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To: Members of the Executive Board  
From: The Secretary  
Subject: Portugal - Modification of Exchange Arrangement

Attached for the information of the Executive Directors is a paper on a recent change in the Portuguese exchange rate policy.

Mr. Spitaeller (ext. 4546) or Mr. Gilman (ext. 8524) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:  
Department Heads



INTERNATIONAL MONETARY FUND

Portugal

Modification of Exchange Arrangement

Prepared by the European Department and the  
Exchange and Trade Relations Department

(In consultation with the Legal Department)

Approved by Massimo Russo and S. Kanesa-Thanan

October 4, 1990

In the attached communication dated September 24, 1990, the Portuguese authorities have informed the Fund that, with effect from October 1, 1990, the basket of currencies against which the exchange rate of the Portuguese escudo is being adjusted to achieve the long-term objective of exchange rate policy will consist of the main currencies of the participants of the European Monetary System, weighted according to their importance in Portugal's international trade. The long-term objective of exchange rate policy, which remains unchanged, is to attain an annual depreciation of 3 percent against the currency basket in nominal terms, but the exchange rate of the Portuguese escudo will be allowed to fluctuate within margins of a few percentage points around this long-term rate of depreciation in response to supply and demand conditions in the exchange market.

In the Staff Report for the 1990 Article IV consultation (SM/90/168, 8/20/90), the staff recommended a change in the exchange rate regime whereby the rate of crawl of the Portuguese escudo could be set to occur within a band in order to facilitate greater consistency of exchange rate and interest rate policies. The staff is of the view that, in the presence of continued substantial interest differentials, the new exchange rate regime is apt to involve a relative strengthening of the Portuguese escudo, and should thereby help dampen inflationary expectations and strengthen price and cost discipline. It should also help brake the momentum of capital inflows, by limiting the scope for riskless interest rate arbitrage, and thus enhance the effectiveness of monetary policy in the effort to cool the economy. Moreover, with the average of main EMS currencies as reference, it should support the convergence of inflation rates. Thus, adoption of the new exchange rate regime may be seen as a welcome step on the way to eventual participation of Portugal in the exchange rate mechanism of the EMS.

The Staff Report for the 1990 Article IV consultation with Portugal (SM/90/168, 8/20/90) is scheduled for Board discussion in late October 1990.

Attachment

INTERFUND  
WASHINGTON, D.C.

CHANGES IN THE PORTUGUESE EXCHANGE RATE POLICY

1. IN ORDER TO PREPARE THE ECONOMY FOR A MORE FLEXIBLE EXCHANGE RATE ENVIRONMENT, BANCO DE PORTUGAL WILL INTRODUCE SOME SIGNIFICANT CHANGES IN THE IMPLEMENTATION AND MANAGEMENT OF ITS EXCHANGE RATE POLICY. THE NEW REGIME, TO START ON OCTOBER 1ST, WILL USE THE CURRENCIES OF THE EXCHANGE RATE MECHANISM (WEIGHTED BY PORTUGAL'S EXTERNAL TRADE) AS A REFERENCE FOR THE EXCHANGE RATE AND WILL LEAD TO A MORE FLEXIBLE EXCHANGE MARKET. IN PARTICULAR, THE ESCUDO WILL BE ALLOWED TO REFLECT MORE ACCURATELY MARKET SUPPLY AND DEMAND, GIVING THE NECESSARY SIGNALS TO ECONOMIC AGENTS AND PREPARING FOR A LESS PREDICTABLE ENVIRONMENT.

2. ACCORDINGLY, THE FOLLOWING CHANGES WILL BE INTRODUCED IN THE MANAGEMENT OF EXCHANGE RATE POLICY:

- A) AN INDEX WITH THE MAIN CURRENCIES OF THE ERM, WEIGHTED BY THEIR SHARE IN PORTUGUESE EXTERNAL TRADE, WILL BE USED AS A REFERENCE FOR THE LONG-TERM OBJECTIVE OF EXCHANGE RATE POLICY, THIS OBJECTIVE WILL CONTINUE TO BE AN ANNUAL DEPRECIATION OF 3 PERCENT.
- B) THE EXCHANGE RATE WILL RESPOND TO SUPPLY AND DEMAND PRESSURES, IT WILL FLUCTUATE WITHIN AN INTERVAL OF A FEW PERCENTAGE POINTS AROUND THE CENTRAL OBJECTIVE.

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