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August 19, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: Portugal - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Portugal, which has been tentatively scheduled for discussion on Monday, September 9, 1985. A draft decision appears on page 17.

Mrs. Ter-Minassian (ext. 8844) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

PORTUGAL

Staff Report for 1985 Article IV Consultation

Prepared by the Staff Representatives for
the 1985 Article IV Consultation

Approved by L. A. Whittome and J. T. Boorman

August 16, 1985

I. Introduction

A staff team consisting of Mrs. T. Ter-Minassian, Messrs. E. Spitaeller, D. Nellor (all EUR), E. Kalter (ETR), A. Lopez-Claros (EP-EUR), and, as secretary, Ms. A. Munante (EUR) visited Lisbon from June 18 to July 2, 1985 to conduct Article IV consultation discussions. The staff met with the Prime Minister, the Minister of Finance and Planning, the Governor and Deputy Governors of the Bank of Portugal and with officials in the Ministries of Finance and Planning, Industry and Energy, Labor, and in the Bank of Portugal. The previous consultation discussion had taken place from May 28 to June 20, 1984, and the staff report was considered by the Executive Board on July 30, 1984, concurrently with a review of the stand-by arrangement which had been approved by the Board on October 7, 1983 for the period to February 28, 1985 in the amount of SDR 445 million (118 percent of quota). A waiver of the nonobservance of the ceiling on the increase in the short-term external debt for July 31, 1984 was granted by the Executive Board on December 17, 1984 (EBS/84/259, 12/10/84). The Portuguese authorities did not request waivers of the ceilings on domestic credit to the enlarged public sector for September 30, 1984 and December 31, 1984 which were exceeded. Therefore, at the end of the stand-by arrangement, SDR 185.7 million remained undrawn.

In January 1985 the Portuguese authorities informed the Managing Director that, in view of the improvement in the external accounts in 1983 and 1984, they did not wish to request a new stand-by arrangement for 1985. They expressed, however, their intention to maintain close contact with the Fund and requested that the staff review the performance under the 1983-84 stand-by and issue a report on its findings to the Executive Board. A staff team consisting of Mrs. T. Ter-Minassian and Mr. E. Spitaeller (both EUR) visited Lisbon from February 25 to March 1, 1985 to conduct this review. A report on the staff visit (EBS/85/116, 5/9/85) was circulated for information to the Executive Board on May 9, 1985.

On May 31, 1985 Fund holdings of Portuguese escudos amounted to SDR 918.8 million (244 percent of quota) of which SDR 312.6 million (83 percent of quota) corresponding to drawings under the compensatory financing facility.

Since June 1983, Portugal has been governed by a coalition of Socialists (PS) and Social Democrats (PSD). Following a national congress of the PSD in May 1985, its new leadership decided to withdraw from the coalition. The inability to form a new Government that would enjoy a majority in Parliament led the President of the Republic to dissolve Parliament after ratification of the EC accession treaty in July. New parliamentary elections are scheduled for October, to be followed by local and then presidential elections early in 1986. The present Government is to remain in power in caretaker capacity until a new Government is formed after the parliamentary elections. Political uncertainties, which may last well into next year, are likely to constrain the room for maneuver in economic policy in the near term.

II. Report on the Discussions

1. Recent economic developments

Between 1979 and mid-1985 the Portuguese economy has come full circle. Expansionary financial policies and a loss of competitiveness resulted in a shift of the current account of the balance of payments from virtual equilibrium in 1979 to a deficit on the order of 13 percent of GDP in a matter of three years, forcing by mid-1983 a sharp reversal of course which over the next two years restored near balance to the external account. The developments leading to the adoption by the Portuguese authorities of an adjustment program for 1983-84 supported by a stand-by arrangement with the Fund have been described in earlier documents (Portugal--Staff Report for the 1983 Article IV consultation, SM/83/88, 5/18/83; and Recent Economic Developments, SM/83/94, 5/25/83). Here it is sufficient to recall the salient features of these developments. Over the period 1979-82, the authorities pursued expansionary fiscal and monetary policies involving a rapid growth of the monetary and credit aggregates and a widening of the public sector deficit, including the public enterprises, from the equivalent of about 16 percent of GDP in 1979 to 22 percent in 1982. During the same time the net savings balance of the private sector declined from the equivalent of 16 percent of GDP to 9 percent. The factors involved in this decline were initially large increases in real wages and real disposable income and subsequently declines in real interest rates and the savings rate. Total domestic demand in Portugal grew cumulatively by 13.3 percent in real terms during 1980-82, in contrast with virtual stagnation in Portugal's trading partners. At the same time competitiveness deteriorated significantly and the terms of trade registered a cumulative loss of 11 percent. As a result the current account deficit in the balance of payments widened from the equivalent of 0.3 percent of GDP in 1979 to 13.2 percent in 1982 (Table 1), and the external debt rose from

36 percent to 66 percent in relation to GDP and from 55 percent to 120 percent in relation to gross international reserves (Table 2). The foreign exchange component of the latter declined from a level equivalent to over seven weeks of merchandise imports to about two weeks.

Faced with a sudden hardening of conditions in international capital markets and mounting pressures on reserves, the authorities implemented in mid-1983 a substantial adjustment program supported by the Fund under a stand-by arrangement extending to end-February 1985. The main features of this program and the performance of the Portuguese economy under it have been described in various staff papers (Portugal--Request for Stand-By Arrangement, EBS/83/196, 9/9/83; Portugal--Staff Report and Review Under Stand-By Arrangement for the 1984 Article IV consultation, EBS/84/193, 7/2/84; Portugal--Recent Economic Developments, SM/84/170, 7/16/84; and Portugal--Report on Staff Visit, EBS/85/116, 5/9/85). The program included a 12 percent effective devaluation of the exchange rate in June 1983, followed by the maintenance of a depreciating crawling peg at the rate of 1 percent a month, increases in interest rates and administered prices. Financial policies were also substantially tightened. The growth of domestic credit was reduced from 24 1/2 percent in 1982 to 20 percent in 1983, involving a 10 percent decline in real terms, and remained below 20 percent through most of 1984 (Table 3). Restraint in domestic credit was facilitated by the maintenance of relatively high lending rates, which rose markedly in real terms during 1984. It was accompanied by a sharp decline of external credit in real terms, which in 1983 was mainly due to tighter supply conditions but in 1984 reflected improved control by the authorities.

Monetary restraint was supported by a substantial improvement in the public sector accounts in 1983, with the consolidated cash deficit of the General Government and the public enterprises declining by the equivalent of 7 percentage points of GDP, against the background of an increase equivalent to 1 percentage point of GDP in interest payments by the General Government alone. This progress was partly reversed in 1984, when the public sector deficit rose by nearly 2 1/2 percentage points in relation to GDP (over 3 percentage points above the program target of under 14 1/2 percent of GDP). This increase was accounted for in part by higher interest payments on the public debt and by lesser than initially forecast transfers of profits from gold sales by the Bank of Portugal to the budget. However, it also reflected shortfalls in tax revenues, the failure to adjust some administered prices in line with the undertakings of the program and overruns in some expenditures. The tightening of financial policies was largely responsible for the moderation of nominal wage increases which, in conjunction with a cumulative increase in the CPI on the order of 62 percent over the period 1983-84, resulted in a cumulative decline of real wages before taxes of 15 percent during the same period.

The effects of the program on the external accounts were quite marked. The current account deficit in the balance of payments narrowed by the equivalent of nearly 11 percent of GDP between 1982 and 1984. The

marked improvement of competitiveness in 1983, which in terms of relative unit labor costs continued into 1984, helped the external adjustment but the main factor involved was the steep decline in domestic demand (13 1/2 percent cumulatively in 1983-84) and the reversal in its relative cyclical phasing--domestic demand rose by 4 percent in Portugal's main trading partners over the same period. The outturn for the balance of payments in 1983 and 1984 involved an overachievement of the target for the current account in relation to GDP on the order of 40 percent. This overachievement has made the level of the external debt and its prospective service burden significantly more manageable, thereby providing room for a higher sustainable growth of imports over the medium term--undoubtedly a welcome prospect in the light of the opening up of the economy connected with the forthcoming EC accession.

The cost has been a decline of domestic demand substantially sharper than anticipated (Table 5), although its effects on output have been cushioned by a much stronger than expected export performance. With hindsight it appears that the impact of the improvement in competitiveness on the real trade balance was somewhat underestimated in the initial program. So were the effects of administered price increases and of the depreciation of the escudo vis-à-vis the U.S. dollar on the CPI, and the lag with which financial restraint began to affect the inflation performance. The higher than expected increase in prices, in the face of a deceleration in nominal wages, resulted in deeper than anticipated declines in real wages, real disposable income and consumption. It also made the credit ceilings tighter. Financial restraint in 1983 was in the event greater than envisaged in the program as the monetary authorities, faced with a larger than expected increase in the velocity of circulation of money and fearing an excess of the public sector borrowing requirement over the ceiling, progressively lowered the ceilings on credit to the private sector, which declined by over 12 percent in real terms. Total domestic credit rose by 20 percent--involving a decline of over 10 percent in real terms--as opposed to the 27.5 percent targeted for in the program, which was intended to involve a decline of less than 1 percent in real terms (Tables 3 and 5). The burden of monetary restraint fell especially on those components of domestic demand--investments and inventory accumulation--which are relatively more import-intensive, thereby contributing to the overachievement of the current account target.

Information available on economic developments so far in 1985 indicates continued progress in the external accounts, in reflection of the maintenance of a relatively low level of domestic demand and of a comfortable competitive position to date. Preliminary trade data for the first quarter point to an increase year-on-year of 12.5 percent of exports in volume terms and to a decline of nearly 6 percent in imports. The latter is, however, mainly attributable to a sharp fall in agricultural imports, in reflection of a good harvest. The deficit in the current account of the balance of payments is estimated at around US$70 million in the first quarter of 1985, compared with US$270 million in the first quarter of 1984. The overall balance of payments recorded a surplus of over US$450 million in the first four months of 1985, allowing some rebuilding

of foreign exchange reserves to a level equivalent to about six weeks of imports. Total international reserves, with gold valued at market prices, amounted to about US$9 billion (over one year of imports) by end-May 1985.

The scanty conjunctural indicators available suggest an incipient recovery of consumer demand since the fourth quarter of 1984, but investment, especially in industries oriented toward the domestic market and in construction, appears to have remained depressed in the first half of this year, reflecting the high degree of unutilized capacity, political and economic uncertainties and the maintenance of a high cost of credit. Inflation has been on a clearly decelerating trend, aided by the weakening of the U.S. dollar and the moderation of foreign prices, as well as by the fact that administered prices, which weigh heavily in the CPI, were adjusted on average by less than 20 percent at the beginning of the year. The 12-month rate of inflation in consumer prices has declined to 20 percent by June from nearly 25 percent in January. However, it appears that increases in nominal wages have accelerated, exceeding in some sectors and especially in the public enterprises, the official 22 percent guideline.

2. Economic policies

a. The overall strategy

The Portuguese authorities consider that, with a low deficit in the current account, a more comfortable level of foreign exchange reserves and a renewed good standing in international capital markets, the priority for economic policy in the short term should be to create the conditions for a sustained, albeit controlled, recovery of domestic demand, output and employment, along with a continued gradual deceleration of inflation.

At the time of the consultation discussions, with available indicators pointing to the maintenance of a relatively low level of domestic demand and to a continued strong performance in the external accounts, the Portuguese authorities saw a serious risk that GDP growth for 1985 as a whole would remain significantly below 2 percent. This forecast was premised on the assumption of a small further decline in real wages, virtual stagnation of real disposable income of households (Table 5) and some withdrawal of fiscal stimulus, with the public sector deficit projected to decline marginally in relation to GDP, against the background of an increase of over 1 1/2 percentage points of GDP in interest payments by the General Government (Table 4). The authorities saw as a further major impediment to a recovery of activity and ultimately of investment the maintenance of lending rates equivalent to nearly 10 percent in real terms, which contributed to a continued sluggish demand for bank credit by the private sector.

The authorities recognized that private consumption was likely to recover significantly in the second half of 1985, given the acceleration in nominal wage increases in recent months, the decelerating trend of inflation, and the rapid growth of liquidity over the last 12 months--M2

was estimated to have risen by over 7 percent in real terms by mid-1985. They were also aware of the risks of slippages in the implementation of the budget and of a worse than projected financial performance of the public enterprises, which could turn the planned fiscal restraint into actual stimulus as well as provide an additional boost to liquidity in the economy. Nevertheless, they felt that a prompt impulse to private demand should be provided through a significant reduction in the cost of credit (2.5-3 percentage points) and through selective increases in expenditures on public works. The cut in lending rates was implemented in early July, just ahead of the dissolution of Parliament.

The current political uncertainties prevented a comprehensive discussion of economic policies for 1986. Indeed, it is uncertain whether the 1986 budget can be presented and receive parliamentary approval on schedule--i.e., before the end of 1985. On a general level, the authorities saw as desirable objectives of policy for next year the attainment of a growth rate of GDP on the order of 3 1/2-4 percent, along with a further deceleration of inflation and the maintenance of the current account deficit of the balance of payments below the equivalent of US$1 billion (about 5 percent of GDP). The authorities recognized that for the external target to be achieved at a time of cyclical recovery of private sector demand, it would be necessary to secure a significant decline in the public sector deficit in relation to GDP. The "on present policies" prospects are, however, for a significant increase in the deficit, given the inherent dynamics of interest payments on the public debt, the foreseeable budgetary consequences in 1986 of measures taken in 1985, the limits to the possibility of increasing the tax burden without a comprehensive tax reform, and the likely continued deterioration in the financial position of major public enterprises in the absence of fundamental adjustments in government policies toward them.

Prospects for 1986 and beyond are also likely to be substantially affected by the accession to the EC. Many uncertainties prevent a firm assessment of its effects on the economy, especially the balance of payments and the budget, in the short as well as in the medium term. It appears that, on balance, the net impact on the current external accounts is likely to be negative in the short run, and it is unclear to what extent this can be offset by financial transfers from the Community. Over the longer term, Portugal's ability to take advantage of the opportunities offered by integration will depend, inter alia but above all, on the country's ability to modernize its productive structure and to eliminate some of the existing rigidities and distortions that hinder that modernization.

b. Monetary policy

For nearly a decade the main instrument of monetary policy in Portugal has been ceilings on domestic bank credit to the private sector (defined to include the public enterprises). Following the experience of the early 1980s when uncontrolled resort to external credit helped

finance excessive increases in domestic demand and attendant large deficits in the current account, as well as relatively high rates of inflation, the authorities have increasingly shifted the focus of their monetary programming to total (domestic and external) financing of the economy and to its allocation between the private and the public sector (including the public enterprises). In 1984, in an effort to secure compliance with the ceilings agreed upon in the stand-by program, the authorities began to supplement the ceilings set for the banks with guidelines on the resort by individual major public enterprises to domestic, as well as external, credit. This effort, which met with only a modicum of success in 1984, partly on account of the unclear definition of responsibilities of various government entities with respect to the public enterprises, appears to have waned so far in 1985.

The authorities are well aware of the shortcomings of the existing system of monetary control, particularly of the distortions engendered in the banking system's activities by a prolonged use of credit ceilings. They are, however, hampered in resorting to a more market-oriented system of control by the lack of well developed financial and monetary markets and by a tradition of rather inflexible management of interest rates. In these circumstances, the large deficits of the Treasury have been traditionally financed by the Bank of Portugal, which in turn sells government paper to the banks in the so-called interbank bond market to absorb a part of the large excess liquidity that these banks traditionally hold. The banks tend to be very liquid because time deposits represent virtually the sole outlet for financial savings and their growth tends to exceed the permissible growth of credit under the ceilings. The existence of such a "captive audience" has allowed the financing of the government deficit at relatively low rates--rates in the interbank bond market have typically been negative in real terms--at the cost, however, of a serious deterioration in the profit position of the banking system in recent years. The latter has been aggravated by the increase--connected with the recession in the domestic market--of bad debts and of arrears in interest payments by some public enterprises as well as--on a large scale--in the reimbursement of interest subsidies by the budget to the banks.

As a first step toward a comprehensive financial reform that would over time eliminate the above mentioned rigidities and distortions and allow a fuller play of market mechanisms in the conduct of monetary policy, the authorities have announced recently a package of measures aimed at reducing the cost of bank credit, improving the profitability of the banking system, creating short-term government paper for sale to the nonbank public and beginning a consolidation of the public sector's arrears toward the banking system. Specifically, lending rates have been reduced by 2.5-3 percentage points depending on the maturity of the loan, while deposit rates have been cut by 3 percentage points. In order to preserve an adequate remuneration on deposits on a net of tax basis, the rate of the tax on interest income on residents' deposits has been reduced from 20.7 percent to 15 percent and that on emigrants' deposits from 11.5 percent to 4.6 percent. Following this move, interest rates on time deposits of residents net of taxes stand, on average, at a level slightly positive

in real terms, while those on emigrants' deposits remain substantially positive (about 4.5-5 percent at the current 12-month rate of inflation). Due to the timing of the implementation of this measure, its cost to the budget in 1985 is minimal. However, a substantial revenue loss--estimated at about Esc 25 billion (0.7 percent of GDP) compared with the projected revenue from the interest tax in 1985--can be expected for 1986. The fact that the reduction in interest rates is larger for deposits than for lending rates, together with the fact that the stock of deposits exceeds substantially the stock of credit, will improve significantly the profitability of the banks, especially in 1986. In addition, the authorities have decided to consolidate some of the arrears of public enterprises and of the budget toward the banking system by issuing to the banks government bonds carrying relatively high interest rates. This measure will also, of course, boost the budget deficit in 1986. Finally, it has been decided to begin issuing in the second half of 1985 treasury paper of three to six months' maturities, which will initially be purchased by the banks and then passed on to the nonbank public at discounted rates which will, however, be higher than the net of tax rates on time deposits.

The monetary program of the Bank of Portugal for 1985 (which does not reflect a likely shift of some time deposits into the new treasury paper) postulates a sizable further decline in the velocity of M2, given the projected growth of real GDP (over 2 percent) and inflation (about 21 percent) through the year (Table 4). The decline would be even more substantial if, as it appears likely, the rate of inflation decelerates faster than projected. Total domestic credit is projected to rise by about 22 percent while, in reflection of a sizable inflow of foreign capital (Table 1), total financing would increase by nearly 23 percent. The allocation of this financing between the public and the private sectors is expected to improve, compared with recent years, with domestic credit to the private sector rising by over 2 1/2 percent in real terms. Credit to the private sector has been rising at substantially lower rates in the first half of the year, partly in anticipation of a reduction in lending rates, but can be expected to pick up in the second half, following the recent measures and as prospects for an upturn in consumers' demand become more firm. An obvious danger lies in the risk of a significant overrun in the target for credit to the public sector. Should such a slippage occur, the monetary authorities would be confronted once again with a difficult choice between tightening the ceilings on credit to the private sector or allowing an accumulation of liquidity in the economy which would in all likelihood create risks for the balance of payments and inflation in 1986.

c. Fiscal policy

The weaknesses besetting the public finances in Portugal have been extensively discussed in previous reports. As regards the General Government, they include a tax system and a tax administration badly in need of reforms (see Appendix II of the recent economic developments paper), a pervasive system of subsidies not always fully reflected in the budgetary statistics on account of the above mentioned accumulation of arrears

toward the public enterprises and the banking system, and an excessively large and reportedly not highly productive civil service, partly reflecting the rapid growth of the labor force during the last decade. The finances of major public enterprises, on the other hand, have been weakened in the last several years by overambitious and often ill-conceived investments, largely financed with external debt, by inadequate adjustment of administered prices to costs (for example, electricity rates currently cover less than two thirds of economic costs) and, in some instances, by the maintenance of excess capacity and manpower. The difficulty of securing a steady improvement of the public sector finances is compounded by the high level of the debt of both the General Government and the public enterprises and of its interest service, especially given the large share of external debt in total public debt and the downward trend of the escudo. The Portuguese authorities have been engaged for over a year in discussions with the IBRD for a public enterprise restructuring loan, involving changes in the institutional mechanisms of control of the public enterprises, a consolidation of arrears within the public sector and financial and physical restructuring of selected companies. These discussions have been slowed by the recent political developments and are unlikely to be concluded before the end of this year.

Official projections for 1985 involve a slight reduction in the consolidated borrowing requirements of the public sector as a whole, relative to GDP, reflecting a deterioration in the finances of the General Government more than offset by an improvement in the public enterprises' position (Table 4). The improvement is more marked in the noninterest component of the deficit. The official projections for the General Government involve a small increase in the tax ratio, mainly on account of the introduction at the beginning of the year of a tax on interest on emigrants' deposits, and a reduction in noninterest expenditures of the General Government, concentrated in subsidies and public investments. The projections for the public enterprises are based on an enterprise-by-enterprise survey conducted earlier in the year. The authorities were not in a position, at the time of the consultation discussions, to provide a comprehensive update of these projections which therefore are subject to a large margin of uncertainty.

The Portuguese authorities recognize that, on present policies, there are substantial risks that the projected borrowing requirements of the public sector will be exceeded. Although tax revenues in the first few months of the year were generally on target, shortfalls are likely to develop in some areas later in the year, especially as regards the revenue from taxes on petroleum products, the prices of which have not been adjusted as called for by the schedule underlying the official projections. By the same token, expenditures will have to rise for those petroleum products--such as fuel oil--which are subsidized. Moderating factors in this respect will be the current weakness of oil prices and of the U.S. dollar. Even barring slippages in expenditures control on account of the current political phase, there appear to be likely overruns in interest payments, health expenditures, and in treasury loans to selected public enterprises. The authorities are also contemplating a

significant increase in public works to support the depressed construction sector. On the basis of preliminary information, it appears that the rate of growth of credit to the public sector has accelerated considerably in recent months and by July it exceeded the target for year-end by a couple of percentage points.

While the prospects for the public enterprises finances will be favorably affected by the current weakness of prices of imported commodities and of the U.S. dollar, by the moderation of foreign interest rates and the recent reduction in domestic lending rates, the trend apparent toward an acceleration of wage increases in major public enterprises gives some cause for concern. Information available on developments in total financing--domestic and external--of the public enterprises during the first five months of the year points to a rate of growth in this financing roughly in line with the target for the end of the year.

d. External policies

The Portuguese authorities continue their exchange rate policy involving a 1 percent effective depreciation of the escudo per month. This policy appears to have allowed them to maintain most of the improvement in competitiveness secured through the devaluation of mid-1983. While the real exchange rate in terms of relative consumer prices has recorded a slight appreciation in 1984 and may register a further one in 1985, alternative (and probably better) indicators of competitiveness such as the ratio of export to domestic prices and relative unit labor costs point to a continued improvement of competitiveness in 1984, and to little or no loss in 1985, provided that the authorities' projections of costs and prices are realized (Table 1). The authorities regard the maintenance of an adequate competitive position as essential for an economy like the Portuguese which, given its relatively high debt service burden and import elasticity, can only look to a sustained growth of output and consequently of imports if it can secure steady gains in market shares.

Portugal's total external debt (including that of the monetary authorities) approached the equivalent of US$15 billion (over 77 percent of GDP and 170 percent of gross international reserves) at the end of 1984. Its structure continued to improve, with the share of short-term debt declining to 20 percent, compared with over 28 percent two years before. However, the debt service ratio recorded a sizable jump (to over 35 percent) in reflection of the unwinding of grace periods on large loans contracted in 1981-82. The borrowing program of the Portuguese authorities for 1985 envisages a net increase in the debt of the nonmonetary sector on the order of US$1.4 billion, partly offset by a reduction of US$275 million in the foreign liabilities of the Bank of Portugal. The short-term component of the debt is projected to increase by less than US$200 million implying a further decline in the share of short term in total external debt. The bulk of the borrowing program (nearly US$1 billion on a net basis) was carried out in the first half of the year, primarily by the State and a few public enterprises, notably the electricity company (EDP). The debt service ratio is projected to remain

broadly unchanged at around 35 percent of foreign exchange earnings in 1985 but to decline to below 30 percent in 1986, reflecting the favorable impact on amortizations of the sharp deceleration in the growth of the debt which occurred in 1983 and 1984.

The authorities have made considerable progress in their management and control of the external debt in the last two years. Also, the terms received by Portuguese borrowers in international capital markets have improved significantly and are more favorable than those received by most developing countries. Nevertheless, despite improved conditions, the size of the debt and its service is likely to continue to constrain significantly the room for maneuver on the external side over the medium term. Appendix III presents some illustrative scenarios of the external debt during the next ten years, on alternative assumptions about the path of the current account deficit of the balance of payments and the external environment. These scenarios suggest that, in all likelihood, it will be necessary to keep the current account deficit below 6 percent of GDP a year on average, if the debt to GDP and the debt service ratios are to be broadly stabilized. The scenarios also highlight the vulnerability of the Portuguese economy to external conditions, such as the growth of foreign demand and the behaviour of real interest rates in international capital markets (Table 6).

The prospects for Portugal's balance of payments beyond 1985 will be importantly affected by accession to the EC, scheduled to become effective in January 1986. The terms of accession and its prospective effects on major sectors of the economy are discussed in greater detail in Appendix I of the recent economic developments paper. Only the salient features of the agreement are recalled here.

The basic transition period will be seven years, ten years for agriculture. During this period tariffs will be reduced gradually and in accordance with an agreed-upon yearly schedule for some 40 industrial products, which enjoyed relatively high protection in the past. Existing import surcharges of 10 percent and 60 percent will be removed immediately upon accession. The process of trade liberalization within the EC is to be accompanied by the removal of trade barriers between Portugal and Spain. Effective January 1, 1986, Spain will eliminate tariff barriers against Portuguese imports and simplify administrative procedures, while retaining for five years quantitative restrictions on selected products (in particular, textiles). Portugal will lower tariffs on Spanish imports to the same level applying to imports from other EC countries. It will also eliminate import licenses as part of the general trade liberalization. The reduction of tariffs on imports from EC countries will be accompanied by a cut in tariffs on third countries to current EC levels of around 5 percent (the average Portuguese tariff is currently around 16 percent).

The reduction of tariff and nontariff barriers, especially vis-à-vis Spain and third countries, will mean increased competition for a number of industries, including textiles, and result in increased import penetration, especially in the short term. On the export side, the Portuguese

authorities see opportunities for the expansion of exports to the EC of a number of products including clothing, pulp and paper, furniture, selected metal mechanic products, ceramics, and footwear. The full exploitation of these opportunities will, however, require considerable investments to restructure and modernize the relevant industries. To aid in this process the authorities are currently preparing a new scheme of investment incentives to replace the existing one which is felt to be too complex and ineffective. The new scheme will be limited to investments (in any sector of the economy) which meet prespecified criteria of restructuring or innovation. It will take the form of cash grants, as opposed to interest rate subsidies as in the current scheme, but it will not be open-ended, as a limit will be set in the annual state budget on the total amount of funds available under the scheme. It is expected that these funds will be largely used as counterpart to resources to be transferred by the EC under a special industrial restructuring facility.

In the area of agriculture, transition to the Common Agricultural Policy (CAP) of the EC is to be accomplished over a ten-year period for the majority of Portuguese products and over a seven-year period for the remaining products. The ten-year period is subdivided into two five-year stages, with the status quo prior to accession applying during the first stage, while the second stage foresees a gradual elimination of protective barriers and other policies at variance with the rules of CAP. The approach inherent in the second stage applies also to the products covered under the seven-year transition period. Eventually, agricultural prices in Portugal are to be equalized with those in the EC, temporary subsidies being permissible only where reductions in the real price of a given product over the short run are too marked. At present, many agricultural producer prices in Portugal are substantially higher than in the EC, partly on account of increases in the last two years which were necessary to reduce budgetary subsidies. Thus, substantial increases in productivity in agriculture will be essential if too pronounced a squeeze on the incomes of farmers is to be avoided. The Community will make available to Portugal the equivalent of ECU 700 million over the ten-year period after accession to help in the agricultural restructuring effort.

It is not easy to predict at the present time to what extent the probably adverse initial impact of accession on the trade balance of Portugal will be offset by an increased inflow of direct investments and by financial transfers from the Community. Portugal will receive transfers under both the Guarantee and Guidance sections of the EAGGF and under the European Social and Regional Development Funds. These inflows will depend importantly on the timely preparation and presentation to the Community of qualifying projects, as well as on the allocation in the budget of adequate counterpart funds. Portugal will have to transfer to the Community revenues from customs duties and a portion of revenues from VAT, which in the first three years will be replaced with a contribution based on Portugal's relative weight in the Community's GDP and will be rebated to Portugal at a declining rate during the whole transition period. Preliminary and tentative calculations suggest that the net financial transfer from the Community will probably be relatively small (below the

equivalent of ECU 150 million in constant prices) in the early years of accession, rising to perhaps double that amount over time. Portugal has also negotiated in principle recourse to a balance of payments support facility of the EC for a total amount of ECU 1 billion over the transition period, concentrated in the first and sixth years after accession.

e. Labor market policies

The industrial restructuring effort in both public and private enterprises which will be necessary over the next several years to improve the financial position of some major public enterprises and to take full advantage of the opportunities offered by EC accession would be greatly helped by a reduction of rigidities in the labor market.

Traditionally, employment in Portugal has shown little sensitivity to cyclical developments in the economy. Although a change in the methodology of the employment survey in 1983 prevents a precise assessment of the impact of the stabilization program on employment over the last two years, indications are that it remained limited, except in the construction sector. The flexibility of real wages--as well as a reflow of the labor force into agriculture--undoubtedly contributed to cushioning the effects of the recession on employment.

The low cyclical sensitivity of employment is at least in part a reflection of rigidities in the institutional mechanisms governing the labor market. Although procedures for collective dismissals--involving more than five workers--are in principle fairly liberal and the authorities claim that most requests for authorization of such dismissals are approved without excessive delays, in fact there has been limited use of dismissals especially by large private and public companies. A law on layoffs for up to two years approved in early 1984 has not been utilized to date. In addition, regulations concerning individual dismissals are very cumbersome and can involve substantial costs for the enterprise.

The limited flexibility in the labor market has been at least partly related to inadequate income maintenance provisions for redundant workers. Until 1985 unemployment compensation was minimal and often workers of enterprises in financial difficulties accepted partial payments of wages rather than unemployment. Typically, the Unemployment Fund ran sizable surpluses which were partly used to support enterprises of doubtful viability, partly transferred to the state budget. Recent legislation has substantially improved unemployment benefits, which are now related to the employment and salary history of the beneficiary and have a minimum duration of six months, extended by one month for each year of employment. In addition, a Wage Guarantee Fund has been created to ensure payment of wage arrears of bankrupt enterprises. These improvements in unemployment benefits should help increase flexibility in the labor market. Their prospective cost to the budget could be minimized by withdrawing support to enterprises which have little prospect of becoming financially viable over the medium term. The authorities intend further to increase flexibility in the labor market by promoting resort to part time work and to

fixed term contracts, and by providing some incentives to the geographic mobility of labor, especially in the public sector. Geographic mobility of labor should also be affected favorably by the recently approved law liberalizing rent controls, which is expected to take effect in 1986.

A Social Coordination Council including representatives of the Government, trade unions and employers' associations, under the chairmanship of the Prime Minister, has been established in 1984. The purpose of this body is to provide a forum for dialogue among the social partners and the Government on relevant social and economic issues, especially those concerning the labor market. The Council will report to the Government on the consensus (or lack thereof) on these issues and advise it accordingly.

III. Staff Appraisal

The Portuguese economy has undergone a strong and successful adjustment in its external position over the last two years. The deficit in the current account of the balance of payments has been reduced by the equivalent of 11 percentage points of GDP, the growth of the external debt has slowed substantially, the standing of Portugal in international markets has been restored and its foreign exchange reserves are at a more satisfactory level. Instrumental in this adjustment have been the tightening of financial policies, the moderation of wages in the face of a temporary pickup of inflation and a strong competitive position. The impact of a sharp decline of domestic demand on output has been cushioned by an impressive export performance.

The prospects are for a moderate pickup of demand and output in 1985, supported by a recovery in real disposable income of households, by an easing of the stance of monetary policy and by a significant reduction in interest rates. The rate of inflation is likely to be substantially lower than in 1984, and the deficit in the current account of the balance of payments is expected to remain below the equivalent of 3 percent of GDP. The outlook for 1986 is considerably less favorable. Political conditions are likely to remain unsettled for several months, hindering the timely definition of a comprehensive economic policy strategy for next year. The structural weaknesses which continue to beset the Portuguese economy in many areas will become more threatening at a time of cyclical recovery in domestic demand and when the economy is being exposed to the initial impact of accession to the EC.

These weaknesses have been discussed extensively in previous staff reports. They include a structure of industry in great need of modernization in sectors with a promising export potential and of reduction of capacity in others such as basic industries dominated by public enterprises; an agriculture with very low productivity compared with the rest of the EC; a public sector deficit which at close to 19 percent of GDP--after allowance for the continuing accumulation of arrears--absorbs an excessively large share of financial resources; and pervasive distortions and rigidities in the financial and labor markets.

The scope for fundamental correction may be limited in the near term. It is, however, essential that a firm stance of economic policies be pursued in the next few months. In the view of the staff, the authorities should guard against the risk that the already high target rates of growth of the monetary and credit aggregates for this year are exceeded. This implies, first of all, the need for tight control over public spending, whether through the budget or through treasury loans, for a prompt adjustment of some administered prices--especially of petroleum products and electricity--and for continued effort in tax enforcement, to ensure that the projected borrowing requirement of the General Government for 1985 is not significantly exceeded. It is also important to monitor more closely the borrowing needs of major public enterprises and to take prompt corrective steps if they threaten to exceed the target. A sizable excess of the financing needs of the public sector over the target would force the monetary authorities either to reduce the permissible growth of credit to the private sector, thereby negating the main purpose of the recent cut in interest rates, or to accept an excessive growth of liquidity in the economy, with adverse consequences for the balance of payments and inflation in 1986. In the view of the staff, it is also crucial to maintain the crawling peg at its current rate. This is necessary to preserve competitiveness, given the current and prospective development of cost and price differentials between Portugal and its main trading partners.

In shaping economic policies for 1986 and beyond, the new Government will need to take bold and wide-ranging actions to address the fundamental weaknesses mentioned above, if it is to ensure a sustained growth of output and employment over the medium term, in the context of decelerating inflation and without the re-emergence of balance of payments constraints. The challenges posed by integration into the EC add urgency to this action. In the view of the staff, the priority should be a lasting improvement in the public sector finances, accompanied by a reduction of existing rigidities in the financial and labor markets. Adequate progress in these areas would help create the conditions for a sustained recovery of domestic investment, greater inflow of foreign nondebt capital and a strong performance of exports over the medium term.

A lasting improvement in the public finances would certainly be fostered by greater transparency in the public sector operations, by a consolidation of the widespread existing arrears both within the sector and toward the banking system and by the adoption of measures to prevent a recurrence of such arrears. It is essential to make rapid progress in reforming the tax system to make it more equitable and responsive to changes in the tax base and to strengthen the tax administration. In this respect the staff regrets the recent decisions by the authorities to postpone the introduction of VAT to 1986 and to cut substantially the taxes on interest income, at a large revenue cost for next year. On the expenditure side, it will be necessary to cut the pervasive open and hidden subsidies in the system, which often have little justification in terms of income distribution and affect resource allocation adversely. It will also be necessary to curb the growth of public consumption by

increasing the mobility and productivity of the civil service--including the health service. A faster growth of public investment than in recent years will be necessary to take advantage of facilities offered by the EC. It is important that these expenditures be directed toward projects that improve the productive potential of the country, especially in agriculture.

As regards the public enterprises, proposed plans of financial restructuring, especially in industry, should be accompanied by adequate programs of physical restructuring, which should ensure an improved economic performance and be monitored closely during their implementation. These may have to involve in some instances reduction in capacity and employment. It is also crucial that the prices of public enterprises subject to administrative control--notably electricity tariffs--be adjusted in a timely fashion fully to reflect cost developments, after allowance for required productivity gains, and that the investment programs of public enterprises be closely scrutinized to avoid a recurrence of costly mistakes such as those made in the late 1970s and early 1980s. The staff hopes that discussions between the Portuguese authorities and the IBRD for a public enterprise restructuring loan will be concluded as soon as possible and will lead, among other things, to a better definition of areas of responsibility in the management of the public enterprises than is currently the case.

The staff welcomes the broad thrust of the measures announced recently to increase the nonmonetary financing of the budget deficit and to strengthen the banking system, although it believes that adequate progress in this area could have been made at a lesser cost to the budget. It is important that in 1986 and beyond efforts be stepped up to broaden the scope of monetary and financial markets by offering savers a more varied range of financial assets at appropriate interest rates, thereby gradually creating the conditions for a more flexible and market-oriented management of monetary policy. The recent opening of the banking system to private domestic and foreign initiative should help increase flexibility and competition in financial markets.

The recent modifications of the unemployment compensation scheme should help reduce rigidities in the labor market, as would a liberalization of existing labor legislation. The staff hopes that it will be possible to make quick progress in this area.

To sum up, in the view of the staff, the stabilization effort of 1983-84 has created the conditions for a sustainable recovery of growth and an improved inflation performance without resurgence of external constraints in the next few years, provided that firm control is exercised over financial policies in the near term, competitiveness is maintained at an adequate level, and the authorities take decisive action to tackle the remaining fundamental weaknesses of the economy as soon as the current political uncertainties are clarified.

It is recommended that the next Article IV consultation with Portugal take place on the standard 12-month cycle.

IV. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision in concluding the 1985 Article XIV consultation with Portugal, in the light of the 1985 Article IV consultation with Portugal conducted under Decision No. 5392-(77/63) adopted on April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes with satisfaction that Portugal maintains a system relatively free of restrictions on current payments and transfers for current international transactions, and welcomes the authorities' commitment to the maintenance of this system.

Table 1. Portugal: Summary of the Balance of Payments, 1981-85

(In millions of U.S. dollars, except as otherwise indicated)

	1981	1982	1983		1984		1985
			Program	Outturn	Program	Outturn 1/	Official forecast
Exports, f.o.b.	4,088	4,108	4,535	4,569	5,050	5,210	5,430
Imports, f.o.b.	9,282	8,941	8,385	7,644	7,560	7,241	7,240
Merchandise trade balance	-5,194	-4,833	-3,850	-3,075	-2,510	-2,031	-1,810
Services, net	-544	-1,092	-880	-736	-790	-667	-670
Of which:							
Tourism, net	777	609	670	591	720	727	...
Investment income, net	-975	-1,269	-1,250	-1,064	-1,300	-1,200	-1,300
Transfers, net	2,888	2,680	2,730	2,171	2,050	2,178	2,030
Of which:							
Emigrants' remittances	2,832	2,599	2,660	2,151	2,000	2,155	...
Current balance	-2,850	-3,245	-2,000	-1,640	-1,250	-520	-450
As percent of GDP	(11.5)	(13.2)	(9.3)	(7.2)	(6.0)	(2.3)	(2.3)
Medium- and long-term capital	1,853	2,585	1,075	1,466	1,050	1,273	1,300
Short-term capital 2/	848	783	-215	-649	200	-385	-60
Overall balance	-149	123	-1,140	-823	--	368	790
Change in net foreign assets of commercial banks 3/	43	-15	--	-243	--	-173	...
Change in official net foreign assets 3/	106	-108	1,140	1,066	--	-195	...
Memorandum items:							
(percentage change)							
Market growth	-1.0	2.1	3.0	3.6	6.3	7.8	6.1
Export, f.o.b., unit value 4/	13.3	16.5	37.5	26.8	27.5	30.5	19.0
Export, f.o.b., volume 4/	-2.1	10.8	8.5	20.3	10.0	15.4	7.5
Import, c.i.f., unit value	21.1	17.3	32.0	28.9	28.5	31.9	19.5
Import, c.i.f., volume 4/	5.8	5.5	-3.4	-7.6	-3.0	-3.0	2.5
Effective exchange rate	-3.6	-13.9	-22.3	-20.5	-15.0	-16.9	-13.0
Escudo/U.S. dollar rate	-18.7	-22.6	-36.0	-39.5	-26.5	-32.1	-22.7
Real exchange rate 5/	4.0	-0.9	...	-6.7	...	1.2	3.2
Relative unit labor costs	4.7	-6.9	...	-12.0	...	-4.9	--

Sources: Data provided by the Portuguese authorities; and Fund staff estimates and projections.

1/ Provisional estimates.
2/ Includes errors and omissions.
3/ Negative sign denotes an increase.
4/ Merchandise trade, customs basis, in escudos.
5/ Measured by relative consumer prices (trade-weighted).

Table 2. Portugal: External Debt Outstanding and Debt Service Ratio, 1982-84

(In millions of U.S. dollars; end of period)

	1982		1983		1984	
	Total	Of which: Short-term	Total	Of which: Short-term	Total	Of which: Short-term
General Government	2,865	--	3,435	--	3,843	--
Bank of Portugal	670	120	1,089	300	1,051	200
Other monetary institutions and nonmonetary financial sector	1,469	51	1,805	71	1,799	13
Public enterprises	7,747	3,514	7,380	2,907	7,644	2,694
Nonfinancial private sector	910	177	776	144	601	103
Total	13,661	3,862	14,485	3,422	14,938	3,016
Of which:						
Government and government-guaranteed	4,730	176	5,855	343	6,191	...
Bank guaranteed	816	6	660	10	474	...
Memorandum items: (in percent)						
Share of short-term debt	28.3	...	23.7	...	20.1	...
Ratio of debt to GDP	58.4	...	70.4	...	77.4	...
Ratio of debt to foreign exchange earnings 1/	158.0	...	169.6	...	158.6	...
Ratio of debt to gross international reserves 2/	117.9	...	146.1	...	169.5	...
Ratio of debt service 3/ to foreign exchange earnings	27.1	...	27.6	...	35.5	...

Sources: Bank of Portugal; and staff estimates.

1/ Foreign exchange earnings from exports of goods and services plus remittances.
2/ With gold valued at the quarterly average London market price.
3/ Excluding amortizations of short-term debt.

Table 3. Portugal: Monetary Survey, 1983-85

(In billions of escudos; end of period)

	1983	1984		1985	1983		1984		1985
	Outturn	Program	Outturn	Official forecast	Program	Outturn	Program	Outturn	Official forecast
					Percentage changes				
Net foreign assets of the banking system	700.1	704.0	1,039.9	1,200.0	...	...	...	...	...
(In millions of U.S. dollars)	(4,850.0)	(4,850.0)	(5,192.0)	(5,981.0)	...	...	...	...	...
Total domestic credit	2,526.5	3,096.0	3,102.7	3,820.0	27.5 3/	19.9 3/	21.0 3/	21.4 3/	21.9 3/
of which:									
To enlarged public sector	943.9	1,158.0 1/	1,230.1	1,503.0	... 3/	23.9 3/	19.2 3/	20.3 3/	19.0 3/
To general Government	582.7 1/	710.0	773.3	1,055.0	26.5	19.1 3/	19.9 3/	25.5 3/	24.6
To public enterprises	361.2	448.0	461.8	447.8	...	35.3	24.0	27.9	-3.1
To private sector 2/	1,584.4	1,938.0	1,872.6	2,316.9	...	17.5	22.3	17.8	24.1
Total assets	3,288.4	3,800.0	4,142.6	5,020.0	24.0 3/	23.0 3/	16.5 3/	24.7 3/	20.4 3/
M1	651.9	730.0	750.8	...	10.0	5.7	12.0	15.2	...
Time deposits of residents 4/	1,274.5	1,562.0	1,645.2	...	23.4	21.1	23.3	29.1	...
M2	1,926.4	2,292.0	2,396.0	3,031.0	19.9	16.6	19.5	24.4	26.5
Foreigners' deposits	650.8	800.0	885.2	1,177.0	36.5	33.1	33.0	36.0	33.0
Commercial financial institutions	25.7	25.0	35.5	35.0	...	...	...	...	...
M2*	2,602.8	3,186.0	3,316.7	4,243.0	23.1	20.3	22.8	27.4	27.9
Commercial liabilities	105.2	113.5	124.4	141.0	...	...	...	...	...
Exchange rate valuation	392.7	390.0	526.9	500.0	...	...	...	...	...
Other items, net	127.6	170.5	174.7	130.0	...	...	...	...	...
Memorandum items:									
Percentage change in total domestic and external credit 5/	...	...	...	...	23.1	17.9	21.0	20.1	22.8
Percentage change in total domestic and external credit to the enlarged public sector	...	...	...	...	...	21.9	21.7	24.5 6/	23.4 6/
Percentage change in velocity of M2* 7/	...	...	...	...	0.8	5.0	-0.8	-4.0	-3.1
Interest rate on six-month deposits 8/	...	...	...	...	28.0	26.0	25.0	28.0	24.0

Source: Data provided by the Portuguese authorities.

1/ Performance clauses.

2/ Including state participated enterprises and nonmonetary financial institutions.

3/ Percentage changes calculated including in total domestic credit (credit to the public sector) Esc 108.7 billion as counterpart of revaluation of gold reserves in February 1980.

4/ Excluding time deposits of public sector.

5/ The percentage changes in the external credit component are calculated by reference to the flow of borrowing in each year converted at average exchange rates.

6/ 25.9 percent in 1984 and 24.9 percent in 1985 including payments by the Exchange Guarantee Fund of the Bank of Portugal to selected public enterprises (see footnote 4, Table 7). These amounts are included with a negative sign in the exchange rate valuation item.

7/ Through the year.

8/ End of period.

Table 4. Portugal: Public Sector Operations, 1982-85

(In billions of escudos)

	1982	1983		1984		1985	1984 1/ 1985	
		Program	Outturn	Program	Outturn 1/	Official forecast	Percentage changes	
General Government								
Current revenue	563.7	774.0	768.1	980.0	901.3	1,105.1	17.3	22.6
Direct taxes	138.9	196.0	195.0	228.0	232.3	304.4	19.1	31.0
Indirect taxes	261.0	361.0	359.5	478.0	423.9	531.2	15.2	25.3
Social security contributions	140.3	167.0	166.0	195.0	191.2	230.5	15.2	20.6
Nontax revenue	23.5	50.0	47.6	79.0	53.9	39.0	13.2	-27.6
Current expenditure	643.9	836.0	824.2	1,072.0	1,017.4	1,307.0	23.[illegible]	29.[illegible]
Wages and purchases	280.7	340.0	337.6	407.0	415.5	509.5	23.1	22.6
Subsidies 2/	79.9	108.0	112.2	144.0	121.2	125.0	8.0	3.1
Transfers	182.2	227.0	227.5	282.0	280.6	364.5	23.5	29.9
Interest payments	101.1	161.0	146.9	239.0	200.1	308.0	36.2	53.9
Current deficit	80.2	62.0	56.1	92.0	116.1	201.9	...	...
Capital revenue	14.7	13.0	16.0	17.0	23.2	20.2	45.0	-12.9
Capital expenditures	100.2	114.0	122.0	121.0	124.6	145.2	2.[illegible]	16.[illegible]
Investment	71.4	78.0	81.0	83.0	80.7	86.6	-	7.3
Transfers	28.8	36.0	41.0	38.0	43.9	58.6	7.1	33.5
Net lending	25.8	27.0	30.3	49.0	37.1	37.0	22.4	--
Overall deficit	191.5	190.0	192.4	245.0	254.6	363.9	...	...
Treasury operations and other adjustments (net)	27.5	39.0	12.7	7.0	24.0	29.5	..	...
Borrowing requirements	219.0	229.0	205.1	252.0	278.6	393.4	...	...
Financed by:								
Domestic bank credit	156.9	167.0	119.0	127.0	193.4	281.0	...	...
External credit	53.4	60.0	80.0	120.0	76.2	97.9	...	...
Other	8.7	2.0	6.1	5.0	9.0	14.5	...	...
Public enterprises								
Borrowing requirements	191.5	...	140.2	163.0	217.6	210.4	...	...
Financed by:								
Domestic bank credit	24.2	...	106.7	86.5	99.6	-14.0	...	...
External credit	153.4	...	25.6	71.5	86.0	178.4	...	...
Other	13.9	...	7.9	5.0	32.0 3/	46.0 3/	...	...
Memorandum items: (In percent of GDP)								
Tax revenue	29.3	31.2	31.5	31.6	30.0	30.6	...	...
Total general government expenditure	41.7	42.2	42.7	43.5	41.8	42.8	...	
Of which:								
Interest payments	5.5	6.9	6.5	8.3	7.1	8.9	...	...
General government borrowing requirements	11.9	9.9	9.0	8.7	9.9	11.3	...	
Public enterprises borrowing requirements	10.4	...	6.1	5.7	7.7	6.0	...	.
Enlarged public sector borrowing requirements	22.2	...	15.1	14.4	17.6	17.4	...	...

Source: Data provided by the Portuguese authorities.

1/ Provisional estimates.

2/ Including repayments of arrears of the Supply Fund to public enterprises which import essential foodstuffs and petroleum products.

3/ Including payments by the Bank of Portugal of arrears of the Exchange Guarantee Fund to public enterprises which import essential foodstuffs and petroleum products, amounting to Esc 27.3 billion in 1984 and Esc 40 billion in 1985.

Table 5. Portugal: Selected Economic Indicators, 1982-85

(Percentage changes)

	1982	1983		1984		1985 2/
		Program	Outturn	Program	Outturn 1/	
Real demand and output						
Gross domestic expenditures	3.4	-3.7	-6.9	-4.7	-7.0	--
Private consumption	2.0	-1.6	-1.0	-2.0	-3.0	--
Public consumption	3.5	2.0	4.0	2.5	1.4	1.5
Gross fixed investment	2.9	-3.5	-7.9	-13.0	-18.0	-6.3
Increase in inventories 3/	1.3	-2.6	-5.8	-0.5	-0.7	1.3
Foreign balance 3/	-0.6	2.6	8.3	3.9	6.0	1.8
GDP at market prices	3.5	-1.1	--	-1.4	-1.7	1.8
Labor market						
Employment	-0.9	-1.0	... 4/	-1.0	-1.0 5/	--
Unemployment rate (levels)	7.4	11.0	10.2 4/	11.0 4/	10.5	...
Wage bill	20.5	19.0	19.0	18.0	15.1	19.0
Unit labor costs in industry	14.7	20.0	15.0	18.0	14.3	16.0
Prices						
Consumer prices (average)	22.4	25.0	25.5	29.0	29.3	22.0
Consumer prices (through the year)	18.8	28.5	33.9	23.0	21.2	20.0
GDP deflator (average)	21.4	22.2	24.0	27.0	25.5	21.0
Disposable income of households	22.2	...	21.0	22.9	24.5	21.9
Households' savings ratio (levels)	27.5	...	25.1	21.8	24.6	24.5

Sources: Data provided by the Portuguese authorities; and Fund staff estimates.

1/ Provisional estimates.
2/ Official forecasts.
3/ Contribution to GDP growth.
4/ Based on a new methodology in the labor force survey adopted by the National Institute of Statistics since January 1983.
5/ Last three quarters of 1984 over last three quarters of 1983.

Fund Relations with Portugal

(As of July 31, 1985; in millions of SDRs)

I. Membership status

Portugal became a member of the Fund on March 29, 1961. Portugal continues to avail itself of the transitional arrangements under Article XIV of the Articles of Agreement.

A. Financial Relations

II. General department

(a) Quota: SDR 376.6 million.
(b) Total Fund holdings of escudos: SDR 918.8 million (244.0 percent of quota).
(c) Fund credit: SDR 571.9 million (151.9 percent of quota).
Of which:
SDR 145.8 million (38.7 percent of quota) under credit tranches;
SDR 113.5 million (30.1 percent of quota) under enlarged access;
SDR 312.6 million (83.0 percent of quota) under the compensatory financing facility.
(d) Reserve tranche position: SDR 29.7 million.
(e) Current operational budget: no use of the Portuguese escudo is planned in the current budget.
(f) Lending to the Fund: Portugal is not a participant.

III. Stand-by or Extended Arrangements and Special Facilities

(a) There is no current stand-by arrangement.
(b) Previous stand-by arrangements:
On April 25, 1977 the Executive Board approved a one-year stand-by arrangement with Portugal in the first credit tranche for an amount equivalent to SDR 42.4 million (36.3 percent of quota). The full amount of the arrangement was drawn in May 1977.
On June 5, 1978 the Executive Board approved a one-year stand-by arrangement in the second credit tranche for amount equivalent to SDR 57.4 million. No drawings were made under the stand-by.
On October 7, 1983 the Executive Board approved a stand-by arrangement for the period to February 28, 1985. The arrangement was for an amount equivalent to SDR 445 million (118.2 percent of quota). The undrawn balance at the conclusion of the arrangement was equivalent to SDR 185.7 million (49.3 percent of quota).

(c) Special facilities:

On October 7, 1983 the Executive Board approved a request for a drawing under the Compensatory Financing Facility in the amount of SDR 258 million (68.5 percent of quota or 100 percent of Portugal's previous quota). A further drawing under the CFF in the amount of SDR 54.6 million (14.5 percent of quota) was approved by the Executive Board on July 30, 1984.

IV. SDR Department

(a) Net cumulative allocation: SDR 53.3 million.
(b) Holdings: SDR 9.6 million or 18.0 percent of net cumulative allocation.
(c) Current designation plan: Portugal is not included in the current plan.

V. Administered accounts

Not applicable.

VI. Overdue obligations to the Fund

None.

B. Nonfinancial Relations

VII. Exchange rate arrangements

Portugal maintains a crawling peg system for the escudo, based on a basket of currencies of major trading partners (weighted by the shares of each country in Portugal's trade flows, tourism, and emigrants' remittances). Following a 9.4 percent devaluation in 1982, the competitive position of Portugal was restored to the level prevailing at the end of 1980, but a further erosion took place subsequently as the rate of monthly depreciation was maintained at 0.75 percent, or less than the inflation rate differential between Portugal and its main trading partners. On March 24, 1983 the monthly rate of depreciation was increased to 1 percent and the escudo was also depreciated by 2 percent in effective terms. Following continuous pressure on foreign exchange reserves, on June 22, 1983 the authorities announced a further devaluation of the escudo by 12 percent in effective terms. The escudo continues to be depreciated at the rate of 1 percent a month. On July 15, 1985, US$1 was worth Esc 175.6.

VIII. The last Article IV consultation was concluded in June 1984 and the staff report (EBS/84/143, 7/2/84) was discussed by the Executive Board on July 30, 1984. At that time the following decision was adopted.

1. The Fund takes this decision in concluding the 1984 Article XIV consultation with Portugal, in the light of the 1984 Article IV consultation with Portugal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance Over Exchange Rate Policies).

2. The Fund notes with satisfaction that Portugal maintains a system virtually free of restrictions on current payments and transfers for current international transactions, and welcomes the authorities' commitment to the maintenance of this system.

Portugal is on a 12-month consultation cycle.

Basic Data

Area and population	
Area	34,312 square miles
Population (1981 estimate)	10 million
GDP per capita (1983 estimate)	US$2,050

Income and expenditure in 1984 (at current prices)	In billions of escudos	In per cent
Private consumption	1,969	70
Public consumption	406	14
Gross domestic investment	645	23
Exports of goods and services	1,096	39
Aggregate expenditure	4,116	146
Imports of goods and services	1,292	46
GDP at market prices	2,824	100

Selected economic indicators (annual percentage change)	1982	1983	1984 Estimate
Real domestic demand	3.4	-6.9	-7.0
Real GDP at market prices	3.5	--	-1.7
Nominal wages	19.6	19.2	18.1
Consumer prices	22.4	25.5	29.3
Unemployment rate (level)	7.4	10.2	10.5
Broad money, year-end	25.7	20.3	27.4
Domestic credit, year-end	24.5	19.9	21.4
Public sector accounts (as per cent of GDP)			
General Government			
Tax revenue	29.3	31.5	30.0
Total expenditure	41.7	42.7	41.8
Borrowing requirements	11.8	9.0	9.9
Public sector borrowing requirements	22.2	15.2	17.6
Balance of payments (in millions of U.S. dollars)			
Exports	4,108	4,569	5,210
Imports	8,941	7,644	7,241
Trade balance	-4,833	-3,075	-2,031
Net invisibles	1,588	1,435	1,511
Current account balance	-3,245	-1,640	-520
Medium- and long-term capital	2,585	1,466	1,273
Short-term capital	783	-649	-385
Overall balance	123	-823	368
Foreign exchange reserves, year-end	393	353	475
External debt outstanding, year-end	13,661	14,485	14,938
Gold, year-end (in millions of ounces)	22.1	20.4	20.3
Effective exchange rate (per cent change)	-13.9	-20.5	-16.9

Sources: Data provided by the Portuguese authorities; and staff estimates.

Alternative Medium-Term Scenarios for the External Debt

Despite the improvement recorded in 1983-84, Portugal's external debt at the equivalent of over US$16 billion (84 percent of GDP) remains relatively high, as does its service burden which in 1985 is expected to amount to about 35 percent of foreign exchange earnings. It is therefore important that over the medium term the current account deficit of the balance of payments be maintained at a level which allows, at a minimum, the stabilization and preferably a decline of these ratios. This appendix presents a few illustrative scenarios of developments of the external debt over the next ten years based on alternative assumptions about the path of the current account deficit, the growth of foreign exchange earnings and the level of real interest rates abroad. The main conclusion that stems from these scenarios is that even under relatively favorable assumptions about the external environment, in order to maintain a manageable level of the external debt and to reduce gradually its service burden it will be necessary to keep the current account deficit to at most the equivalent of 6 percent of GDP on average during the period. Sensitivity analysis shows, however, that even relatively small changes in the assumptions regarding the external environment, especially if cumulating in the "wrong" direction, would considerably worsen the prospects for the external debt service under the assumed path of the current account and correspondingly reduce the room for growth of imports.

Assumptions common to all scenarios are: (a) that international prices rise by 4 percent in 1986, by 5 percent a year on average in 1987-90 and by 4 percent a year on average in 1991-95 (in U.S. dollar terms) with the differential between domestic and foreign price movements being fully offset by changes in the exchange rate; (b) that official transfers from the EC rise gradually from the equivalent of US$100 million at the beginning of the simulation period to about US$300 million by the end of it--probably an optimistic assumption on balance--(c) that net direct foreign investment rise by 15 percent a year in U.S. dollar terms, reflecting the favorable impact of EC accession; and (d) that foreign exchange reserves are increased by US$100 million per year. This increase is equivalent to about 1 percent of imports at the beginning of the period, declining to 0.5 percent by 1995. Foreign exchange reserves would thus decline significantly in relation to imports. However, total reserves including gold would still remain relatively high as percent of imports.

In the central scenario (A) it is assumed: (a) that the current account deficit rises from the equivalent of 2.3 percent of GDP in 1985 to 4.3 percent of GDP in 1986 and to 6 percent thereafter; (b) that the average interest rate on external debt is 8 percent throughout the period (about 3 percent in real terms); and (c) that exports of goods increase by 7 percent a year in volume, export of services by 5 percent and remittances by 3 percent in 1986, 4 percent a year in 1987-90 and 3 percent a year in 1991-95 in U.S. dollar terms. These assumptions imply the maintenance of a sustained expansion of world trade on average during the period, as well as some continued gains in market shares. In this

scenario the external debt declines slightly from 80 percent to about 76 percent in relation to GDP, as does the debt service ratio--to about 28 percent by the end of the period. Gross borrowing would increase by nearly 90 percent (about 23 percent in real terms). Assuming no change in the terms of trade, imports of goods and nonfactor services would rise on average by 6.3 percent a year in volume terms, increasing from 48 percent of GDP in 1986 to over 61 percent in 1995.

Scenario B illustrates the sensitivity of these results to changes in the external environment. In this scenario interest rates abroad are assumed to be 3 points higher in nominal (and real) terms, and the rates of growth of exports of goods and of services are assumed to be 2 points and 1 point lower, respectively, on account of slower growth abroad. Remittances are assumed to grow by 3 percent a year in U.S. dollar terms throughout the period. It is, however, assumed that the current account is kept as under scenario A. Thus, the external debt does not differ from the latter. However, the debt service is substantially higher in relation to foreign exchange earnings, rising to 39 percent by 1992 before declining to about 37 percent by the end of the simulation period. At the same time, the growth of imports in volume is compressed, averaging just over 4 percent over the period, which would imply a lower growth of demand and output, assuming the same elasticity as in scenario A.

Scenario C illustrates the effects of more expansionary policies, leading to substantially higher current account deficits during the period of simulation. Specifically, under the same assumptions as in scenario B but with current account deficits equivalent to 6 percent of GDP in 1986 and to 9 percent thereafter, the external debt would rise to nearly 100 percent of GDP and the debt service ratio to 46 percent, clearly unsustainable levels. Even so the rate of growth of imports in volume would only average 4.4 percent per year, in reflection of the sharply rising burden of the debt. This scenario clearly points to the constraints posed by the external environment on the growth potential of a small open economy like that of Portugal, with a high level of external debt. These constraints could be eased through policies that secured more marked gains in market shares, a reduction of the import elasticity over the medium term and a greater inflow of foreign nondebt capital.

Table 6. Portugal: Alternative Scenarios of External Debt, 1986-95

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Scenario A										
Assumptions										
Rate of growth of merchandise exports (in U.S. dollars)	11.3	12.4	12.4	12.4	12.4	11.3	11.3	11.3	11.3	11.3
Rate of growth of exports of nonfactor services	9.2	10.2	10.2	10.2	10.2	9.2	9.2	9.2	9.2	9.2
Rate of growth of remittances	3.0	4.0	4.0	4.0	4.0	3.0	3.0	3.0	3.0	3.0
Interest rate on foreign debt	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Current account deficit (in percent of GDP)	4.3	6.1	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Results										
Total external debt (in millions of U.S. dollars)	16,572	17,956	19,381	20,843	22,336	23,865	25,417	26,981	28,576	30,199
Same as percent of GDP	79.6	79.8	80.0	79.9	79.6	79.3	78.9	78.2	77.3	76.3
Debt service ratio 1/	28.0	29.5	32.9	32.3	29.5	29.5	31.4	29.3	29.1	27.9
Gross borrowing (in millions of U.S. dollars) 2/	5,552	6,425	7,267	7,699	7,825	8,349	9,214	9,410	9,979	10,396
Rate of growth of imports of goods and services in volume	11.3	8.7	5.0	5.1	5.2	5.3	5.4	5.5	5.6	5.7
Scenario B										
Assumptions										
Rate of growth of merchandise exports (in U.S. dollars)	9.2	10.3	10.3	10.3	10.3	9.2	9.2	9.2	9.2	9.2
Rate of growth of exports of nonfactor services	8.1	9.2	9.2	9.2	9.2	8.2	8.2	8.2	8.2	8.2
Rate of growth of remittances	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Interest rate in foreign debt	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0
Current account deficit (in percent of GDP)	4.3	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Results										
Total external debt (in millions of U.S. dollars)	16,572	17,956	19,381	20,843	22,336	23,865	25,417	26,981	28,576	30,199
Same as percent of GDP	79.6	79.8	80.0	79.9	79.6	79.3	78.9	78.2	77.3	76.3
Debt service ratio 1/						36.9	39.5	37.6	37.7	36.8
Gross borrowing (in millions of U.S. dollars) 2/	5,552	6,425	7,267	7,699	7,825	8,349	9,214	9,410	9,979	10,396
Rate of growth of imports of goods and services in volume	4.7	7.3	4.4	4.5	4.6	4.8	4.9	4.0	4.1	4.2
Scenario C										
Assumptions same as in B except:										
Current account deficit in percent of GDP	6.0	9.0	9.0	9.0	9.0	9.0	9.0	9.0	9.0	9.0
Results										
Total external debt (in millions of U.S. dollars)	16,921	18,961	21,132	23,426	25,811	28,143	30,001	33,299	35,963	38,773
Same as percent of GDP	81.3	84.3	87.2	89.6	91.6	93.6	95.2	96.4	97.3	98.0
Debt service ratio 1/	33.4	33.6	40.4	41.4	40.3	42.0	47.5	44.4	46.4	46.2
Gross borrowing (in millions of U.S. dollars) 2/	5,900	7,108	7,993	8,440	8,972	9,404	10,730	11,124	11,993	12,653
Rate of growth of imports of goods and services in volume	6.4	9.6	2.7	2.4	3.1	3.4	3.4	3.6	3.7	3.8

Source: IMF calculations.

1/ Total interest plus amortization of medium and long-term debt as percent of foreign exchange earnings.

2/ Including the increase of short-term debt.

3/ Ratios to GDP are calculated assuming a level of GDP as in Scenario A.

Statistical Issues

1. Outstanding statistical issues

a. Monetary accounts

Concerning data for the Bank of Portugal and deposit money banks, there are no substantive problems. However, the monthly reporting of these data has tended to lag leading to uncurrentness in International Financial Statistics (IFS). In addition, data for nonmonetary financial institutions are not reported to the Fund.

b. International banking statistics

In the monetary statistics, the foreign liabilities of Portugal's monetary authorities and commercial and savings banks to international banks are consistently lower than international banks' reported claims on banks in Portugal. This may be due to the netting out of some foreign accounts in the monetary statistics and to the exclusion from foreign liabilities of foreign loans negotiated by the banking system but on-lent to domestic entities. Fund methodology recommends that all foreign accounts be reported on a gross basis and that all foreign loans where banks are the obligors be recorded as part of their foreign liabilities.

c. Government finance

The last complete annual data published in the 1984 Government Finance Statistics Yearbook are for 1977, and in view of this no data are presently being published in current issues of IFS. The Portuguese pages in the Yearbook include tax revenue data reported by Portugal to the OECD, and the corresponding time series extend to 1982. A report on the technical assistance mission which visited Lisbon in July 1984 was sent to the authorities in December 1984.

d. National accounts

A new system for the compilation of national accounts was introduced in 1984 which resulted in the publication of data for 1977-83. Data in IFS are updated from the Bulletin of the central bank.

e. General economic data

A technical assistance mission on general economic statistics visited Portugal during February 4-14, 1985; a report on its findings, including recommendations to improve the methods of compilation and currentness of certain data, was sent to the authorities on May 6, 1985.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Portugal in the July 1985 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bank of Portugal, which during the past year have been provided on a timely basis, although the currentness of some data could be improved.

Status of IFS Data

		Latest Data in July 1985 IFS
Real sector	- National accounts	1983
	- Prices: CPI	April 1985
	WPI	September 1984
	- Production	September 1984
	- Employment	n.a.
	- Earnings	1984 fourth qtr.
Government finance	- Deficit/surplus	n.a.
	- Financing	n.a.
	- Debt	n.a.
Monetary accounts	- Central Bank	December 1984
	- Deposit money banks	December 1984
	- Other financial institutions	n.a.
External sector	- Merchandise trade: values	March 1985
	- Merchandise trade: prices (imports)	December 1983
	- Balance of payments	1984 third qtr.
	- International reserves	April 1985
	- Exchange rates	May 1985