case already.

With respect to the exchange rate policy, and given the need for Portugal to move in the near future toward freedom of capital markets, I do agree that the reinstatement of capital control measures should only be temporary. As for the recent change in the exchange rate regime made to reduce the scope for riskless arbitrage, I have heard the staff's good arguments to justify this change, but I wonder whether such a measure would be sufficient to discourage the large short-term capital inflows Portugal is facing.

The fact that the authorities have kept the width of the band secret is certainly a useful decision. But there are ways to try to circumvent these uncertainties, as recalled by Mr. Wright; I wonder whether such a policy would not have some consequences for the credibility of exchange rate policy--which, according to the staff, had increased in recent years--and thereby complicate the entry into the ERM.

In connection with monetary policy, I wonder whether further ways cannot be explored to try to develop monetary policy instruments aimed at sterilizing the monetary impact of such inflows. To this end, the issuance by the Treasury of a large amount of paper, which would substitute for the large amounts of remunerated reserves constituted in the central bank, would be a good step in the right direction in giving to the central bank more flexibility in the conduct of monetary policy and in facilitating open market operations. I agree with the staff, however, that such a policy, given its budgetary impact, calls for actions in the fiscal area. Finally on this point, to rely on indirect instruments will require--as stated by Mr. de Groote--indispensable structural financial reforms.

Finally, on monetary policy, I wonder whether there are possibilities to accentuate the long- and short-term interest rate differential, with a view to lowering short-term interest rates, in order to discourage speculative capital inflows, while maintaining positive real interest rate returns on long-term instruments for savers. Could the staff comment on this?

Along with these brief remarks, I would like to express my confidence in the authorities' ability to prepare their country for full-fledged participation in the European Community within a reasonable amount of time.

Mr. Iqbal made the following statement:

The sharp investment-led growth in aggregate demand, combined with an expansionary fiscal policy and an increasingly ineffective monetary policy, has exacerbated inflationary pressures. Unless quickly and effectively contained, such pressures will derail the admirable growth process and potentially weaken the external accounts. In addition, unabated inflation would pose difficulties for Portugal for full participation in the exchange rate mechanism of the EMS.

The staff have called for a multifaceted approach to address inflationary pressures. They would, quite appropriately, like to see expenditures restrained and revenues raised so that the target of a primary budget surplus is realized. However, given the interest rate differential in favor of Portugal and the declared crawling peg of the escudo, monetary policy could not effectively supplement the fiscal restraint. The staff are also averse to taking steps that would reduce domestic interest rates as a means for discouraging capital inflows, on the grounds that such action would have negative effects on domestic savings. Therefore, the staff have supported a combination of administrative controls over capital inflows and a change in the exchange system, which would raise the exchange risk of interest arbitrage and, presumably, reduce capital inflows. This would enhance the effectiveness of monetary policy in controlling domestic liquidity without reducing long-term interest rates in Portugal.

While I can see logic in the staff prescription, I am somewhat uncomfortable about acquiescing to a strengthening of capital controls. Once accorded respectability, capital controls have a tendency to be retained. They also have a tendency to be ineffective except in the very short run. In particular, retention of such controls would be inconsistent with plans for full integration into the EC. Instead, it would be better to seek a solution without administrative controls on capital flows. What is needed is a moderate cooling of the economy through a strengthened restraint on domestic consumption via a stronger fiscal effort. At the same time, faster movement toward full integration into the exchange rate mechanism of the EMS would reduce the need for introducing capital controls. It would also reduce inflationary tendencies by favoring the convergence of inflation toward the European average.

Keeping the band a secret from the market is useful in the short run; however, in due course, market participants will be able to deduce it, thus making the policy less effective. A stable rate would be clearly preferable.

In this context, it is helpful not to lose sight of two important points: first, despite rising domestic interest rates in Portugal, the private savings rate has declined; and second, the bulk of capital flows to Portugal are probably facilitated by the higher productivity of capital in that country. Therefore, while a modest decline in interest rates in Portugal is not likely to reduce savings, restraint on domestic consumption would facilitate higher investment and growth without overheating the economy. Slightly lower interest rates would also discourage arbitrageoriented capital movements while the economy moves quickly toward full membership in the exchange rate mechanism of the EMs. Greater stress on indirect instruments of monetary control should supplement these measures.

Mr. Yoshikuni said that he had not meant to suggest for Portugal an exchange rate adjustment along the lines of that implemented recently by Sri Lanka. Rather, the appropriate approach would be to let the exchange rate go. It might be expected to appreciate rather than depreciate, in which event monetary policy should be tightened to offset the real appreciation through a reduction in inflation. He agreed with the Acting Chairman that, in allowing for a nominal appreciation, his suggestions were not significantly different from those the authorities were currently implementing.

Mr. Wright observed that what speakers had proposed was not necessarily inconsistent with what was proposed for Sri Lanka. The main characteristic of the Sri Lankan situation was that there had been a period of fairly continuous nominal depreciation, which in the past year had been compounded by a quite large step depreciation, which in turn had been reinforced--or undermined, depending on how one looked at it--by a deterioration in domestic monetary conditions. Those developments had led to a loss of competitiveness and had caused several Directors to conclude that the experience demonstrated that nominal depreciation--and, in particular, sustained nominal depreciation--was not very effective in improving competitiveness in the long run. Nominal depreciation might be expected to cause some improvement over a limited number of years, but there was a danger that its effects would eventually surface in the form of inflationary pressures, relaxed labor markets, or some other relaxed constraint. Consequently, there were some parallels with the present case.

Table 15 of the background paper on recent economic developments had been mentioned by Mr. Noonan, Mr. Wright recalled. That table showed that, notwithstanding problems of measurement and interpretation of the Portuguese price and cost series, relative unit labor costs in Portugal had risen by 15 percent in the previous four years. While it was true that unit labor costs had risen from a low base, if absolute costs in Portugal were only half of those in other EC countries, one third of that advantage had been eroded in a period of three years, which reflected a serious loss of competitiveness.

The point which he and others had attempted to make was that the worst policy prescription for an inflationary country was to have a certain rate of depreciation, Mr. Wright continued. A better outcome, but not an ideal one, was to have a continuous depreciation with some uncertainty attached, such as would be generated with some kind of banded depreciation. That approach was better, because there was uncertainty attached to it; however, there was still the question whether any nominal depreciation would be appropriate in a relatively inflationary country. He would argue that the use of a nominal anchor--in the sense that there was no certainty that the exchange rate would depreciate--could be very useful under those circumstances. Whether that could be described as a market-determined or a fixed exchange rate was a question of terminology. He was all in favor of exchange rates that were determined by market forces; however, one could also envisage a mixed exchange rate policy such as he had described earlier. On that basis, there were no particular inconsistencies in the policy prescriptions that were offered to Sri Lanka and Portugal, even though the circumstances were obviously very different.

Following on from a point made earlier by Mr. Hogeweg on a possible parallel between the prospects for Portugal's exchange rate and the wide bands of the exchange rate mechanism of the EMS, there was an important difference in such a parallel that should be made clear, Mr. Wright went on. When a country entered the exchange rate mechanism of the EMS with a wide band, the expectation was that the exchange rate would be the same in one year's time. There was, of course, the possibility that it could be higher--as would be the case with a realignment; however, the central expectation was that the exchange rate would be the same. It was not clear to him, as a result of the discussion, that such an expectation was true of Portugal at present. In Portugal, the exchange rate was indeed held within a band, but it was not clear to him what the authorities' central expectation was for the exchange rate in one year's time. Would the band itself move down? It would be wrong to have a clear expectation of the future direction of the exchange rate; indeed, he had already argued strongly against being too specific about such expectations. Nevertheless, it was not his own estimate, on the basis of the staff paper and the current discussion, that the central point of the band in one year's time would be where it was currently.

Mr. Filosa commented that, with respect to the views expressed by Mr. Cirelli, Mr. Hogeweg, and Mr. Wright, it was important to maintain an historical perspective on the question of capital controls. Until quite recently, both France and Italy had maintained capital controls; it was therefore quite important that one not make judgments only on the basis of the most recent events; recommending similar prescriptions for countries that were in different circumstances risked losing sight of the struggle that many countries, particularly those in Europe, had endured to achieve progress.

He strongly disagreed that the recent exchange rate policy change was contrary to the trend in other European countries, Mr. Filosa stated. One of the authorities' main objectives was to reduce the annual crawling peg in order to have the exchange rate function more as an anchor, and the recent exchange system change was intended to achieve that objective. One should not confuse that central issue with the question of short-term flexibility, which was a different issue, linked mainly to more flexibility in the internal management of monetary policy; in that respect, sterilization was an important example. The intention was to move toward greater exchange rate stability, and greater influence of that stability over wage and price setting, which had been the experience of his own country. In that respect, it was interesting to note that Mr. Peretz had said--in an earlier informal discussion on exchange rate developments--that by exerting influence over wage and price setting, the exchange rate did not bale out excessive wage price increases; that was indeed the intention of his Portuguese authorities.

It was obviously too early for Portugal to move in the direction of those European countries that had eliminated capital controls, Mr. Filosa continued. Inflation was still high, and it was understood by the authorities that additional efforts on the fiscal front and, perhaps, on incomes policy, might be called for. If fully implemented, those measures were expected to produce a 3 percent deceleration of inflation in the current year, which would be a substantial achievement. Mr. de Groote had stressed the fact that, in the absence of a financial market, one would need to be developed; otherwise interest rates and the exchange rate could not be expected to move in the proper direction. In order to have an exchange rate that did not accommodate price and wage setting, the textbook prescription would have been to maintain higher interest rates. However, in Portugal--as Mr. de Groote had stressed--the budget deficit needed to be restrained, and virtually all of the public deficit in both the current and the following years would be due to interest payments. Such trade-offs were important, and, in the circumstances, higher interest rates were not an option. As had been the experience of many European countries, Portugal had undertaken to implement a number of policies--fiscal, incomes, and monetary--with capital controls, and in that way Portugal was moving in the direction of entry into the ERM.

Accordingly, at the particular stage of development in which Portugal found itself, the necessary instruments would need to include capital controls, Mr. Filosa remarked. Even in the case of a fully-fledged monetary union, a safeguard clause existed for the use of capital controls, and that clause could conceivably be invoked by some European country. Portugal was using that transitional instrument only to facilitate entry into the exchange rate mechanism of the EMS, and to minimize a problem that would otherwise have implied a different position on incomes policy--which was a political issue--or on the budget, which was also a sensitive policy. The authorities clearly wanted to join the exchange rate mechanism of the EMS soon and were preparing the grounds to do so.

As to the short-term flexibility of the exchange rate, Mr. Filosa said, the authorities were trying to maintain a stronger exchange rate without high interest rates. That was being done through the possibility, albeit temporary, of exchange rate fluctuation, in order to discourage some part of the short-term capital movements that had created the liquidity problem. In that connection, the authorities were also trying to reduce the excessive liquidity of the banks.

As Mr. Wright had suggested the financial system could be described as Byzantine, Mr. Filosa continued. To the extent that that description was true, it was yet another limitation that argued for the use of orthodox instruments. Moving in the direction of a stronger financial system would take time, and such structural measures involved difficult choices. There was, as the staff representative from the European Department had said, a rather uniform view within the Government--an exemplary one under the circumstances--that it was necessary to move rapidly toward those structural changes.

The policy package was consistent with the objective of convergence with the European Community, Mr. Filosa considered. Owing to limitations in the structure of the Portuguese economy, macroeconomic convergence toward European standards required the introduction of an additional administrative instrument, namely, capital controls. That measure should be commended by the Fund, because it represented a means of accelerating the process of convergence to which the authorities were committed; indeed, their resolve in that respect was evident in the banking sector, where the relevant EC directive would soon be implemented, and that fact had been recognized by the staff. One should not lose sight of the authorities' intentions, as well as the particular types of instruments that were needed for Portugal to develop the same structure as that of the more industrialized countries in Europe.

Mr. Hogeweg stated that his view on the change in the exchange system was not inconsistent with Mr. Filosa's. He welcomed the change, and the reintroduction of capital controls on inflows was understandable.

Moreover, Mr. Hogeweg continued, when the EC had embarked on a clear policy of removing all capital controls several years previously, his Netherlands authorities had tended to distinguish between controls on capital outflows and controls on capital inflows. Controls on outflows were interpreted as a means to shield the economy from the consequences of poor domestic policies, while controls on inflows were seen as a useful addition to the arsenal of domestic monetary instruments. Therefore, while he welcomed the reintroduction of capital controls as a way to prepare for full entry into the exchange rate mechanism of the EMS, they could only be a temporary measure; the fact that it was currently needed showed that the policy mix was not yet compatible with full entry. Consequently, the authorities needed to amend the domestic policy mix so that capital controls an short-term fluctuations in the exchange rate would no longer be necessary.

Mr. Filosa commented that he agreed with Mr. Hogeweg, with the exception of his observation on the adequacy of the policy mix. While one could not infer precisely whether the policy mix was fully consistent, he had tried to concentrate on the policy instruments themselves. In his view, it might be appropriate to distinguish between capital controls that were the result of an inadequate policy mix--which was not the case in Portugal--and capital controls that had been imposed because of a lack of the necessary instruments to implement monetary policy. However, he did not rule out the possibility that a somewhat better policy mix could be envisaged.

Ms. Creane made the following statement:

My authorities have asked me to first welcome Portugal's fifth year of exceptional economic performance. We have been impressed with several aspects, including the rapid growth, the narrowing of the budget deficit, the ambitious privatization program, and the double-edged ability to attract strong inflows of foreign investment. As I agree with the focus of most of the previous speakers on inflation and the necessary financial policy mix, I will add my emphasis to just a few points.

In response to the destabilizing effects of the strong capital inflows, and rather than refining existing controls--or adding others that would only further mangle the process--ideally, Portugal should have moved forward quickly to align its policies with those of its EC partners by increasing the flexibility of both its exchange rate and interest rate policies. Therefore, we add our welcome to that of others for the introduction of the new and more flexible exchange rate policy. Accordingly, we also hope that the new restrictions on capital inflows will be a very temporary measure.

We would also like to add our voice to those that encouraged a matching movement away from direct monetary policy controls as a method of stemming inflation. Important laws were enacted in 1990 enhancing the authorities' move to indirect monetary controls and potentially enhancing the independence of the central bank from financing the government borrowing requirement. However, to allow the new structure to work effectively, a well-functioning financial market must be in place. For this reason, we recommend quick removal of the remaining administrative controls, and further competition in the banking sector.

On fiscal policy, notwithstanding the continued progress last year in reducing the budget deficit, we share the general concern expressed today regarding the prospects for 1990 and the future, and the need to move toward tighter fiscal policy as a method of attacking the root of the inflation problem. We view last year as a sort of lost opportunity, as the Portuguese authorities did not take advantage of the one-time improvement in revenue by restraining expenditures and paying off outstanding debt.

Finally, as a matter of emphasis, my authorities believe that future narrowing of the budget deficit should be achieved by expenditure cuts rather than focussing on raising overall revenue levels. We do not believe that Portugal's ratio of tax revenue to GNP of 35 percent is low, and do believe that the average EC ratio of 40 percent is far too high to be viewed as a goal.

Mr. Chen made the following statement:

My first general point is that we continue to be impressed with the five consecutive years of higher growth since 1986, which culminated in an impressive growth rate of 5.4 percent. Much of the credit can perhaps be attributed to Portugal's accession to the European Community in January 1986. Since then, several healthy events have occurred in this formerly isolated economy.

First, given the favorable investment environment, Portugal has been fortunate enough to attract large amounts of foreign direct investment, especially in the context of today's increasing global demand for funds. The question now is whether this trend will continue in the face of the current world economic situation and the prospects of more uncertainties ahead.

Second, with the influx of foreign capital and EC-supported funds--as well as buoyant exports to EC countries--Portugal's economic structure has undergone noticeable changes, which would have taken much longer to accomplish without EC membership.

Third, EC membership did give a strong impetus to the positive development of market mechanisms, which brought pressure to bear on the economy to abide by market rules in a much more competitive environment. But, as Mr. Filosa said, much needs to be done, especially in the financial markets. In a word, we highly appreciate the material benefits, as well as the stimuli, brought about by Portugal's membership in the European Community.

My second general point concerns inflation. After a substantial decline, inflation began to climb in 1988, reaching at present around 13 percent, which is a puzzle, given that it occurred in spite of relatively tight monetary and credit policies. One wonders whether this inflation is inevitable, given the high level of economic activity and investment, backed by a high level of domestic savings and appropriate inflows of foreign capital, rather than accommodated by a rapid expansion of liquidity and total credit. This is a cause of frustration for the authorities, who were surprised by the latest acceleration of inflation, especially as both the growth rates of private consumption and gross fixed investment have declined. The same is true for domestic demand in 1989.

My third general point is that much improvement has been seen in elementary infrastructure, such as water supply in rural areas, sewerage and drains, and electricity, but much still needs to be done in the area of human resources--which may be considered as part of the social economic infrastructure. In order to increase competitiveness, there is a need not only for better equipment, but also sufficient skilled workers, which would call for an overall improvement in education. Without these basic components, Portugal will find it difficult to compete effectively in EC markets in the near future. These matters, therefore, must be given strong and equal attention.

Finally, we note that structural reforms, which have been carried out on quite a number of fronts, are crucial for reducing and eliminating various rigidities in the economy and increasing efficiency; we welcome this tendency. With increasing integration into the European Community and the world economy, this process will undoubtedly accelerate for a while, but at the same time pressures will increase. The authorities could well be faced with some unexpected difficulties associated with adapting to the speed required for full economic integration, including participation in the exchange rate mechanism of the EMS, under less favorable domestic conditions.

It is our sincere hope that the new mix of macroeconomic policies will be effective in maintaining the growth momentum, while consolidating internal and external balances. I would also like to wish the authorities well in their endeavors to tackle the current economic difficulties.

Mr. Marino made the following statement:

The achievements of Portugal during the second half of the 1980s are impressive. Charts 1 and 2 of the staff report give an excellent medium-term picture of Portugal's turnaround and success with the economic program.

Since 1985, Portugal's growth rate has been higher than in the EC countries, with the engine of growth being investment motivated by formidable profit opportunities and important improvements in productivity. The current account of the balance of payments turned from a deficit to a surplus, which was maintained for three consecutive years, before reverting to a small deficit in 1988-89, which has been more than adequately financed by the unprecedented surge in capital inflows. Similarly, Portuguese exports have consistently gained market shares. The inflation differential with the EC has narrowed from over 20 percent to slightly over 5 percent in 1989. Since 1985, the primary balance of the general government budget has registered a surplus, while the borrowing requirement of the public sector declined from over 20 percent of GDP in 1984, to slightly above 5 percent in 1989. The foreign debt as a percentage of GDP has been halved and, for the first time since 1982, gross international reserves are greater than foreign debt. Since 1985, unemployment has fallen from 10.4 percent to 5 percent, almost half the EC average. In general, Portugal has achieved a marked convergence toward the policy performance of the other EC countries, while being able to bridge the gap in terms of economic welfare.

All these achievements have been made possible through decisive conduct of policies by the Portuguese authorities, and the framework that EC membership has provided.

It seems that Portugal today--as in 1985--is again at a turning point. Portugal has the challenge of translating the current boom into a sustainable growth process. There are several issues that need to be addressed. In our view, the most important are, first, the consistency of exchange rate and interest rate policy and, second, the stance of fiscal policy.

With regard to exchange rate policy, we welcome the new policy adopted by Portugal that allows the escudo to fluctuate within a band defined in terms of a basket of European currencies. The new flexibility in the exchange rate will provide some room for maneuver for other financial policies. In general, financial policies that simultaneously try to achieve a fixed target for the exchange rate and interest rates are only sustainable in the medium term by a great coincidence. The capital flowing into Portugal to take advantage of the so-called risk-free investment might be signaling that either the exchange rate should be appreciated or interest rates should be allowed to fall. Both options represent difficult choices at the current juncture in terms of the macroeconomic needs of Portugal. If interest rates are allowed to fall, the capital inflows would diminish and thus limit the expansion of liquidity; however, lowering interest rates by increasing the demand for credit could end up augmenting overall liquidity.

However, it appears that the private sector has been increasing its recourse to medium- and long-term foreign borrowing, in view of the lower covered interest rates in foreign currency. Given this situation, perhaps a modest reduction in domestic interest rates would not lead to an increase in the demand for credit, since an important part is satisfied from external sources and--perhaps paradoxically, through its wealth effects on private savers--could contribute to containing demand pressures in the Portuguese economy. Additionally, lower interest rates would reduce the cost of servicing public domestic debt, helping reduce the public sector borrowing requirement.

The other option, to allow an appreciation of the escudo, could lead to an erosion of competitiveness. However, exporters still seem to be enjoying ample profit margins, and unit labor costs are still among the lowest in Europe. Therefore, we concur with the insightful analyses of the issue in Mr. Filosa's statement and in the staff's appraisal. If the new exchange rate policy effectively facilitates entrance into the exchange rate mechanism of the EMS, it will indeed provide an extraordinary weapon in the battle against inflation.

With regard to fiscal policy, we concur with the staff's thorough analysis in the background paper on recent economic developments. Indeed, the role of fiscal policy in 1990-91 will be decisive in determining the future performance of Portugal's economy. Since monetary policy will have little room for maneuver--given the inflationary pressures, the capital inflows, and the intention to join the exchange rate mechanism of the EMS as soon as possible--fiscal consolidation will play a central role. We are encouraged to learn from Mr. Filosa's statement that this is the first and overriding goal of the Portuguese authorities, since the stance of fiscal policy in 1990 has been expansionary, boosting aggregate demand in an economy that is showing some signs of overheating.

The great success of Portugal's economic program makes us confident that the authorities will respond adequately and promptly to the policy dilemmas that they are currently facing. Thus, before concluding, we want to ask Mr. Filosa to convey to his Portuguese authorities our commendation for their successful economic program of the last five years, and we wish them well in their future endeavors.

The staff representative from the European Department, responding to a point made by Mr. Iqbal, said that while household savings had declined, the overall savings position of the economy was fairly strong, as could be seen from the projected current account deficits. Although Table 1 of the staff report indicated that there was a widening of the current account deficit, from 1.2 percent in 1989 to 2.5 percent in 1990, the latest estimate of the Portuguese authorities was that there might be no further widening in relation to GDP in 1991. The decline in the household private savings rate could be explained in terms of expectations of continued employment growth and financial innovation. The decline had been more than compensated by comfortable company profit margins, and by considerable reduction in the borrowing requirement of the overall public sector, which had declined from 17.7 percent in 1985--the last year of a program with the Fund--to 9.4 percent in 1990. In addition, the sustainability of the current account deficit was clearly strengthened and secured by the strong investment activities that the country was experiencing. Therefore, the counterpart of the current account deficit was not found in a weakening savings position as much as it was reflective of a strong investment performance.

With respect to Mr. Hogeweg's concerns that recent policy changes might not have been entirely consistent with the interests of the international community, the staff representative said, an overriding aim of the authorities' program seemed to be convergence of inflation toward the EC average. The change to a new exchange rate system and a temporary rollback of capital liberalization should be seen as a means to make more progress on convergence, and in that sense was quite consistent with the interests of the international community.

Responding to Mr. Cirelli's suggestion that there might be scope for a reduction in short-term interest rates, the staff representative recalled that during the previous summer the central bank had refrained from intervening in the inter-bank market and had permitted the overnight rate to drop significantly. Indeed, that strategy had been pursued for a while and had succeeded in introducing a certain element of risk to short-term interest rates. Over the medium term, however, one could not rely on engineering changes in the term structure of interest rates, as the short end could not be detached from the longer end.

The Portuguese authorities were aware of the structural deficiencies and were making strenuous efforts to improve the situation, in particular through improving labor force skills and general educational standards, the staff representative from the European Department concluded. Moreover, the staff report had indicated that the authorities would prefer greater flexibility in the use to which EC structural funds could be put, so that those resources would not be limited to vocational training but could also be used to improve general educational standards.

The Acting Chairman then made the following summing up:

Directors welcomed the continuing strength of Portugal's overall economic performance during the last two years, which they ascribed to its integration into the EC, the strength of its policies, and the ensuing catch-up process with partner countries. They noted especially the sustained growth in productivity, investment, and exports, which had allowed for strong output gains and the attainment of virtual full employment, while at the same time helping further consolidate Portugal's financial position, including a buildup of foreign exchange reserves to record levels. Directors noted with satisfaction the significant decline in the ratio of public debt to GDP since 1988, which was a marked reversal of the previous trend, and the continuing decline of Portugal's external debt to levels well below gross international reserves.

Directors, however, cautioned that Portugal's economic performance in the period ahead could be jeopardized by the recent reacceleration of the rate of inflation, a trend that Directors thought was traceable to a certain inconsistency between the fiscal and monetary policy mix that had been followed, and the virtual certainty with respect to the direction of the nominal exchange rate. The downward movement of inflation had been interrupted in 1988; however, inflation had picked up in 1989-90, and this further widened the differential vis-à-vis Portugal's main trading partners. Directors observed that, for Portugal to stay on a path of sustained growth and to fulfill its aspiration to be a full participant in the process of European financial and monetary integration, urgent measures were needed to contain excess demand pressures and resume the process of inflation convergence. Directors noted the containment of wage pressures so far, but cautioned about signs of incipient wage pressure, which suggested that the recent trends in wage behavior might not be sustained in the absence of a decisive effort to cool inflation.

Directors were of the view that, at this juncture, fiscal consolidation should be the centerpiece of any effort to restrain inflationary pressures. A tighter fiscal policy would have a direct effect on aggregate demand and would reduce the burden on an increasingly constrained monetary policy. Tighter fiscal policy would also facilitate the attainment of the medium-term objective of fiscal convergence with other EC countries. In this regard, Directors were disappointed with the widening of the fiscal deficit envisaged in the 1990 budget, which could only work to exacerbate the strains facing an already overheating economy. Directors stressed the importance of the authorities' limiting discretionary spending, including greater restraint in setting government salaries and also scaling down non-EC-related investment expenditures. In addition, Directors saw possibilities for raising revenues through both a few selected excise taxes and through strengthening tax administration. The stance of fiscal policy would need to be tightened significantly in 1991 and beyond if there were to be any inroads against inflation and if convergence were to be secured, particularly because of the rising cost of interest payments on public debt. Accordingly, Directors welcomed the commitment of the authorities to a program of substantial fiscal adjustment and debt reduction over the next few years, but they were concerned that the adjustment envisaged in the 1991 budget would not be a sufficiently decisive step in this direction. Similarly, while welcoming the authorities' commitment to an incomes policy, Directors felt that the recent agreements in this area provided an ambiguous signal against inflation, even assuming further substantial gains in productivity.

Directors noted that the role of fiscal policy had assumed increasing importance as monetary policy became ever more constrained. Directors supported a continuation of a tight monetary policy, and endorsed the authorities' moves from the old system of direct credit controls toward a system of indirect monetary management. Directors understood the reasons that spurred the reintroduction of some controls on capital inflows, particularly in light of the need for Portugal to maintain a high nominal interest rate differential. Directors remarked, however, that such controls could only be a temporary expedient. In an otherwise open economy, controls on capital movements were apt to lose effectiveness over time and would, in any case, eventually be inconsistent with financial integration within the European Community.

In this context, adherence to a nonaccommodative exchange rate policy acquired particular importance. Directors, therefore, endorsed recent steps to move closer to an EMS-type system, with a few Directors, indeed, expressing the view that there was no longer a case for a continued crawling peg, even within an unannounced band. As elsewhere in the EC, balancing the mix between monetary, fiscal, and exchange rate policies could exercise a disciplining influence on wage and price behavior in Portugal, helping to lower inflationary expectations.

Directors noted with satisfaction the progress of Portuguese banks in conforming with the requirements of the various EC directives relating to matters of bank supervision and regulation. Directors welcomed especially the Portuguese efforts to recapitalize some of the weaker public banks, partly through the use of proceeds from privatization. On the question of privatization, a few Directors expressed concerns about the artificial limits imposed on foreign interests in privatized companies, noting in this context that this might unduly frustrate the process of privatization and would also be contrary to the spirit of European financial integration.

Directors welcomed the acceptance by Portugal of all obligations under Article VIII of the Articles of Agreement.

It is expected that the next Article IV consultation with Portugal will be concluded within 24 months.

The Chairman then assumed the chair.

2. EXECUTIVE DIRECTORS

The Chairman bade farewell to Mr. El Kogali and Mrs. Filardo upon the conclusion of their service as Executive Directors, and to Mr. Kwon upon the conclusion of his service as Alternate Executive Director.

At Informal Session 90/18 (10/24/90), the Chairman bade farewell to Mr. Ghasimi upon the conclusion of his service as Executive Director.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/152 (10/22/90) and EBM/90/153 (10/26/90).

3. BHUTAN - INTERIM ARTICLE IV CONSULTATION DISCUSSIONS - DECISION CONCLUDING 1990 ARTICLE XIV CONSULTATION

1. The Fund takes this decision in concluding the 1990 Article XIV consultation with Bhutan, in the light of the staff report on the 1990 interim Article IV consultation discussions with Bhutan conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions described in SM/90/197 are maintained by Bhutan in accordance with Article XIV, Section 2. The Fund encourages the authorities to administer these restrictions in a liberal manner. (SM/90/197, 10/16/90)

Decision No. 9572-(90/153), adopted
October 23, 1990

4. AUDIT COMMITTEE, FY 1991 - COMPOSITION AND NOMINATIONS

The Executive Board approves the Managing Director's recommendation that Australia, France, and Trinidad and Tobago be invited to submit nominations of persons to serve on the External Audit Committee for financial year 1991 and confirms the nominations set forth in EBAP/90/259 (10/12/90).

Adopted October 23, 1990

5. BULGARIA - TECHNICAL ASSISTANCE

In response to a request from the Bulgarian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/354 (10/22/90).

Adopted October 25, 1990

6. CAMEROON - TECHNICAL ASSISTANCE

In response to a request from the Cameroonian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/351 (10/19/90).

Adopted October 24, 1990

7. MONGOLIA - TECHNICAL ASSISTANCE

In response to a request from the Mongolian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/352 (10/19/90).

Adopted October 24, 1990

8. ROMANIA - TECHNICAL ASSISTANCE

In response to a request from the Romanian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/350 (10/18/90).

Adopted October 23, 1990

9. SOUTH EAST ASIAN CENTRAL BANKS (SEACEN) - TECHNICAL ASSISTANCE

In response to a request from the Research and Training Center of the South East Asian Central Banks (SEACEN) for technical assistance in developing projections for its Annual Survey, the Executive Board approves the proposal set forth in EBD/90/349 (10/18/90).

Adopted October 24, 1990

10. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 90/6 through 90/14 are approved.

11. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/90/268 (10/22/90) and EBAP/90/270 (10/24/90) is approved.

APPROVED: August 30, 1991

LEO VAN HOUTVEN
Secretary