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Portugal

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Executive Summary

The performance of the Portuguese economy since 1985 has been encouraging and a catching-up process in real terms with the rest of the Community seems established. Faster output growth has been brought about by a rapid expansion of investment and exports. Employment creation has been substantial and the unemployment rate is low by any standards.

Aware of the large gap in the level of economic development compared with the EC average, the Portuguese authorities have started a long-term policy of structural adjustment helped by Community Funds. Modernization and diversification of the industrial structures have started, sustained by buoyant foreign direct investment particularly in new, more technologically-advanced sectors.

However, a number of concerns remain, stemming in part from success achieved. Since 1988, inflation performance remains at a level which is hardly compatible with a successful participation of Portugal in the Exchange Rate Mechanism (ERM). The acceleration of inflation occured despite a favourable evolution of wages and salaries, real wages increasing at a rate well below productivity growth. The strength of domestic demand, mainly via its impact on the relative price of non-tradables, appears to have been one of the main factors behind adverse price developments. Furthermore monetary policy was made much less effective in countering excess demand by the large capital inflows in the last few years which the degree of financial integration already achieved between Portugal and abroad made possible. The pre-announced exchange-rate target together with a decreasing risk-premium on Portuguese assets and high nominal interest rates also strongly encouraged capital imports. This aggravated the difficulties for monetary control, given the overliquid condition of the banking system. In these conditions, a sharp rise in food prices and the diffusion through the whole economy of wage increases in the tradeable sectors have fuelled inflation.

The deficit of the current account has been relatively modest until now; the large trade deficit - not least due to the dynamism of investment - has been partially compensated by the growing surplus on services and transfers. Since 1988, the basic balance of Portugal has recorded a large surplus as a result of long-term capital inflows. The existing pattern of the external accounts may be considered appropriate at the present stage of development of Portugal; although the private sector saving rate is high, the importing of real resources should help the development process.

Portugal has made substantial progress on the public finance front since 1984. In 1989 the general government deficit amounted to less than 4% of GDP. Unfortunately the orientation of fiscal policy became more expansionary in 1990 in contradiction with the Portuguese authorities' own multi-annual fiscal adjustment strategy. The latter was slightly revised with the adoption of QUANTUM (Framework for the National Portuguese participation in EMU) which elaborates on the need for an adequate macro-economic programme based upon budgetary adjustment and the priority given to an early entry of the escudo into the ERM. The fiscal adjustment component of the QUANTUM programme is based on expenditure restraint, which should be reinforced by newly introduced ceilings on global expenditure. An increase of indirect taxation in line with the Commission proposals on tax harmonisation is also envisaged. The budget for 1991, recently approved by the Parliament, is a step, albeit limited, in the direction of a reduction in public finance imbalances.

The Portuguese public debt (71,4% of GDP in 1989), although far from being the highest in the EC, remains well above the Community average. The substantial privatization programme (some 80% of the proceeds will be used to reduce existing public debt) will make an important contribution towards a further decline in the debt/GDP ratio. Together with ceilings on global expenditure, such reduction in public debt would make the implementation of the multi-annual fiscal adjustment strategy fully credible and thus prepare future ERM entry.

Since 1984 the Portuguese authorities have been taking a series of measures to modernize and expand the financial system, accompanied by a gradual removal of controls on capital movements. Progressively the banking sector is being opened up to more competition and at the same time there has been a gradual abandoning (almost completed by now) of the administrative setting of bank interest rates. Compulsory ceilings on private credit expansion have also been abolished. However excess liquidity of the banking sector resulting from past central bank financing of large public sector deficits has delayed the change to a more market-oriented monetary control. The removal of exchange controls while inflation remained high and within the context of a pre-announced exchange-rate depreciation encouraged large short-term capital imports; the authorities reacted at the beginning of July 1990 by imposing transitional capital controls, measures which clearly need to be substituted after some time by more market-conforming policies. Exchange-rate policy was also also modified, the rate of depreciation of the currency being no longer programmed. From 1 October 1990, short-term fluctuations of the escudo against the main ERM currencies were allowed, as a preparatory step towards future ERM membership.

The main priority for the Portuguese economy must be the control of inflation. Economic policy needs to be consistently oriented towards stabilization of the economy. Particular emphasis should be and has been given to :

- a reinforcement of monetary stringency in combination with less predictable exchange-rate movements;
- a tigthening of fiscal policy, reasserting the downward trend in public deficits to which the government is committed in its medium-term strategy;
- the resumption of an active incomes policy geared to decreasing nominal wage rises but based on prudent and credible targets.

However it should be taken into account that developments in the Gulf area continue to introduce an important element of uncertainty for the Portuguese economy, which has the highest dependency on oil imports in the Community.

PART I

Portugal since accession

Strong economic performance since accession, but inflation remains too high and the catching-up process needs to be reinforced

After significant fluctuation in the first half of the 1980s, the performance of the Portuguese economy, in the period since accession to the Community in 1986, has by and large been encouraging. Output growth has been faster than in the rest of the Community; the strong expansion has been brought about by a boom in investment and exports; employment creation has been substantial, pushing further down the unemployment rate which was already low relative to most other Community countries. With rapid import growth, however, the external current account has moved into deficit, but at the same time long-term capital inflows became very substantial and so the basic balance of payments (current account balance plus net long term capital inflows) is in large surplus. Progress has also been achieved in reducing the government deficit and in reversing the rise in the public debt to GDP ratio; a start has been made on privatization sales to reduce the heavy role of the State in the ownership of the economy, especially outside the export sector; the financial markets are gradually being opened up and freed of administrative controls and monetary policy is shifting (although not without difficulty) to a more market-oriented approach.

Hence, economic performance and the policies being implemented since accession suggest that a good start has been made on a soundly-based catching-up process. But a number of concerns and difficulties remain : indeed some of these have been exacerbated by previous successes, the most notable example being the achievement of Portuguese financial integration into the Community which has brought new problems for domestic stabilization policies.

In particular, the inflation performance continues to be a major area of concern. Between 1984 and early 1988 a substantial reduction in the inflation rate was achieved, but since then disinflation has been interrupted. The latest available data show a 12-month increase in the CPI about 13%, more than three times the average for all countries belonging to the narrow band of the exchange rate mechanism (ERM). Price instability of this order leads to serious misallocation of resources and puts sustainable growth at risk and if it were to continue would hinder the further integration of Portugal into the Community.

While after accession exchange rate policy became progressively less geared to offset the inflation differential with the main trading partners, it was faced by a dilemma concerning the use of the exchange rate to bear down fully on inflation and the risks this might create of a gradual loss in competitiveness of Portuguese exports. In particular the roughly predictable nominal devaluation path for the domestic currency together with high interest rates encouraged capital inflows, which enhanced the financial integration process, but this had at the same time severely limited the effectiveness of monetary policy. The recent move to a managed float in preparation to ERM membership must be seen in this light.

The deterioration in public deficits apparent in 1990, if not strongly reversed in 1991, will also become a subject of concern; however, the budget for 1991 is only a limited step in the direction of a reduction in public finance imbalances. With monetary policy impeded by high capital inflows, it is especially important that a more restrictive stance of fiscal policy be pursued to achieve greater nominal convergence with other Community countries. In particular the planned adaptation of Portuguese valued added tax (VAT) and excise duties in line with the Commission's proposals will make an important contribution to the necessary reduction of the public sector deficit. In this respect it should be recognized that the Portuguese authorities are committed to a medium-term fiscal adjustment strategy which furthermore is also the subject of a joint work programme set up between the Commission services and the Portuguese Ministry of Finance.

Portugal is among the least-developed members of the Community, and its geographical distance from the main Community concentrations of economic activity makes it likely that deep structural adjustment will take place in the run up to Economic and Monetary Union (EMU). For the catching-up process now once again under way to be strengthened and for the stimulus provided by the completion of the internal market to be benefitted from fully, the competitiveness of the Portuguese economy will need to be maintained and if possible reinforced. This implies that against a background of sound macroeconomic policies and with a proper setting of relative factor prices the emphasis should be on encouraging markets to work better, thus improving the allocation of resources and facilitating structural adjustment. Focusing on the sectors producing tradeable goods, the competitiveness of Portuguese products requires, in particular, that wage increases in Portugal remain reasonable relative to those elsewhere in the Community. In this respect it is important to establish a cooperation with the social partners in order to define an appropriate strategy for wage moderation; such an agreed strategy could lessen the need to use exchange-rate policy as an instrument of discipline of the internal costs which might impose too high losses in terms of employment and growth. This is an important prerequisite for the continuation of the catching-up process in increasingly disinflationary conditions and would allow Portugal to join the ERM soon.

The policies already embarked upon by the Portuguese government of budgetary consolidation and reform, privatization and deregulation have to be pursued and to be flanked by a more successful disinflation strategy. Over and above that, Community policies have to play an important role, both in terms of defining the agenda for domestic reform and in providing direct support to infrastructure investment, especially to improve transport and communications, and to education and training, so as to help adjustment in the Portuguese economy.

Developments in the Gulf area have introduced an important element of uncertainty. Portugal is by far the most oil-dependent country in the Community and consequently the one likely to be most affected if high prices of oil were to be of long duration.In that case a deterioration of the relative macroeconomic performance of Portugal vis-à-vis the other Community countries cannot be excluded. This might lead to even greater difficulties for regaining price stability, a slowdown in the catching-up process and a widening of the current account deficit. Therefore countervailing policies, notably in the field of wage determination, are of utmost importance. Mastering the present challenges thus represents a difficult but by no means insurmountable obstacle on the Portuguese road to EMU.

Growth led by investment and exports

After a difficult decade following the first oil shock and the political upheavals of the Portuguese revolution, culminating in the application of a tight IMF-approved stabilization policy from 1982 onwards, the Portuguese economy has been on a recovery path since 1985. Between that year and 1989 real GDP rose on average by some 4,7% per year (table 1). Rapid expansion of fixed investment (by over 12% per year, after having fallen away sharply during 1983-85) and of exports (10,5% per year) have been the most prominent features of the growth process, but private consumption has also risen strongly (5,2% per year), recently supported by a declining saving ratio. Total demand growth clearly outpaced the rise in output and so the volume of imports also expanded very rapidly (16% per year) putting some strain on the balance of payments. The imbalance between demand and domestic supply was particularly marked in 1987 and 1988, but eased somewhat in 1989 partly in response to some tightening of monetary and fiscal policy. This more balanced growth pattern is thought to have been continuing in 1990: real GDP is expected to rise by some 4,2% (according to the Commission services' November 1990 forecasts, see table 2). Private consumption could increase by 4,5%, while fixed investment and exports growth should continue strongly (9,1% and 10,3% respectively), although a marked deceleration of the latter was evident in the second half of the year.

Hence, growth in Portugal since 1985 has been faster than in the rest of the Community (by 1 1/2 percentage points per year; Portugal 4,7%, EC 3,2%). As a consequence there has been a gradual improvement in the level of GDP per head of the population in Portugal relative to the average for the Community (measured in current purchasing power standards), rising from 52% in 1985 to 55% in 1989 and forecast to continue rising to 56% in 1990 (Graph 1). But this only takes Portugal back to the relative position it had already reached in 1973. Nonetheless, the catching-up process, which had been stalled for over a decade, does now seem to be firmly re-established, provided that it can be accompanied by the necessary disinflation.

The world trading environment has strongly contributed to the present economic expansion, with world trade volumes rising steadily, and the fall in the oil price in 1986 and the depreciation of the US dollar offering Portugal substantial terms of trade gains which have bolstered enterprise profitability and improved general government accounts. On the other hand, part of the growth surge, at least in 1986 and 1987, represented a cyclical rebound from the recession in 1983 and 1984. However, a number of indicators seem to suggest that the growth trend can be sustained. Portuguese marketshares have improved in most of its trading partner's markets for manufactured goods. Improved expectations about future income growth - particularly with the prospects of further integration of Portugal in the Community - have generated the faster expansion in investment. On the political side, the situation has been much more stable than in the previous decade and the majority government has embarked upon a programme to modernize and liberalize the economy, helping to build up confidence.

Portugal has traditionnally had a relatively high investment share in GDP, until it was substantially dented by the investment collapse of 1983-1985. Since then, however, the sustained massive expansion of fixed investment (by a cumulative 59% in volume terms) has taken the share (in current prices) of gross fixed capital formation back up to 27% of GDP in 1989 (compared with 21% in the Community as a whole), a rise which should continue. Much of the investment is being financed by a surge in direct investment from abroad, especially since 1988, and by rising Community transfers. Investment in equipment has been even more buoyant than in construction.

Rapid rise in employment pushes unemployment down even lower

The recovery in the Portuguese economy has been accompanied by substantial employment creation, no doubt helped by highly flexible real wage setting. After many years of gradual trend decline in total employment, which became more marked in the first half of the 1980s, the numbers in jobs have been rising strongly, recording a cumulative increase of almost 8% between 1986 and 1989. Although the labour force has been expanding, due to both the steady increase in the population of working age and a rise in the participation rate, the increase in employment has been sufficient to result in a decline in the unemployment rate from 8,2% in 1986 to 5,0% in 1989 (table 3).

However, the low unemployment rate seems to hide a high degree of underemployment in the Portuguese economy, with a very large proportion of employment (around 20%) still in the low-productivity agricultural sector and with much employment in the public sector at low levels of efficiency. There is thus every reason to expect that the growth process will not be held back by general labour shortages, as there is scope for shifts in labour to expanding high-productivity sectors. Nevertheless, there is a danger of specific skill shortages, as the level of general education of the Portuguese workforce compares unfavourably with most Community countries and training and vocational qualifications have been neglected in the past.

Structural adjustment process sustained by Community aid and foreign direct investment.

Structural policies and reforms are receiving increasing attention from the Portuguese authorities, aware of the structural deficiencies of the country in view of the EC full membership and the European Single Market. The large gap in the level of economic development relative to the EC average calls for long-term policies aimed particularly at reducing the inadequacy of the infrastructures which aggravates the peripheral situation of the country and at improving the education of the labourforce. In order to assist Portugal in its development effort, a Community Support Framework (CSF) was established for the 1989-1993 period. The country may benefit from the maximum rate of assistance (70% of eligible public expenditure) and the Community will more than double its transfers to Portugal between 1988 and 1993, reaching some 3,5% of the Portuguese GDP (table 4). The two main priorities are precisely the economic infrastructures projects and human resources. By its comprehensive nature and by the volume of resources deployed, the CSF represents an unprecedented development effort in the country and may contribute significantly to the catching-up process in Portugal.

At present a structural adjustment process is underway in Portugal aiming at the modernization and diversification of the industrial structure. The Portuguese manufacturing sector still relies strongly on low technology, labour intensive consumption goods (food products, wood, textiles, paper and clothing represent some two thirds of exports). The pattern of trade with the rest of EC shows mainly an inter-sectoral kind of specialization. With the country more strongly integrated into the Europen Single Market, which in turn may become more open to newly industrialized competitors, it will be more difficult to maintain a comparative advantage based exclusively on low wage costs. However, other sectors are emerging which eventually may replace some traditional ones : metal and electrical products, transport equipment, ceramics, glass. These sectors are characterized not only by a more advanced technological content but also by a high degree of intra-sector international exchanges and by the important role of multi-national investment. Whichever pattern of specialization will prevail in the future, foreign investment and cooperation will play a strategic role in structural adjustment of the Portuguese industry. In this respect, a high investment ratio and a rapid expansion of the capital stock are important preconditions for sustained growth, but past experience suggests that high investment in Portugal has not always been used effectively - a result which is particularly harmful in a developing country with a high relative scarcity of capital. The opening up of the Portuguese economy to foreign investment flows, in conditions of adequate real interest rates, the liberalization and development of domestic financial markets, and the greater share of the economy in the private sector should be helping to improve allocative mechanisms for productive investment.

Foreign trade very dynamic; the current account deficit does not at present appear to be a serious constraint

As already noted, Portuguese exports and, in particular, imports have been rising very strongly in the last few years. Exports have been benefitting from the rapid expansion of markets, from a competitive position that in a long-term context looks quite favourable (although, with exchange rate policy becoming less geared to the depreciation of the escudo, competitivity may gradually be eroded by too strong a rise in nominal wage costs) and from the expansion of capacities through the investment boom.

Imports have been sucked in by the rapid growth of demand, especially for capital goods. Trade with the rest of the Community dominates, representing some 71% of total exports and 68% of imports in 1989, shares that have been rising both before and since accession. There has been a striking increase in the share of Portuguese exports going to Spain, which prior to those two countries joining the Community was a relatively unimportant trading partner of Portugal but which is now increasingly becoming a market on a scale consistent with its geographical closeness.

The accumulated terms of trade gains reached more than 20% during the period 1985-1988; this positive factor helped to offset partially the effect of the deterioration, in volume terms, of the Portuguese trade balance, which has for long exhibited a structural deficit. Nevertheless, the deficit widened sharply from some 6% of GDP in 1986 to 13% in 1988, before narrowing to 11% in 1989 as a result of a very good export performance last year. But the trade deficit is to a large extent offset by surpluses on services (especially from tourism) and on transfers (remittances home from emigrants and EC transfers). The swing in the current account (table 5) from a surplus in 1986 into a deficit of some 2,3% of GDP in 1988 (before narrowing to 1,2% in 1989) does not - as yet - appear disquietening, the more so as these deficits have been more than financed by foreign direct investment inflows so that the basic balance (current balance plus all long-term capital flows) recorded a surplus of 4,5% of GDP in 1989. In any case imports of real resources from the rest of the world would not appear to be inconsistent with the present state of the Portuguese economy which is faced with an enormous requirement for real convergence. Indeed, for a country at Portugal's stage of development, with the prospect of higher returns than in more mature economies, it is quite appropriate that foreign capital inflows should finance a part of the high investment needs (quite apart from the advantages of technology transfer, marketing links, etc. this brings). Domestic saving in Portugal is, after all, at a relatively high level, with private sector saving representing some 26% of GDP in 1989, although the government sector is a small dissaver. A current account deficit can thus help the development process, which would be unnecessarily constrained if forced to rely only on domestic resources.

Progress on inflation arrested since 1988

Throughout the decade after the first oil shock, Portugal continuously recorded an inflation rate well above the Community average, peaking in 1984 at 29%. Realizing on one hand that a sustainable growth process requires more price stability and that a high rate of inflation results in a marked loss in the efficiency of the economic system and, on the other hand, that a successful integration of the Portuguese economy in the Community requires better nominal convergence, the national authorities began in 1985 to place disinflation as the top priority of economic policy.

From then until Spring 1988, there was a period of steady disinflation during which the inflation rate (as measured by the consumer price index (CPI) was brought down to almost 8%. This sharp reduction in inflation was achieved as a result of the slower rise of world prices (influenced by the widespread success of disinflationary policies, by favourable movements in the US dollar and by the oil price fall), a lower depreciation rate for the escudo, the beginning of a policy of fiscal consolidation and moderate wage developments (table 7). A degree of social consensus helped to obtain this relative wage moderation which, together with rapid productivity gains, has resulted in a steady decline in real unit labour costs (down by a cumulative 19% between 1981 and 1989) and a corresponding rise in the profit share. It has to be noted that, real wages have shown significant downward flexibility, even in the long run, in response either to exchange rate devaluations or to higher than expected price increases. This was supported by wage settlements which were not fully indexed to price changes and thus had a moderate effect on inflation dynamics.

However, the inflation rate accelerated sharply in the Summer of 1988, climbing back up during 1989 to 12,7%, and to 13,6%, in average, the following year. This acceleration occurred despite the continued favourable evolution of wages and salaries (the nominal rise per head decelerating by some 4 percentage points to 13,4% between 1987 and 1988) and despite substantial reductions in the government deficit in both 1988 and 1989, but in the context of a highly accomodating domestic monetary policy until early 1989. The effectiveness of monetary policy has also been decreased over the last few years by the existence of a pre-announced exchange-rate target (in the form of a crawling-peg). Associated with a rapidly increasing level of capital mobility between Portugal and abroad and flanked by high nominal interest rates, this made capital imports all the more rewarding. The overliquid condition of the banking system, sitting on a huge stock of secondary liquid assets mainly resulting from past monetization of government deficits, increased the ineffectiveness of credit ceilings as an instrument of monetary control.

In these conditions, a sharp rise in food prices, resulting from difficult weather conditions in the Summer of 1988 and again at the end of 1989 and early in 1990 contributed to a turnaround in inflation. Food products have a large weight (46%) in the CPI, and food imports have for the most part not yet been liberalized (the transition arrangements under the Treaty of Accession extend, in some cases, until 1996), so food prices appear particularly sensitive to domestic supply conditions. The prices of services also continued to rise strongly as wage awards in line with productivity gains in the sectors subject to international competition spread through the economy.

Furthermore, the progressive integration of the Portuguese economy into the Community is resulting in an enlargement of the range of tradables, driving some Portuguese prices to an incipient rise, which should lead to a greater equalization with those abroad. More generally, demand growth in 1987 and 1988 appears to have been excessive and well above supply potential, as evidenced by the rapid rise in imports and the upward trend of profit margins, which, within the framework of an expansionary monetary policy stance, allowed food price developments to be transmitted to other prices. The impact of strong domestic demand on inflation is likely to have resulted particularly from pressure on non-tradables prices, where supply constraints are clearly more binding; in addition, demand for certain non-tradables may have been increasing at an even faster rate than households permanent income, reflecting their high income elasticity.

Some tightening of monetary policy in March 1989 and some slowing in domestic demand growth have led to a steadying of the inflation rate at its higher level, but there are as yet no signs that the necessary downward trend has been re-established. An acceleration in nominal wage costs seems to have taken place in 1990 and future wage negotiations face the difficulty that bargaining on the basis of government inflation targets has not yet regained credibility. Moreover, while exchange rate policy remains non-accommodating, fiscal policy showed a more expansionary stance in 1990. In view of this insufficiently restrictive stance of overall demand management the price climate remains very vulnerable to any adverse developments. Given the importance that should be attached to reentering decisively a path of disinflation and to the achievement of nominal convergence with the rest of the Community (beyond its own merits the attainment of this objective is vital for a successful Portuguese participation in EMU), a wider range of stability policy options needs now to be considered, and the final section of this paper addresses this problem. In this context, an active incomes policy, based on prudent and credible targets, is to be welcomed.

Budgetary consolidation and reform still have further to go

The Portuguese government embarked upon a process of budgetary consolidation after 1984, when the general government deficit (national accounts definition) reached a peak of 12% of GDP. The main aims of the programme have been :

- to achieve a marked reduction in the general government deficit;
- to reform both indirect and direct taxation;
- to increase transparency in public debt financing.

A stronger commitment to budgetary adjustment as part of a comprehensive medium-term macro-economic strategy came in March 1987 when the government adopted the PCEDED (Programme for the structural adjustment of the external deficit and unemployment) which set rules for medium-term expenditure restraint. A revised version was published in July 1989, emphasizing the importance of the fiscal adjustment programme for the control of inflation and the encouragement of the catching-up process, and recognizing the need for a gradual rise in the tax burden along with continued tight control of spending in order to achieve deficit reduction targets.

In June 1990 the national authorities announced the QUANTUM (Framework of National Adjustment for the transition to EMU) as the strategy for Portuguese participation in EMU. Besides expressing the full Portuguese commitment to EMU, QUANTUM sets nominal convergence as the first priority of economic policy and its main component is a fiscal adjustment programme based not only on expenditure restraint but also on an increase of indirect taxation, in line with the Commission's proposal on tax harmonization.

Between 1984 and 1989, the general government deficit was reduced by more than 8 percentage points to 3,8% of GDP (table 8). This was secured through a 4% of GDP reduction in total expenditure (mainly achieved in 1985 and concentrated in reduced transfers and subsidies to enterprises) and a 2% rise in the tax burden (including social security contributions). The adjustment was undoubtedly helped by the rapid expansion of the economy during this period and was achieved despite less success in restraining expenditures than planned.

Overhauls of the tax system were made in 1986, when VAT was introduced to replace a wide range of existing indirect taxes, and in 1989, when the direct tax system was reformed with marginal personal income tax rates reduced and many exemptions and incentives abolished. The new VAT system has been successful in generating much higher tax revenues than the sales taxes it replaced, and the Portuguese authorities are confident that the direct tax reforms will also yield large permanent revenue gains.

The high deficits in the late 1970s and early 1980s led, despite the high inflation rates, to a rapid escalation in the public debt ratio which climbed from only 17% of GDP in 1974 to 74% by 1988, but a reduction (to 71,4%) was already achieved in 1989 (graph 2). This is higher than the Community average but still lower than in several other Community countries with budgetary problems. On 1989 parameters, the debt ratio is no longer on an unsustainable path, the primary balance (excluding interest payments) being in surplus by 2,4% of GDP (but this is before taking into account financial transactions which also have to be financed by borrowing), and the average effective interest cost of the public debt being less than the nominal growth rate of the economy. But this picture needs to be qualified in relation to several specific features of the Portuguese situation :

- administrative control of the financial system, credit ceilings and the consequent need for banks to invest in government securities have in the past resulted in cheap financing for the public sector through a form of hidden taxation; as the financial system is liberalised with preferential circuits more or less abolished and interest rates set in a market framework, the government is now also being obliged to borrow under market conditions, pushing up the average real cost of the public debt - a process that still has further to go. Success in lowering inflation is also likely to imply some further increase in real interest rates for government borrowing. On the other hand, as Portugal became more closely integrated in European financial markets, the risk premium was reduced. At longer term as Portugal is achieving convergence further reduction can be expected;
- in the period up to 1984 much borrowing was carried out by autonomous government agencies and public enterprises and was not included in the government accounts and public debt figures. Since then the Treasury has been taking over much of this debt, where it cannot be serviced by the issuing institutions, leading to a larger rise in the public debt than can be explained by annual borrowing flows; further cases of Treasury debt takeovers are expected, helping to make the public finances more transparent;
- by contrast, the government has embarked upon a privatization programme which, after constitutional

amendment to allow the full sale of public enterprises, is now being extended and accelerated, with receipts totalling over 7% of GDP likely by 1993; these receipts are being used to reduce the public debt.

The need to set in train a reduction in the debt/GDP ratio and (in due course) the interest burden, to reduce the high share of domestic financial resources pre-empted by government borrowing and consequently denied to the private sector, to support a tighter and more effective monetary policy, to greatly reduce the monetary financing of the government sector, to exert some dampening effect through fiscal policy on excessive demand growth, and hence, in conjunction with other policies, to bear down strongly on inflation, all emphasize the importance of a continued medium-term adjustment strategy for the public finances. This will require the maintenance of expenditure restraint and restructuring of the budget to reflect prioritites : for example, the domestic financial counterpart required to match transfers from the Community structural funds will impose a very stringent and selective approach to public sector investment projects not eligible for Community funding. A further gradual rise in the tax burden also appears inevitable; the adaptation of Portuguese VAT and excise duties in line with the Commission's harmonization proposals would provide some welcome extra revenues (through high excise duties on alcohol and tobacco and a reduction in the large coverage of the zero rate of VAT), and some further broadening of the direct tax base may be necessary.

In 1990 a rise in the general government deficit to some 6% of GDP seems likely (from 3,8% in 1989), although efforts have been made to control the execution of the budget. This increase results mainly from a higher wage bill induced by civil service pay reform, the effect of accelerated tax payments under the direct tax reform in 1989, and a substantial rise in the interest burden following not only the hike in interest rates last year but also a large placement of public debt at the end of 1989. Additional measures of expenditure restraint have been adopted during the year (aimed at saving some 0,5% of GDP) but they were followed by a decision to award a large 2increase in social security pensions. Budgetary developments in 1990 were clearly out of line with the government's medium-term intentions, and may have given the wrong signals at a time when countering inflationary pressures is so important. The credibility which the government has successfully built up over the last five years in this area needs to be maintained as it is a major input to the overall credibility of economic policy. For that reason, the mildly restrictive stance of the 1991 budget needs to be reinforced in the forthcoming years.

Development and liberalization of the financial system and a more market-oriented approach to monetary control

Since 1984 the Portuguese authorities have been taking a series of steps to modernize and expand the financial system, so that it can serve the needs of the economy more efficiently. In the past the financial system had been characterized by a low level of sophistication (limited range of instruments, non-existent or shallow secondary markets), a lack of exposure to innovative foreign influence, a domination by the non-competitive nationalized banks, and a wide range of administrative controls on interest rates and lending.

Gradually the banking sector is being opened up to more competition, with new banks and foreign entrants allowed since 1984 and the privatization process now gathering momentum. Attempts are being made to encourage and develop new instruments, markets and financial intermediaries in order to diversify away from over-reliance on short-term bank credit (although this process remains difficult while inflation is still high). Existing institutions (such as the stock exchange) are being modernized. The tax treatment of different financial instruments has been simplified in the 1989 reform, reducing distortions and increasing transparency.

At the same time there has been a progressive abandonment of the administrative setting of bank interest rates; by now only the minimum rate on six-month deposits is still subject to direct control. Compulsory ceilings on the private credit expansion in individual banks' have also been abolished in March 1990; banks were asked to respect a global target of zero credit growth for the second half of 1990 but even this limit is abolished in January 1991. However, given the massive excess liquidity (financial resources which are not being used as credit) of the banking sector, the effectiveness of those instructions is doubtful. Excess liquidity resulted from past central bank financing of large public sector deficits and has been the major reason delaying the change to a system of better monetary control based on open-market operations. Its definitive elimination, via the selling of public debt instruments to the non-banking sector, may imply some increase in public debt interest costs but it is indeed an unavoidable move in order to improve control over the money supply and consequently the effectiveness of monetary policy.

Deregulation of the domestic financial sector is being accompanied by the gradual removal of capital controls, although Portugal is entitled to delay full liberalization of capital movements until 1996. Inward direct investment has been free of exchange controls since the beginning of 1990 and the freeing of outward portfolio investment in several steps has recently been completed in advance of the Community end-1990 deadline. But the difficulties which may be created by the removal of exchange controls before the necessary adjustment in inflationary conditions has been achieved, are illustrated by the strong short-term capital inflows, which could amount to the very large level of 10% of GDP in 1990, attracted by high interest rates and the quasi-guaranteed crawling-peg depreciation path for the escudo. The authorities reacted at the beginning of July by effectively suspending for 90 days purely financial transactions in the forward market and through the imposition of a 40% interest-free deposit on external borrowing - clearly measures which need to be substituted after some time by more market-conforming policies. In an important step to reduce capital inflows and increase the anti-inflationary stance of monetary policy, the Bank of Portugal further decided to replace the pre-announced monthly depreciation with a more market - determined exchange-rate, allowed to fluctuate within certain unannounced limits against ERM currencies.

Within this framework of system reform, monetary conditions, which had been rather expansionary between 1986 and 1988, were tightened as from March 1989 as inflationary pressures became more apparent. The broad measure of liquidity, L-, on which the authorities focus has slowed to an annual rate of expansion of about 10,5% in the second quarter of 1990; however it accelerated sharply in the following months.

Re-establishing the downward trend in inflation and preparing for membership of the ERM

The Portuguese government has committed itself to membership of the ERM and announced its willingness to participate fully from the beginning in the construction of EMU, but the precise timing of entry is likely to depend on achieving the necessary narrowing in the large inflation differential relative to existing ERM countries. Getting the better of present inflationary conditions will call for a tightening of fiscal policy, the maintenance of a restrictive monetary policy, wage moderation and less predictable exchange rate developments (including perhaps a mild appreciation of the escudo during the transitional period before ERM entry) :

- the relaxation of fiscal policy in 1990 has to be reversed as soon as possible, reasserting the downward trend in public deficits to which the government is committed in its medium-term strategy;
- interest rates were raised in 1989 and the growth of the monetary aggregates subsequently slowed, but some reinforcement of this tight monetary stance may have to be considered;
- wage developments have not up to now been the prime source of inflationary pressures in Portugal and it is especially important that the traditional degree of real wage moderation appears not only as a final outcome but that it is fully anticipated and agreed by the social partners. Only if nominal claims against the production potential are reduced from the outset will it be possible to resume the necessary disinflation of the economy;
- the already non-accommodating exchange rate policy has been recently modified; in addition to a change in the reference basket of currencies, which now includes only ERM currencies, since 1 October the escudo has been allowed to float, in order to make the high Portuguese interest rates less attractive to short-term capital inflows and consequently to increase the anti-inflationary stance of monetary policy.

Once the downward trend in inflation is firmly re-established then entry into the ERM (perhaps initially within a wider band) could help to reinforce this process, encouraging expectations of a further fall in inflation, conferring greater credibility on government policies and disciplining cost developments. This is why the current exchange rate regime can be described as a pre-pegging float.

Is there a danger of some incompatibility between the twin objectives of nominal and real convergence and will it be necessary to give priority to one over the other? Certainly the timetable now being discussed for the moves to EMU indicates the urgency of Portugal achieving much lower inflation and a stable budgetary position if it is to avoid becoming one of a second tier of countries not yet ready to take a full part in the EMU process. In the next few years this may mean greater restraint on growth, so that the price-stability objective can be met. Such a policy is not incompatible with the pursuit of strategies to open up, modernize and restructure the economy in the context of the opportunities offered by the completion of the internal market and beyond. The improvement in supply potential to be obtained from the building up of the stock of capital in productive and infrastructure assets, from the upgrading of the skills of the workforce, and from the removal of stultifying and distorting regulations and rigidities need not be interrupted during this period of disinflation. Greater stability once it has been achieved (and the past flexibility of the wage bargaining process in Portugal suggests that this could be at a level of external competitiveness which would not permanently hinder growth), should actually reinforce growth prospects by improving confidence, removing distortions to price signals and facilitating the integration of Portugal into the Community economy.

The above analysis needs however be qualified in some important aspects if the recent developments in the Gulf lead to a lasting increase in the price of oil. For the Community that would represent an assymmetric real shock with Portugal being one of the most affected countries. From a longer term perspective perhaps a depreciation of the currency above the inflation differential with the main trading partners would prove necessary which, furthermore, would be associated, in the more immediate future, with greater difficulties in securing nominal and real convergence with the Community. The disinflation strategy should then rely less on the exchange rate policy and more on the restrictive stance of domestic, fiscal, monetary and incomes policies. Yet the substantial long-run benefits of Portuguese participation in EMU allow a more marked (albeit temporary) slowdown in output and employment growth than otherwise would be necessary to achieve price stability to be expected.

Part II
Special Topics

CHAPTER 1
FISCAL ADJUSTMENT AND PUBLIC FINANCE POLICY

A sharp deterioration of the Portuguese public finances following the first oil shock was reversed only in 1985 when the national authorities embarked on a programme of fiscal consolidation. Despite a significant improvement, the deficit of the general government is still to be considered too high as a proportion of GDP and the debt ratio stands above the Community average. In a longer perspective several factors will have an important impact on the Portuguese public finances, particularly capital expenditures aimed at co-financing the Community structural funds. In such a context, the Portuguese authorities have adopted a medium term comprehensive macroeconomic strategy in the framework of which the necessary fiscal adjustment is defined.

1. Fiscal consolidation

1.1 In the beginning of the seventies, public finance in Portugal was characterized by balanced budgets and a low level of indebtedness. Following the first oil shock, the Portuguese public finances deteriorated sharply. This trend was attributable not only to the unfavourable macroeconomic conditions but also to the change of political regime, lower priority given to fiscal discipline, larger transfers to households, regions and local authorities, decolonization, within a context of an inefficient tax system. As some general government imbalances were shifted to public enterprises accounts, the combined borrowing requirement of the public sector (general government and public enterprises) is the more accurate indicator of the deficit of public finances : it reached 21,5% of GDP in 1984.

In 1985 the Portuguese authorities embarked on a programme of fiscal consolidation which also aimed at a much needed clarification of the public sector financing.

The main features of the programme were :

a)marked reduction in the general government deficit;

b)a reform of both indirect and direct taxation;

c)an increased transparency in public debt financing.

1.2 After peaking at 12% of GDP in 1984, the general government deficit[1] entered a steady downward path and in 1989 amounted to less than 4% of GDP. An effort of expenditure restraint took place, although the level of total budgetary expenditure as a GDP ratio is amongst the lowest of the Community. The improvement in the primary balance was even more impressive than that of the overall balance with a deficit of 4,9% of GDP in 1984 turning into a surplus of 3,5% in 1989. It has to be stressed, however, that the main contributions to this consolidation came from the cyclical upturn of the economy, combined with the appropriation by the public sector of a large share of the impressive terms of trade gains recorded by the Portuguese economy between 1985 and 1988 (the latter explaining for instance the sharp reduction registred by current transfers to enterprises).

1.3 The reform of the direct and indirect tax system were also instrumental in the reduction of the general government deficit. The single most important development was undoubtedly the restructuring of indirect taxation brought about by the successfull introduction of VAT in 1986. In addition to the associated efficiency gains, the broader tax base and the surfacing of previously unrecorded activities boosted VAT receipts about 40% above the level which might have been collected from the taxes it replaced. As far as the reform of direct taxation is concerned, it represented a much less radical departure from the previous system. Its implementation took place in 1989 and, except for a temporary effect due to the change to shorter delays of payment, it should not lead to a marked increase in fiscal pressure[2]. The main positive impact is a marked reduction in several tax distortions (particularly resulting from very high marginal tax rates on household income and the existence of a large and intricate set of fiscal incentives and exemptions) which had characterized the previous system. However, there is a distinct possibility that a greater simplification of the direct tax system could not only achieve further efficiency and equity gains but also generate additional revenues.

1 Excluding financial transactions and in particular "Activos financeiros" e "Outras operaçoes de capital".

2 Except for the newly-introduced taxation of public-debt interest payements, which however has a roughly neutral impact on the budget deficit given the offsetting increase in gross interest payements.

1.4 As far as the outlook for 1990 for the general government deficit is concerned, the available information points to a marked deterioration compared to the previous year. The increase in deficit will reflect the end of the extraordinary gains in tax revenue brought about by the transition to the new system of direct taxation the previous year, the sharp increase in the interest burden (as a consequence not only of higher interest rates but mainly of a calendar effect resulting from a large placement of public debt at the end of 1989), and more particularly the adverse impact on the wage bill of the current reform of the civil service pay system. In order to counter the deterioration in the budget deficit, the government adopted several measures of expenditure restraint, particularly as far as current purchases of goods and services are concerned. However, these measures, which aim at a saving of 0.5% of GDP, were more than offset by the subsequent increase in social security pensions.

1.5 The 1991 budget has been recently approved by the Parliament. It aims at a return to a downward path for the public finance imbalances : the projected deficit is Esc. 613 billion, decreasing from 6.5% of GDP in 1990 (last official forecast) to 6.3% in 1991. Except for the continued impact of the 1989 change to the taxation of public debt payements, the fiscal burden should remain roughly unchanged; in particular no major increase of indirect taxation - envisaged in the national authorities medium-term macroeconomic strategy - is forecast. An effort to moderate non-interest and non-wage current expenditure has been made in order to make room for a 20% increase in central government investment, this last development being closely associated with the rising trend of utilisation of Community structural funds by Portugal. On the other hand, social security transfers to households should continue to rise a a fast pace, in part due to demographic factors. A very positive development, particularly from the point of view of curbing expenditure growth, concerns the expanded coverage of the State budget. The budgets of the central administration autonomous bodies, which are still responsible for a large share of total public expenditure, are now included in the State budget document and approved together with the latter. All in all, the 1991 budget can be described as a mildly restrictive one which, together with the projected privatizations proceeds for the next year, should lead to another reduction in the public debt/GDP ratio.

1.6 In order to improve the transparency of the public sector financing, financial imbalances which were shifted during the first half of the 80's to autonomous bodies of the central administration and public enterprises were progressively incorporated since 1985 into the public debt : on one hand widespread arrears existing both towards public enterprises and the banking system and which roughly amounted to 12,5% of 1986 GDP were settled; additionnaly, several autonomous funds and services of the central administration were wound up or integrated within government bodies covered by the state budget, with the Treasury taking over their liabilities. However, despite the substantial debt takeovers by the Treasury, which have already occurred, there remains several important cases to be solved (local authorities' debt to the electricity monopoly, bad loans of public sector banks, etc.).

The main financial consequence of this greatly improved transparency in public finance management was, at general government level, a much faster increase in public debt than that warranted by deficits. The Portuguese public debt/GDP ratio rose steadly up to 1988, when it peaked at 74%. Due to a large negative real interest rate - GDP growth differential, a marked improvement in the primary balance and despite new debt take-overs by the Treasury, a reduction in the debt/GDP ratio (to 71,4%) took place last year; in 1990 another reduction in the debtGDP ratio is expected to have occurred. However, even at this level the Portuguese ratio - although far from being the highest in the Community - stands well above the Community average.

The second aspect of the clarification effort undertaken by the Portuguese authorities is connected with the increased transparency in public debt financing. Until recently, large budget deficits were mostly financed by the issue of high-powered money, leading the central bank to resort to credit ceilings to avoid an unsustainable level - particularly from an external point of view - of overall domestic credit. The resulting excess liquidity of the banking system was then used to place public debt at very favourable interest rates. Another consequence of credit ceilings and the situation of financial repression was that, in order to sustain the profitability of the banking system, the differencial between deposit and lending rates became very large.

The internal and external liberalization of the financial markets which has also been taking place since 1985 have led to a progressive reduction of the importance of "implicit taxation" (seignorage, benefits indirectly accruing to the budget from the large differential between lending and borrowing interest rates, etc.). Above all, interest rates on domestic public debt became largely market-determined and began to signal the true cost of public debt. The move from credit ceilings towards indirect instruments of monetary control, which is now taking place, will certainly imply further progress in the conditions of public debt financing.

2. Longer term factors of evolution of public finance :

2.1 On a more extended perspective, several factors will have a particularly important impact on the evolution of the Portuguese public finances. In addition to the current transition to indirect instruments of monetary control which is expected to lead to a lasting increase in public debt domestic interest rates, they are : the budgetary impact of structural funds, demographic trends and their implications for the social security accounts, indirect tax harmonization within the Community and the privatization process.

2.2 The Portuguese authorities face the problem of how to achieve full utilization of Community structural funds without an unsustainable acceleration of total capital expenditure.

The financial flows of the Community structural policy in favour of Portugal for the period 1989-1993 are concentrated in the Community Support Framework (CSF). Transfers from the Structural funds will amount to about 3,5% of GDP during that period. Total transfers in favour of Portugal may eventually become higher due to financial support under Community initiatives which are not included in the CSF. They will have an impact on the capital budget of the general government and thus on the strategy of fiscal adjustment due to the fact that a large part of them will be allocated to the co-financing of public capital expenditure. Under the CSF indicative plan for the period 1989-1993, in a total public spending, mainly investment, of 13.616 million ECU (in 1989 prices) the share of the national public finance requirements will amount to about 49%. The growth of such spending will be steady during the period (17,7% in 1990, 9,2% in 1991, 8,9% in 1992 and 15,1% in 1993). However, the precise figures to be recorded in the general government budget will be different given the indicative nature of the financial plan of the CSF and the fact that the budget is made on a payment basis. Due to the large share of commitments related to the Structural funds in total capital expenditure (around 50% in 1990), the non-cofinanced capital expenditure will have to grow marginally or even decline, unless total capital expenditure is allowed to accelerate significantly. This means that the room of manoeuvre of the Portuguese authorities is becoming increasingly limited and the success of the medium term fiscal adjustment strategy may imply a very modest real growth, or perhaps even a freeze in public non-cofinanced investment.

2.3 In regard to the financial situation of the social security system, the problem facing the Portuguese authorities is not only the budgetary implications of the gradual ageing of the population but also the very low level of the old age and disability pensions, particularly those of the non-contributive regime. The key policy variable in this area is undoubtedly the extent of the annual uprating of pensions in real terms; according to previous statements made by the Portuguese authorities, this would remain below 2%. Under this scenario and given the continuation of a favourable macro-economic situation (namely a low rate of unemployment and positive real wage growth) the financial position of the social security system would not suffer a deterioration for the next few years despite the already low ratio between contributors and beneficiaries and the increasing number of the latter; as for other European countries, the long-term prospects for the social security system are much more pessimistic due to an expected acceleration in the population ageing process. It has to be stressed that this year extraordinary increase of social security pensions (granting of an extra monthly payement) - although justified from a purely social viewpoint - represents a clear departure from the fiscal adjustment strategy announced by the Portuguese authorities. However pressure for further substantial increases in the purchasing power of pensions is likely to persist.

2.4 The projected harmonization of indirect taxation within the Community would provide Portugal with an excellent opportunity to boost tax revenues and a contribution to a reduction of the level of the general government deficit. Current Commission proposals imply, in particular, the suppression of the zero rate which applies now to more than 20% of the VAT base and the increase in excise duties on tobacco and alcoholic beverages, resulting in a net gain to the budget; this increase in revenues might be close to 2% of GDP. Anyhow, the minimization of its adverse impact on inflation calls for a gradual implementation of the harmonization measures.

2.5 Another important contribution to the public finance adjustment is expected to come from the massive government privatization programme. As a result of the nationalization in 1975, Portugal currently has a large public sector in both the "productive" and the financial sectors. Figures for 1988 show that the former accounted for about 12,5% of GDP while stage-owned financial institutions retain, by far, a dominant position in the financial sector. The privatization process began in April 1989 but, for constitutional reasons, privatization operations were last year restricted to 49% of the capital involved. The constitutional ammendment in the summer of 1989 opened the way to the first full privatizations, which have already taken place this year. Under the government's programme full privatization shall be the rule for virtually the entire public sector and they are expected to last at least until 1993.

Although the amount of revenue to be raised is impossible to assess given the unpredictability of capital market conditions, it could be in excess of 600 billion escudos at 1990 prices (around 7,5% of GDP). As announced by national authorities, privatization proceeds (a minimum of 80% of gross receipts) should be used to reduce existing public debt in order to ease the dynamics of the debt GDP/ratio and to reduce the budget deficit via a lower interest burden. However, its positive impact will be partially offset by the expected continuation of debt takeovers by the Treasury.

3. Fiscal adjustment strategy : PCEDED (Programme for the structural correction of external deficit and unemployment) and QUANTUM

An improvement in the design of the Portuguese fiscal policy came with the adoption of a comprehensive macroeconomic strategy (PCEDED-Programme for the structural correction of external deficit and unemployment) by the government in March 1987. For fiscal policy purposes the most important feature was the acknowledgment that the successful reduction of the general government deficit needed a strong but continued effort in the framework of a medium-term programme. The fiscal adjustment strategy was based exclusively on expenditure restraint, namely : zero or close to zero real growth of public consumption, subsidies and budget transfers to autonomous central administration bodies, real growth of per-capita social security transfers to households below 2% a year and a very strict selection process for public investment projects without EC funding. A revised version of the PCEDED was published in July 1989[3], giving a much more important role to the fiscal adjustment programme; the success of the latter was explicitly presented as a necessary condition for the achievement of the catching-up process of the Portuguese economy and the reduction of the inflation rate to the Community average. Another important departure from the original PCEDED concerns the acknowledgment by the Portuguese authorities that the expenditure restraint effort needed to be complemented by a progressive increase in the tax burden, which was supposed to be induced solely by last year's direct tax reform.

Recently the national authorities announced the Quantum (Framework of the National Adjustment to the transition for EMU) as a strategy for the Portuguese participation in EMU being currently developed at the Ministry of Finance. Quantum elaborates on the long-term benefits of EMU, the need for an adequate macroeconomic strategy based upon budgetary adjustment in order to reduce transition costs (mainly identified as resulting from the inflation differential) and the priority given to an early entry of the escudo to the ERM. Quantum can be seen as an improved and revised version of the PCEDED, focusing on the transition to EMU. It is, however, much less detailed.

The fiscal adjustment component of the Quantum is once again based on expenditure restraint but an increase of indirect taxation, in line with the Commission's proposal on tax harmonization, is also envisaged. It is difficult to evaluate the fiscal adjustment effort implicit in Quantum as no detailed data were yet provided. Anyhow it seems to be an adequate fiscal adjustment strategy, compatible with the progressive reduction of the inflation differential between Portugal and the EC average and an active participation of Portugal in the construction of EMU.

The general impression is that the Portuguese authorities have sufficient room for manoeuvre to successfully implement a fiscal adjustment effort. However, the existing room for manoeuvre depends, to a large extent, on the "windfall" receipts resulting from the privatization process. Given its transitory nature - albeit with positive lasting effects when used to reduce public debt - the underlying adjustment must be robust enough to avoid the re-emergence of imbalances from 1993 onwards, when the process of privatization might have come to an end. On the other hand, the experience of Portugal and countries that have followed fiscal adjustment strategies based almost entirely on expenditure restraint suggests that a reduction or even a stabilization in real terms in public expenditure is very difficult to achieve and that, in many cases, it is essential for the revenue side to contribute to the adjustment. Consequently, in view of the importance of a successful fiscal adjustment for the future of the Portuguese economy, there are grounds to recommend that the possibility of taking discretionary measures to increase the tax burden (others than those associated with fiscal harmonization within the Community) should not be ruled out. Furthermore, additional revenues are to be expected from a greater simplification of the tax system than that achieved in the 1989 tax reform, even without involving increased rates.

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3 A detailed evaluation of the fiscal adjustment strategy contained in the revised version of the PCEDED, together with an analysis of the medium-term prospects of the Portuguese public finances was done in the Commission document "Contributions towards a Multiannual Fiscal Adjustment Strategy (MAFAS) for Portugal" (see background papers).

CHAPTER 2
MONETARY AND EXCHANGE RATE POLICY

1. The stance of monetary policy since 1986

There is no single measure for the stance of monetary policy in Portugal and any analysis of the subject should take into account that the rapid financial integration of the Portuguese economy with the world economy which took place in the last few years rendered progressively more difficult to reconcile domestic monetary control with an exchange rate target (crawling-peg). This led on 1 October 1990 to a float of the escudo within non-specified limits defined against other ERM-currencies which can be described as a pre-pegging float. While interest rates and liquidity aggregates would suggest an expansionary stance from 1986 to 1988, exchange-rate policy was less accomodating. Moreover, financial deregulation and integration made the interpretation of monetary variables and their control increasingly more difficult. After the rebound in the inflation since the end of 1988, interest rate and credit developments indicate a monetary tightening, that was, however, not accompanied by an exchange-rate policy sufficiently tight to reinforce the anti-inflationary measures.

From 1986 to 1988, monetary policy was rather expansionary:

- The targets set allowed the liquidity ratio of the economy to rise. Moreover, money supply growth tended to overshoot even these objectives as capital inflows turned out to be larger than anticipated. The growth of the target liquidity aggregate, L-, decelerated from 28.5% at the end of 1985 to 26.3% by December 1986 and 17.5% by December 1987 to 15% December 1988 but remained above rates considered by the Banco de Portugal to be in line with monetary stability.
- The loose stance of monetary policy was also reflected in short-term interest rates (three month treasury bill) which came down from over 20% in 1985 to 12.5% in December 1988.
- However, exchange-rate policy had a disinflationary impact during this period. The crawling-peg exchange rate policy was based on decreasing rates of depreciation from the beginning of 1986 : 8.1% in 1986, 6.7% in 1987 and 4.8% in 1988 and 3% in 1989. Comparing the relative unit labour costs of Portugal with its 19 main trade partners, this implied a cumulative real appreciation of the escudo of some 8%.

But in March 1989, restrictive monetary policy measures to cool inflationary pressures were prompted by a marked acceleration in the inflation rate, which was projected at the time to reach 12% in 1989:

- the discount rate was raised by 1 percentage point to 14%. The capital market reference rate increased similarly to some 16%;
- reserve requirements were increased to 17% up from an average of 5.6% and unified across an enlarged incidence base;
- credit expansion was tightened and its control was changed to a monthly basis from a bi-monthly one;
- the crawling-peg of the escudo was fixed at an annual effective rate of depreciation of 3%, in continuation of the deflationary exchange rate policy.

The consequences of this tightening may be illustrated by the indicative lending rate for 90 day operations (reported by the Portuguese Bank Association) which jumped by two percentage points to 19.4% at the end of April 1989. It has remained on a rising trend and reached a level of 23.4% at the end of December 1990.

The growth of the monetary aggregates has calmed down since then: L- growth declined to 7.5% by the end of 1989 and has remained at that level until March 1990. Since then there was a reacceleration (16.5% in August 1990). However, inflation, after recording a peak in the third quarter of 1989 and again in October 1991 (14,4%) is not yet in a clearly downward trend (14.1% in November 1990).

However, very substantial capital inflows accentuated in recent months by increasing speculation about early entry of the escudo in the ERM have created difficulties in maintaining the present stance of monetary policy. These difficulties led the Banco de Portugal to impose from 25 June 1990 onwards, a 90-day ban on term operations in Escudo in an attempt to stem capital inflows. In July 1990, new financial borrowing from abroad became subject to a 40% non-interest bearing deposit with the Banco de Portugal. At the same time outward portfolio investments by Portuguese residents were completely liberalized in anticipation of the official Community deadline (31.12.1990). In an important step to reduce the attractiveness of domestic interest rates to non-residents, the Bank of Portugal has allowed greater unpredictability for the exchange-rate evolution of the escudo since the 1st October.

2. Towards a market-oriented monetary policy approach

Due to monetary financing of the budget deficit and to the absence of well developed money markets, monetary policy in Portugal was for long based on credit ceilings (with an associated target for the liquidity aggregate, L-), administered interest rates and a crawling-peg exchange-rate policy. Since 1985, monetary policy has been in transition towards a market-oriented approach : (1) new instruments have been introduced on the money market; (2) an effort is made to sterilize excess liquidity which was the result of the monetary financing of the public debt; (3) interest rates have been progressively liberalized; (4) and more recently compulsory credit ceilings have been abolished. At the same time Portuguese financial markets are becoming increasingly integrated internationally and the question arises as to which exchange rate policy should be envisaged in the near future. This question, which is of course essential also for the role of monetary policy in stabilizing the economy, is dealt with in section 4.4.

Potential excess liquidity (the difference between deposits and credit quota) of the banking sector has been a major subject of concern for the Banco de Portugal. Already in 1976 when the interbank money market was created and in 1978 when the interbank securities market was started, efforts were made to drain excess liquidity. In 1985, the money market was made more flexible and a new treasury bill was launched as an additional draining measure. Later in 1987, the central bank issued monetary certificates with a maturity of 1 to 7 days for intervention in the very short end of the money market. In the same year intervention certificates and time deposits to be held at the central bank were introduced to contribute to the mopping-up of liquidity. However, the measures taken have not been sufficient to prevent a continuation of liquidity accumulation in the banking system. In 1989, great efforts have been made to drain out excess liquidity from the banking system in order to prepare a more market-oriented approach of money management, putting more emphasis on indirect market control. The most important measures are the increase in reserve requirements (March 1989), continuing intervention of the Banco de Portugal in the interbank money market through the maintenance of high rates on long-term deposits with the Central bank, and intervention in the interbank securities market, created to absorb short-term excess liquidity.

Initially, these measures were successful, but massive capital inflows jeopardized the draining efforts. Hence, the monetary authorities envisaged more mopping-up operations and for the last quarter of 1990 it was planned to issue large amounts of public debt for subscription by commercial banks who can sell it to the public in order to (i) reimburse the Banco de Portugal (its holdings of such debt were the main counterpart of bank's excess liquidity up to 1988 or 1989; more recently capital inflows have been the major contributor to liquidity creation); (ii) advance repayment of government's and state owned enterprises' external debt. By reducing the monetary financing via the Central bank, this operation should contribute to making the financing mechanism of the budget more transparent.

Complete success would imply an increased explicitly budgetary cost to the extent that government borrowing gradually approaches market conditions. Increased central bank profit transfers, made possible by the elimination of highly remunerated deposits at the central bank, which are used to subscribe to the newly issued public debt, would help offset that cost. Also, this would lead, in the long run, to a better functioning of the financial markets and would help solve the tension between the desire to keep the cost of public debt service as low as possible, on the one hand, and to move to market methods of monetary control, on the other.

In such a framework of excess liquidity and poorly developed financial markets administratively fixed interest rates and credit ceilings were the most important instrument of monetary control in Portugal for many years. The gradual modernization of the financial system has led to the progressive liberalization of almost all bank interest rates (credit and deposits rates), with the only exception of the minimum rate for six month deposits. In the past, administered interest rates played an important role as an instrument of monetary management, with particular effectiveness in controlling capital flight and improving domestic financial savings. It may, however, have also served as a hidden fiscal policy instrument seeking revenues by imposing an implicit intermediation tax on borrowers and depositors of the banking system. Since March 1990, compulsory credit ceilings, which discriminated against the productive sector in favour of the public sector, have been suspended. Nevertheless, banks were still asked to keep their credit expansion in line with a recommended value announced by the central bank. From 1 January 1991, also this was abolished.

The move away from quantitative credit restrictions and from administered interest rates made possible by the modernization of the financial system implies a major structural change in the functioning of financial markets in Portugal. It represents a major improvement, paves the way for the development of efficient markets and creates a need for the continuing development of market-oriented policy instruments. Nevertheless, further deregulation in financial markets remains necessary. Contrary to other member countries the Portuguese legal tradition requires in general explicit approval of most innovations, which discourages private initiative, while at the same time the state alone may be overstrained to create efficient market structures.

3. Quantity targets and indicators

As capital movements were far from being liberalized, and financial markets were only loosely related to international markets the Bank of Portugal had some degree of freedom to target a liquidity aggregate L-, in spite of its exchange-rate orientation; more recently its room for manoeuvre declined substantially. Money markets have, however, been poorly developed and the information content of aggregates has been blurred in view of the large, albeit decreasing, level of regulation.

The Banco de Portugal has constructed a rather broad aggregate L-to mirror potential demand pressure in the economy. L- includes currency in circulation, demand deposits, time deposits, foreign currency deposits held by residents, repos, cash bonds, treasury bills and short-term government securities intermediated by financial institutions (CLIP) held by the domestic non-financial private sector. This aggregate, which comprises both liquid liabilities of the banking system and short-term government securities held by the public, is subject to disturbances produced by the development of capital markets in Portugal.

A main problem with L- is that empirical evidence has not provided strong support for the relationship between the intermediate monetary target and the final objective of price level stability, with periods of even negative correlation between L and inflation. Price controls, which were removed only very recently, may be one explanation. Another explanation may be found in the high degree of interest rate regulation and credit rationing in the past, which rendered aggregates irrelevant as indicators of demand pressure. At the same time, financial deregulation made the relation between L- and the final objective less stable.

Further, the credibility of the announcement of targets as an instrument to influence the formation of expectations of inflation and exchange rates seems to be poor given the ineffectiveness of liquidity targeting in the small open economy of Portugal. Repeated redefinition of the aggregate, in order to include developments and structural changes in the domestic financial market, which is increasingly being internationalised, does not strengthen the information content of target announcements.

A narrower aggregate, more closely linked to the transactions demand for money, such as M1, has been subject to a high degree of instability. This is not surprising, given the changes in the conduct of monetary policy, the adjustment of the banking system to credit ceilings and the other various structural developments in financial markets.

A more general problem is that targeting a monetary aggregate is frequently at odds with the established objective for the effective exchange rate if capital movements cannot be effectively controlled. The problem will become increasingly important the more capital liberalisation is advanced, and once full liberalisation is realised (targeted for 1996 at the latest) only domestic credit would in principle remain controllable.

Given these disadvantages of targeting quantities, the importance of price indicators of the monetary policy stance such as the yield curve, asset prices and the exchange rate may in principle have a more important role to play. Within the framework of not well developed and partly administered financial markets, the information value of price indicators in Portugal has so far been limited. It may grow in importance as financial markets are further liberalized and develop; but it is not surprising that a considerable degree of importance was to be given to the exchange rate as a target policy. The following section discusses the benefits and pitfalls of exchange-rate targeting in more detail.

4. Exchange rate policy and prospects for an ERM entry of the escudo

In the last few years, inflation differentials between Portugal and its main trade partners have not been fully reflected in the announced, monthly depreciation of the escudo. In particular, after April 1986, the monthly rate of depreciation was continuously cut down on the basis of target inflation rates. Since December 1988, however, a constant depreciation rate of 3% a year was fixed, after the inflation rate had jumped again to double digit rates. More recently, ERM-entry became the primary policy aim.

Developments

The crawling peg exchange-rate policy introduced in 1977 involved a programmed monthly depreciation of the effective exchange rate against 13 currencies. Its main purpose until 1985 was to improve or at least maintain external competitiveness. Over the period 1977-1985, the real exchange rate, evaluated on the basis of unit labour costs, declined by 40%, but mainly as a result of several discrete devaluations.

From April 1986 to December 1988, the crawling peg was applied on a degressive basis as a function of quarterly inflation targets. The rate of depreciation of the effective exchange rate of the escudo was continuously cut down from 1% a month in 1985 to 0.2% by the end of 1988. And from the beginning of 1989, after the inflation rate had accelerated again to some 12%, a constant monthly depreciation rate of 0,25% (3% per year) was fixed. This policy has resulted in a 8% real appreciation of the escudo, evaluated on the basis of unit labour costs, since April 1986.

On 25 June 1990, the Banco de Portugal temporarily suspended escudo term operations for a 90 day period, when a massive wave into the escudo put it under strong appreciation pressure. On 1 October 1990, the authorities decided to abandon the crawling peg and only retained the 3% rate of depreciation as a long-term policy objective, although non-binding on a monthly or even annual basis. In addition the reference basket was changed. While previously the crawling peg was measured against a currency basket which also included the dollar and the yen and represented the nominal effective exchange rate of the escudo, exchange rate management is now evaluated against a currency basket only composed of ERM-currencies.

Increased short-term unpredictability was desirable in order to discourage capital inflows attracted by high Portuguese interest rates. In the eyes of the Portuguese authorities the policy move could even bring forward ERM participation because of its probable greater disinflationary impact as compared to the previous crawling-peg regime.

Assessment

An important turning-point was reached when Portugal abandoned its policy of competitive devaluation on accession to the Community. The gradual reduction in the rates of depreciation has reinforced the impact of external disinflation factors.

Unfortunately these factors have been overwhelmed by other determinants of inflation, leading to an inflation rate of 12 to 13% in 1989. As it is typically the case in boom periods, the increase in profit margins explain a significant part of the acceleration in prices with real unit labour costs (or the share of wages in income) declining. Given the present situation of excess demand and inflationary pressure, which will be reinforced once wages start to catch up, a significant real appreciation of the escudo is necessary to restrain demand for domestic output in favour of net imports. This real appreciation may come about through a strong escudo and/or a higher rate of inflation.

The float since October 1990 would probably lead to an appreciation of the escudo, given its high level of interest rates necessary for monetary control and justified by good profitability conditions and investment opportunities. An appreciation of the escudo would help reduce inflation directly in the short run. It also would be beneficial in cooling the economy down not only as a result of the expenditure switch but also as a consequence of the pressure that the currency appreciation would put on producers' profitability, making them more reluctant to accept wage claims than in the current context of strong demand and high capacity utilisation levels. And it would offset the impact of higher interest rates on investment by reducing prices for imported capital goods. However if the recent increase in oil prices turns out to be a permanent real shock, then the degree of (temporary) real appreciation of the escudo to be sought after both by the market and Portuguese authorities should be revised downwards.

Prospects

The ERM commitment would probably lead private economic agents to anticipate a policy mix consistent with both the exchange-rate stability and the fighting against inflation. One may expect that strong exchange-rate discipline would increase the credibility of the economic authorities, and of monetary policy in particular. This would contribute to moderate inflation expectations and discipline domestic costs. The more the exchange-rate commitment is credible and capital movements are freed, the closer will Portuguese interest rates move towards other ERM rates. The lowering of the risk premium would ease the burden of public debt, lower the cost of bond financing of investment expenditures (offset, however, by relatively high prices for imported capital goods, as compared with a situation in which the escudo was allowed to float upwards) and would bring forward consumption expenditures.

It is however, questionable whether the implied increase in domestic demand would be welcomed at the moment when demand pressure is already high and the current account in deficit. In addition, the positive credibility effects are not likely to be sufficient to bring down inflation in due time. A combination of tight monetary and fiscal policies and managed floating would be a strategy to bring down inflation in preparation for Portugal to enter into the ERM.

CHAPTER 3
FINANCIAL MARKETS AND CAPITAL MOVEMENTS

1. Introduction and summary

Conscious of the handicaps which characterize an undeveloped financial system, closed to innovative external influences and dominated by uncompetitive nationalized banks, the Portuguese authorities have started to modernize the financial system. To that end the banking sector was opened to foreign entrants and capital movements are gradually being liberalized. The philosophy is that imported competition will make the domestic financial sector more efficient. This external liberalization has its domestic counterpart in the privatisation of public banks, the deregulation of interest rates, the elimination of credit ceilings and the development of new capital market institutions and instruments.

If this approach to modernization is to be succesful, there is not only the need that the institutional reforms take place without delay but also that the government reduces its borrowing needs and that inflation is curbed, thus facilitating respectively the elimination of priviledged financing channels 2and the development of stable long-term financing instruments which are determined by market forces. These additional requirements seem also necessary in order to be able to continue with the liberalization of capital movements which is likely to be an important trigger for domestic financial modernization.

2. The banking sector and the financing of the economy

Until 1984 the Portuguese financial system was dominated by the banking sector comprising 9 domestic commercial banks (nationalized in 1975 following the Revolution), 3 foreign commercial banks, 2 savings banks and one investment bank. In that year banking sector was opened to new entrants, both from domestic and foreign origin. By 1990 four new domestic and seven foreign commercial banks were created as well as two investment banks, one with domestic and one with foreign capital. At the same time financing through capital markets (see 3.) was stimulated by the creation of new financial instruments and non-monetary financial institutions. Later in 1988 the green light was given for the partial privatisation of one of the nine commercial banks nationalized in 1975. Complete privatisation was not possible until the Constitution was amended, which happened in 1989. More privatisations of banks are scheduled.

Table 1: **Financing of private enterprises (change in financial liabilities, % of total)**

	1985	1986	1987	1988	1989
Domestic bank credit	86.7	54.0	-20.9	15.8	7.4
Foreign credit	2.3	4.0	24.1	21.0	32.7
Bonds + shares	4.4	10.0	33.4	16.5	12.5
Credit from non-monetary financial institutions	4.9	4.0	22.6	16.2	14.3
Other (1)	6.3	28.0	40.8	30.5	33.1
Total	100	100	100	100	100
(bn ESC)	(183.6)	(234.5)	(294.0)	(846.1)	(1093.6)

(1) Other financial assets (which include up to 1986 foreign investment in Portugal), arrears, errors and omissions.
Source: Bank of Portugal, annual reports.

Table 2: **Financing of general government (change of financial liabilities, % total)**

	1985	1986	1987	1988	1989
Domestic bank credit	75.9	26.1	26.7	44.5	-29.4
Foreign credit	14.2	1.1	9.2	2.8	-16.6
Treasury bills and bonds	38.2	87.1	62.1	52.2	142.4
Other (1)	-28.4	-12.1	1.9	0.5	3.6
Total	100	100	100	100	100
(bn ESC)	(535,3)	(490,6)	(678,7)	(672,4)	(547,0)

(1)Arrears
Source: Bank of Portugal, annual report.

As a consequence of the deregulation measures the banking sector lost its dominant position in the financing of the economy as illustrated in table 1 and 2. While in 1985 still 86,7% of the financing of private enterprises occurred through bank credit, it fell to 15,8% in 1988 and further in 1989 (7,4%). The same evolution is observed in the financing of the general government : over the same period bank credit fell from 75,9% to 46,6% in 1988 and became negative (net repayment) in 1989.

Tabel 3: **Bad debts (1) and reserves of the banking system (2)**
(% of total balance sheet, end of period)

	Bad and doubtful debt	Capital and reserves
1981	5.3	3.8
1982	5.5	3.9
1983	6.4	3.2
1984	6.6	3.5
1985	6.4	3.4
1986	6.5	4.3
1987	6.1	5.7
1988	4.0	7.4
1989 (3)	3.2	7.6

(1) Of non-financial (public and private) enterprises and individuals
(2) Commercial banks, savings and investment banks
(3) End of June
Source: Bank of Portugal, Quarterly Bulletin, March 1990

With the opening of the banking sector and its exposure to competition, the authorities aim at a more efficient allocation of capital. In addition the development of capital markets should make the government less dependent on the monetary financing by the banking sector. This increased competition should allow the banks to reduce the high share of bad and doubtful debts they were prone to accumulate in the past (see table 3). Until 1988 the amount of bad and doubtful debts of non-financial (public and private) enterprises and individuals was even larger than the amount of capital and reserves. The adaptation of the public (now being reprivatised) commercial banks to a competitive environment, in which the since 1984 newly created banks occupy a rapidly growing portion, seems however to be a difficult process. In 1989 about 85% of total bank credit was supplied by the public banks, 10% by private domestic banks and 5% by foreign banks established in Portugal.Instead of modernizing the public banks and attacking the problem of the bad debt overhang, which could be seen as a positive response to the competitive challenge, a rather defensive attitude is sometimes taken which led to the introduction of additional regulations on the newcomers in the form of a deposit ceiling and an increased capital requirement.

3. The development of the capital markets

In order to make the financing of the economy less dependent on bank credit, financing through capital markets is activated by the creation of new institutions and instruments on the one hand, and by the preparation of the appropriate regulatory framework with a view to making the capital markets function more efficiently, on the other hand.

To the new institutions created since 1979 belong leasing and investment companies designed to provide medium and long term finance, venture capital companies and a regional development society. Also institutional investors, like pension funds and companies for collective investment in securities, which could contribute in an important way to the smooth functioning of capital markets were missing. These have been allowed since 1985.

Among the new instruments issued by the government or public enterprises are Treasury Bills (maturity up to one year) created in 1985, which also households could buy, savings certificates (five year maturity) and participation bonds (with a part of income linked to profit) both from 1986.

Financial institutions have been allowed since 1986 to issue cash certificates (minimum maturity 2 years) on tap subject to a ceiling and certificates of deposits (maturity between 6 months and five years, minimum amount of ESC 5 m). In general financing instruments are issued in the short end of the market or with a floating interest rate. In 1986 the government experienced with the issue of a three year fixed interest bond. Success was however modest and recently the maturity of fixed interest bonds has even been shortened because of difficulties to suppress inflation.

Table 4: **Structural data for the stock exchanges of Lisbon and Porto in 1989**
(official and unofficial market)

	Shares	Bonds
Securities listed	194	287
Capatalization of securities		
ESC billion	2966	1150
% domestic GDP	42	16.3
Volume of transactions		
on the stock exchange		
ESC billion	300	123
% capitalization	10	10.7
outside the stock exchange		
ESC billion	147	497

Source: Bank of Portugal, Annual Report and Monthly Bulletin

In order to improve the functioning of capital markets, the tax reform of 1989 introduced a withholding tax of 25% on capital income and a 10% tax on capital gains, thus replacing the old hybrid system giving a different tax treatment to almost each financial instrument. Also the stock exchanges of Lisbon and Porto, which were closed in 1974 following the Revolution and reopened in 1977 are being modernized. The government plans to dematerialize securities, link electronically the two stock exchanges, replace the individual brokers by security houses and improve the clearing and settlement system. In addition, the intention is to reduce the high volume of listed securities traded outside the stock exchange (see table 4). Laws to regulate insider trading and take-over-bids are also in preparation.

Table 5: **Savings of households**
(change of financial assets, % of total)

	1985	1986	1987	1988	1989
Currency, demand deposits	16.5	25.6	14.2	13.6	5.6
Time, savings, 66.2 emigrants' deposits	38.9	36.3	50.9	49.6	
Treasury bills	6.9	20.3	15.9	8.2	-3.7
Bonds + shares	7.3	9.5	22.8	21.0	41.9
Other	3.1	4.1	5.9	6.3	6.6
Total	100	100	100	100	100
(bn ESC)	(890.8)	(881.8)	(929.5)	(977.9)	(1119.1)

Source: Bank of Portugal, Annual Report

Table 6: The non-monetary capital account of the balance of payments (million USD)

Year	External credits			Non-debt capital flows				
	medium/long term	short term	total	medium/long term	short term (1)	total	capital account	current account (pm)
1983	1370	-591	779	88	27	115	894	-1645
1984	1238	-199	1039	95	-22	73	1112	-625
1985	917	-271	646	192	-252	-60	586	386
1986	-516	-1245	-1761	223	166	389	-1372	1150
1987	-561	645	84	755	628	1383	1467	444
1988	-88	173	85	931	1653	2584	2669	-1064
1989	341	434	775	2219	1424	3643	4418	-551
1990	-33	84	-117	1406	1196	2602	2485	-734

(1) Including leads and lags, errors and omissions
(2) January-July
Source: Bank of Portugal, Annual Reports and Monthly Bulletin.

As a consequence of the development of the capital market not only the financing of the economy became less dependent on bank credit (see table 1 and 2), but also households diversified their portfolio (see table 5). In 1985 more than 80% of savings accumulated during the year were held with banks. This fell to 64,5% in 1988 and 55,2% in 1989.

4. The liberalization of capital movements

The deregulation of the domestic financial sector goes alongside with the gradual removal of capital controls. The removal of these controls has not been symmetric : inward capital flows are almost totally free whereas substantial restrictions apply to the outflow of, mainly, short-term capital. The acquisition of domestic securities by non-residents was liberalized in January 1986 when Portugal joined the EEC. Inward direct investment was liberalized on 1.1.1990 by abolishing the ceiling (gradually increased since the date of Accession) to which it was subjected. It must however be noted that foreign ownership of reprivatised firms is restricted to 10% of share capital.

Outward portfolio investment has been liberalized in several steps starting in January 1989 with institutional investors which could invest 5% or 10% (depending on the type of institution) of their portfolio in foreign assets. Subsequently, this was increased to 20%. Private individuals could buy up to 4 million escudo of foreign assets in September 1989, which was increased to 10 million escudo in April 1990. On 1.7.1990 outward portfolio investment was completely liberalized in anticipation of the EC-deadline (31.12.1990). At the same time, however, a 40% interest free deposit has been introduced on external borrowing in order to hamper the inflationary upbuilding through capital inflows (see table 6). Indeed, the capital account records a growing surplus (almost 10% of GDP in 1989) to which not only inward direct and financial investments contributed but also the reversal of short-term capital flows in 1985/1986. This recourse to a quantitative measure (which does not entirely rely on market forces) to curb the mounting inflationary pressure, further illustrates the difficulty of Portugal to cope with external liberalization. Also the limitation of foreign ownership of denationalized firms can be interpreted in this sense.

In the present macro economic circumstances capital outflows seem to be more easily to liberalize than the inflows and it is then also expected that the EC-obligation to eliminate certain restrictions on some personal capital movements by the end of the year will not create problems. This must however not disguise the fragility of the external opening of capital markets if the appropriate domestic policy response concentrating on better government finances and a reduction of inflation is not put into operation. Restrictions on the opening of deposit accounts, on financial loans and credits, outward direct investment and outward real estate operations may be kept until 31.12.1992, some of those even until 31.12.1995 subject to an authorization procedure at the European Community.

CHAPTER 4
STRUCTURAL ADJUSTMENT

Public investment needs

Several factors, apart from the relatively low GDP level, explain the lack of investment capacity of the Portuguese government in the past decades: insufficient development of taxation, the cost of African wars, the post-1974 pressures on public finance. The resulting underinvestment in public infrastructure meant that it became insufficient to serve the growing and congested areas of the western strip, while the hinterland were virtually cut off from any development opportunities and communications with the rest of Europe remained inadequate, aggravating the peripheral situation of the country. A study of the infrastructure endownments in European countries carried out for the Commission in the early 1980's shows Portugal to be at the bottom of the EC league in terms of a comprehensive indicator of economic and social infrastructure.

In terms of human capital the country is also in an unfavourable position relatively to its EC partners: a quarter of the active population is still in the agricultural sector and another large fraction in the traditional low-productivity industries. The overall level of qualification is admittedly very low: in 1987/88, 20% of young people leaving school did so with the legal minimum of 9 years and another 30% with less than that. Within the present active population 75% had at most attended the basic school level (initially 4 years and until recently, 6 years). Job-oriented education has just begun to be developed, and the percentage of highly specialized workers in Portuguese firms is only about 5%.

Portuguese industry in the Single European Market

In the light of the preceeding considerations on human capital, it comes as no surprise that the country's industrial structure and in particular its exports, rely chiefly on low labour costs (in 1984, one industrial man-hour cost in Portugal 2.3 ECU, in Greece 4 ECU, in Italy 10.4 ECU and in West Germany 14.1). The moderation of real wage increases in the past has allowed the maintenance of wage differentials, but closer integration within the EEC and EMU can only help to erode that advantage.

The Portuguese manufacturing sector relies strongly on low-technology, labour intensive consumption goods. Food products, wood, paper, textile and clothing represent some two thirds of exports. The pattern of trade with the rest of the EC shows mainly an inter-sectoral kind of specialization, although with a tendency to move towards intra-sectoral exchanges in non-traditional sectors. The impact of the single market upon these trends is very difficult to predict, although it is expected to lead to a deterioration of the balance of trade and to extensive restructuring of import-competing industries. The overall pattern of specialization of the Portuguese industry is not expected to change overnight, neither is a massive re-location of manufacturing towards the South of Europe as consequences of the single market.

The diversification of the Portuguese industrial fabric and inter-sectoral linkages are relatively weak, with moreover a marked dualism of structures which is not apparent from most statistics. Despite the optimism shown in a 1987 EC survey of entrepreneurs, the majority of Portuguese firms do not have the productive or managerial structures to enable them to take any advantage of the European Single Market. A number of 'modern' industries, mainly in the state-owned sector, also lack competitivity and their future may be problematic. In another Commission survey, in 1989, Portuguese industrialists emphasised the need for restructuring at the level of production processes, rather than in the fields of product, marketing, distribution or international cooperation. This suggests that structural adjustment and preparations for 1992 are still at a comparatively early stage.

In the long term, Portugal is looking for a way to consolidate its external position in a durable basis by, inter alia, building an industrial basis with a different pattern of specialization more oriented towards equipment and higher technology goods (see the objectives of PEDIP). With the country more and more strongly integrated into the single European market and economic and monetary union, which in turn will become more open to new industrialized competitors, it will be more and more difficult to maintain a comparative advantage based exclusively on low wage costs. That emphasises the need for microeconomic policies aimed at reinforcing competitivity.

On the other hand, international trade is less and less often carried out in a framework of perfect competition where the cost element is dominant. An increasing part of trade takes place within multinational firms or groups, and much of the rest is determined in a complex oligopolistic framework involving products, technologies and marketing, where again multinationals play a decisive role. Few Portuguese firms will have the ability to play this game on their own, and therefore international connections, which are reflected in the surge of foreign direct investment (cf. below) are welcome and indeed necessary.

Structural support from the EC

The Community Support Framework (CSF) for Portugal, 1989-1993 established, according to the reform of the EC structural funds on the basis of a 5-year regional development plan, marked a substantial increase in the investment effort of the Community funds and the national government. The Community will more than double its transfers to Portugal, by 1993, with respect to 1988, reaching some 3.5% of Portuguese GDP. On the Portuguese side, the investment expenditure by the Government will be 30%-40% higher in the 1989-1993 period than the -already considerable - 1988 level. The country is classified as a whole within objective 1 of the structural funds (development of lagging regions) and benefits therefore from the maximum intensity of Community aid: up to 70% of eligible public expenditure. It benefits furthermore from Community Support under objectives 3, 4 and 5a) - combating long-term unemployment, occupational integration of young people and adjustment of agricultural structures.

The CSF covers 13.6 billion ECU of public expenditure over the five years, and two main priorities are the economic infrastructrure and human resources, with a particular reinforcement of the latter and the extension of Community aid to the general schooling system. The magnitudes of spending in the main categories of the CSF are given in Table 1.

Table 1: Composition of the CSF for Portugal, 1989-1993 (MECU)

	National government	Structural funds	Total public
Infrastructure	2495.0	1339.0	3834.0
(% of total)	37.5%	19.2%	28.2%
Investment aid	901.9	1481.0	2382.9
	13.5%	20.1%	14.5%
Agriculture	495.6	1168.0	1663.0
	7.4%	15.9%	12.2%
Manpower	1731.4	2197.0	3928.4
	26.0%	29.8%	28.9%
Regional programmes	1022.0	1161.0	2183.2
	15.4%	15.8%	16.0%
Other	12.0	22.0	34.0
	0.2%	0.3%	0.2%
Total	6658.1	7368.0	14026.1
(% of GDP)	2.9%	3.3%	6.2%

Source: EC Commission, CSF for Portugal, 1989-1993

Infrastructure investment accounts for more than 1/3 of the CSF spending, if one considers the infrastructure components of agriculture and regional programmes. Within that, about 2/3 respects to road transport, where 70%-80% of the planned national network (including 450 KM of motorways) should be completed by 1993. Following in importance, works on the existing and run down railway network (not expansion) will improve mainly the international links, the Lisbon-Porto axis and the service around these two urban areas. Ports and airports in Lisbon and Porto will also benefit from the CSF. A glance at the distribution of spending among the different projects and regions is quite revealing: emphasis has been put in serving the main economic and demographic agglomerations, and in attenuating the peripheral situation of the country as a whole, more than e. g. serving remote areas or attempting to 'decentralize' away from the congested regions.

As regards the manpower axes of the CSF, the financial resources channelled by the ESF into professional training (over 300 MECU per year) set off a revolution in a field that had remained dormant in Portugal for more than 10 years. In the period prior to the adoption of the CSF, there was a proliferation of small training schemes that ensured the utilization of ESF resources but offered few guarantees in the way of consistency, cost efficiency and adequacy to the needs of the labour market. With the CSF, manpower measures were structured into 4 main vectors - education, vocational training structures, apprenticeships and multi-sectoral training - and emphasis has shifted to the support of the official education and training systems, with a more centralized management. Together with objectives 3 and 4, the contribution of the EC towards these actions will amount to some 2200 MECU over the 5 years.

By its comprehensive nature and by the volume of resources deployed, the CSF represents therefore an unprecedented development effort in the country, and will no doubt contribute significantly to the convergence between Portugal and the Community provided that a macroeconomic strategy be implemented to ensure a context of stable growth.

Private investment, incentives and industrial policy

After Germany, Portugal is the EC country with the highest share of manufacturing in GDP. Given present trends and the characteristcs of the economy - labour force, import dependence etc. - it is expected that manufacturing will continue to have a leading role in the country's economic growth. With the increase in corporate profitability, EC integration and the provision of generous financial incentives (see below), private investment has boomed in Portugal since 1987. Investment in the manufacturing sector represents more than 40% of gross fixed capital formation. The present challenge is how keep a high investment rate without impairing its efficient allocation and marginal productivity.

Subsidization of private investment, mainly in industry, will amount to about 2 billion ECU in the period 1989-1993. That part of the CSF has two main components: the PNCIAP, a regionally-based incentive scheme for industry and tourism, and the PEDIP (Specific programme for the development of the Portuguese industry) a medium-term programme for the creation of an export-based industrial base. Together, they imply an average subsidy rate of about 40% of the investment involved and a de facto absence of a regional selectivity of aid (the PEDIP covers Lisbon and Porto, excluded by the PNIACP). Whatever the results of these schemes, the costs in terms of allocative efficiency and public finance will therefore be considerable. Being elements of a voluntarist policy of industrial development, it is important that those subsidies are not allowed to have negative distortionary effects upon the investment pattern in industry, leading to excessive capital deepening or lower marginal productivity of capital. A positive element to be considered is the increased discipline exerted by the Commission upon state aids in other Community countries; that should allow more significant results for genuine development policies at any given rate of subsidy.

The PEDIP is, however, more than an incentive scheme to private investment. It is a strategic programme which involves from the part of the Community a contribution of 1 bn ECU: 500 MECU from the structural funds and 500 MECU from a special budget line and to be committed between 1988 and 1992. Its 4 axes aim at improving, with Community support, the financial, technological and infrastructural bottlenecks faced by the manufacturing sector.

The PEDIP illustrates the Portuguese authorities' strong committment to the modernization and diversification of the industrial fabric. In the past traditional sectors like textile, food etc. have led a process of mainly inter-sectoral specialization. These industries are showing some loss of competitiveness, especially vis-a-vis the new industrialized countries and their future of those sectors rests on upgrading and renewed marketing strategies. Other sectors are emerging which may eventually replace them: metalic and electric products, transport equipment, ceramics, glass. These sectors are characterized by a high degree of intra-industry and intra-firm trade and by the important role of transnational investment.

Foreign direct investment

After remaining at a very low level between 1974 and 1986, foreign direct investment in Portugal showed a spectacular growth in 1988 and 1989. This is attributed to increased confidence due to the country's current political and economic stability, and the new opportunities opened by EC membership. In fact, very large increases are registered in investments originating in the EC, particularly those from Spain .

These foreign investment flows together with real estate and portfolio investment and other long-run capital inflows, contributed to the much improved balance of payments situation, which allowed the authorities to accelerate the repayment of external public debt after 1985. They currently represent some 11% of gross fixed capital formation in the country. If one considers the capital component of the structural funds, which represents a similar amount, the country is benefiting from a substantial addition (20-25%) to domestic savings in the financing of its investment needs. The permanence of such favourable conditions cannot be taken for granted, and it is therefore important that those cards be correctly played preferably before a the temporary derogations to EC rules, negotiated with accession, expire by the end of 1992. As far as foreign investment, a protective attitude, such as in the past, is not desirable (or admissible within the EC). But there would be an active policy of attracting the type of investment that the country can most benefit from i.e. that with a reasonable technological content, qualified labour requirements and involvement of the domestic sector.

Table 2: **Composition for foreign direct investment, 1987-89 (MECU)**

	1987	1988	1989	1987-89
Agric., forest., fish.	11.7	20.2	18.0	2.0%
Extractive industries	9.9	12.0	18.0	1.7%
Manufacturing	93.7	183.3	234.6	22.6%
Energy	0.0	0.3	1.2	0.1%
Building	3.6	24.1	70.5	5.1%
Trade and tourism	59.7	99.4	315.2	22.3%
Transport	11.4	4.6	12.3	1.1%
Banks and insurance	124.9	197.7	560.0	42.2%
Other services	2.4	13.5	32.6	2.8%
Total	317.3	555.0	1262.6	100.0%

Source: Bank of Portugal

It seems useful to look at the sectoral composition of the recent surge in foreign investment:

As the table shows, the growth has been mostly in the service sectors while manufacturing accounts only for 26% of the total. The financial sector (branches of foreign banks) had a particularly large weight. Within manufacturing, the largest growth has not been in the machinery, electronics and transport equipment that experienced considerable development in the first half of the 1980's but rather in the resource-based industries (sea, forestry, minerals) and in the traditional exporting sectors (textile, clothing).

Connected with the trend away from the manufacturing sectors, the percentage of projects oriented towards export markets is smaller than the one of projects aimed at the domestic market. Finally, the takeover of Portuguese firms has gained importance, as a form of foreign investment, relative to the reinforcement of capital in existing firms with foreign participation. These qualitative features are a major aspect to be taken into account when assessing the recent foreign investment boom.

The perspectives for foreign direct investment remain positive for 1990, and it is expected that in the subsequent years they will be helped by the PEDIP and other incentives, and by the incoming privatisations. Also, the authorities expect to attract foreign investment into sectors of strategic interest for the country's industrial policy. Recent announcements by American and Japanese car manufacturers are encouraging in this respect; on the other hand, the suddenly increased competition from Eastern European countries with close links with the EC may have an adverse influence on foreign direct investment.

Microeconomic policies

The public and private investment efforts are but one aspect of the catching up process of the Portuguese economy. A comprehensive and credible reform of the operating environment of economic agents is another. In both, EC membership plays an important role: by positively shaping agents expectations, helping to finance that investment effort and by pointing the right way for the desirable policy regime changes. Some aspects of microeconomic economic policy are vital, and some will become increasingly important with the movement towards EMU: privatization, labour market, financial markets and taxation.

The privatization process, started in 1989 and expected to last until 1992, will have an important impact on the Portuguese industrial and banking sectors. At present, the non-bank public sector accounts for some 15% of GDP, while public-owned hold a dominant position in the financial sector. The economic performance of the nationalized sector (since nationalization in 1975) has been very poor, and privatisation is expected to bring about substantial improvements in the supply side of the economy, despite the fact that some of the public enterprises (e.g. heavy industry) may remain problem sectors.

With registered unemployment at around 5% , the Portuguese economy seems to be drawing close to full employment. This figure, however, does not reflect existing underempolyment, mainly due to the backwardness of the agricultural sector and the lack of manpower mobility in industry and services resulting from a tradition of protected employment. The Portuguese labour market is governed by a very restrictive legislation, inherited from the 1970's. The private sector has been able to circumvent this problem by resorting to temporary contracts, which account for some 75% of new hirings. This dualistic structure is neither appropriate to an efficient balance between firms' competitiveness and workers' welfare, nor to the investment in human capital which is favoured by a context of stable employment relationships.

Privatization of the large state banks, followed by the external opening of the financial sector and eventualy EMU, is expected to lead to extensive restructuring of this sector. The number of financial institutions is excessive for the size of the domestic market, and by their dimension product range etc. they are not deemed to be internationally competitive. Apart from the consequences upon the banking sector itself, liberalized financial markets will have profound implications for budgetary policy (through the cost of the public debt), monetary policy (now switching from direct controls to market-oriented instruments) and for the rest of the economy, whose financing still rests almost exclusively on the banking sector.

Finally, there is one domain of structural reform with strategic importance for the whole process: taxation. The reform of the tax system was initiated with the introduction of VAT in 1986, and pursued in 1989 with the reform of direct taxation with a single income tax. These new taxes replaced a number of inefficient and overlapping taxes and are expected to result in lower distortions while providing extra resources for the development of the country and the improvement of public finance.

Background Papers

This country study draws on the following papers and documents:

- "Medium term fiscal adjustment for Portugal", by Henning Christophersen
- "Contribution towards a Multi-Annual Fiscal Adjustment Strategy (Mafas) for Portugal", report requested by the Portuguese Minister of Finance. Directorate General for Economic and Financial Affairs, Commission of the European Communities, 1990, forthcoming in Portugal and the Transition to Economic and Monetary Union, Proceedings of an International Seminar held in Lisbon, June 1990.
- "One market, one money. An evaluation of the potential benefits and costs of forming an economic and monetary union". European Economy, N° 44, October 1990, Commission of the European Communities.
- "Social Europe. The impact of the internal market by industrial sector: the challenge for the member States". European Economy, special edition 1990, Commission of the European Communities.
- Unity with diversity in the European economy: the Communities Southern frontier, edited by Christopher Bliss and Jorge Braga de Macedo, Cambridge University Press, 1990, results of a project of the Center for Economic Policy Research sponsored by the Commission of the European Communities.

Statistical Annex - Tables and Graphs

Table 1: **Main economic indicators**

	Averages 61-69	70-73	74-75	76-82	83-85	86-89	1986	1987	1988	1989	1990	1991
1. GDP, prices 1985, yearly % changes												
Portugal	6.3	8.4	-1.6	4.2	0.3	4.7	4.1	5.3	3.9	5.4	4.0	3.8
EUR-12	4.8	4.6	0.4	2.4	2.1	3.2	2.6	2.9	3.8	3.4	3.0	3.1
2. GDP per head (in PPP)												
Index EUR-12=100	43.2	52.6	53.9	54.1	53.0	53.9	52.7	53.8	53.9	55.1	55.8	56.3
3. GDP price deflator												
Portugal	2.9	6.4	17.5	20.5	23.7	13.9	20.5	11.2	11.6	12.5	13.1	10.5
EUR-12	4.1	7.6	14.2	11.4	7.1	4.8	5.5	4.1	4.5	4.9	5.1	4.5
4. Total employment, yearly % changes												
Portugal (1)	-0.1	1.2	-1.5	0.0	-0.9	-0.1	-2.7	0.5	0.1	1.8	1.1	0.8
EUR-12	0.2	0.5	-0.4	-0.1	0.0	1.3	0.7	1.3	1.5	1.7	1.4	0.9
5. Unemployment rate, % of active civil pop. (yearly averages)												
Portugal	-	2.6	3.1	7.3	8.5	6.4	8.2	6.8	5.6	5.0	4.9	4.9
EUR-12	-	2.6	3.4	6.2	10.5	9.9	10.7	10.3	9.7	9.0	8.5	8.4
6. Balance on current account (% of GDP)	-	-	-	-	-2.8	0.4	3.9	1.2	-2.4	-1.2	-1.2	-1.7
7. General Government deficit (% of GDP)	-	-	2.7	5.3	10.4	5.8	7.2	6.8	5.4	3.8	6.1	5.5
8. Exchange rates (yearly averages)												
.USD/PTE	28.7	27.7	25.5	50.2	142.8	147.9	149.6	140.9	143.8	157.4	150.6	152.6
.ECU/PTE	30.5	29.9	30.1	59.5	114.9	163.3	147.1	162.6	170.1	173.4	183.9	189.8
.Effective exchange rate, index with 19 countries 1985=100 (2)	446.2	459.4	449.2	252.3	116.6	84.5	92.2	85.7	81.4	78.7	76.5	74.3

(1) National accounts statistics
(2) Double export weights
Source: Commission services

Table 2: **Real growth rates and contributions to GDP growth**

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Private consumption (a)	3.7	2.9	2.4	-1.4	-2.9	0.7	5.6	5.4	6.6	3.3	4.5	3.0	3.3
Public consumption (a)	7.9	5.2	3.6	3.7	0.1	0.1	7.2	4.9	5.3	1.5	1.5	1.0	1.5
GFCF	8.5	5.5	2.3	-7.1	-17.4	-3.5	10.9	15.1	15.0	8.3	9.1	6.3	7.1
Exports (a)	2.2	-4.4	4.7	13.6	11.6	6.7	6.8	8.6	10.2	16.6	10.3	6.8	6.1
Imports (a)	6.9	2.3	3.9	-6.1	-4.4	1.4	16.9	20.0	16.1	10.8	10.9	6.5	6.7
Domestic final demand (b)	6.1	4.3	2.9	-2.6	-6.8	-0.3	7.3	8.0	9.2	4.6	5.6	3.9	4.4
Net exports (b)	-2.4	-2.3	-0.5	6.6	5.6	1.8	-4.5	-6.0	-4.5	0.9	-1.3	-0.6	-0.9
GDP (a)	4.6	1.6	2.1	-0.2	-1.9	2.8	4.1	5.3	3.9	5.4	4.2	3.2	3.8

Source: Eurostat
(a) Yearly growth rates
(b) Percentage change over previous year GDP.
(c) Commission Forecasts October-November 1990.

Table 3: **Labour market indicators: labour force, employment, unemployment**

	1985	1986	1987	1988	1989	1990 (3)	1991 (3)	1992 (3)
Total population (% change p.a.)	0.7	0.7	0.4	0.2	0.2	0.2	0.2	0.2
Participation rate (% of total population)	43.6	43.6	43.9	44.4	44.9	45.4	45.7	45.9
Total employment (% change p.a.) (1)	-0.1	0.6	2.7	2.9	2.3	1.9	0.3	0.5
Wage and salary earners/total employment (%)	71.4	72.2	71.8	72.8	73.6	---	---	---
Percentage of fixed-term contracts	13.2	15.8	17.6	19.2	19.1	---	---	---
Unemployment rate (2)	8.8	8.2	6.8	5.6	5.0	4.4	4.9	5.0

(1) National surveys
(2) SOEC comparable definition.
(3) Commission Forecasts October-November 1990.
Source: I.N.E. except (2)

Table 4: **Composition of the CSF for Portugal, 1989 - 1993 (MECU)**

	National government	Structural funds	Total public
Infrastructure	2495.0	1339.0	3834.0
(% of total)	37.5%	19.2%	28.2%
Investment aid	901.9	1481.0	2382.9
	13.5%	20.1%	14.5%
Agriculture	495.6	1168.0	1663.0
	7.4%	15.9%	12.2%
Manpower	1731.4	2197.0	3928.4
	26.0%	29.8%	28.9%
Regional programmes	1022.0	1161.0	2183.2
	15.4%	15.8%	16.0%
Other	12.0	22.0	34.0
	0.2%	0.3%	0.2%
Total	6658.1	7368.0	14026.1
	2.9%	3.3%	6.2%

Source: EC Commission, CSF for Portugal, 1989-1993

Table 5: **Balance of payments (as % of GDP in ECU)**

	1984	1985	1986	1987	1988	1989
A.MAIN HEADINGS AS % OF GDP						
1. Current account	-3.1	1.5	3.8	1.2	-2.4	-1.2
of which trade balance	-11.0	-7.3	-5.7	-9.7	-13.2	-11.3
2. Medium and long term capital movements	6.9	5.9	-0.9	0.7	2.0	5.7
2.1 balance of direct investment	0.9	1.0	0.5	0.8	1.6	3.1
of which investment in Portugal	0.9	1.1	0.6	1.0	1.6	3.2
3. Short term capital movements (including errors and omissions)	-1.3	-2.4	-3.8	3.5	4.5	4.1
4. Balance on non-monetary operations	2.4	5.0	-0.9	5.4	4.0	8.6
B.in MIO ECU						
1. Current account	-764	412	1148	386	-845	-487
- trade balance (fob)	-2672	-1987	-1707	-3100	-4657	-4678
- services and income	-850	-518	-96	215	143	207
- unrequited transfers	2758	2917	2951	3271	3669	3984
2. Medium and long term capital movements	1684	1608	-259	214	700	2335
2.1 balance of direct investment	216	277	154	269	556	1262
of which investment in Portugal	218	285	170	313	583	1309
3. Short term capital movements (including errors and omissions)	-328	-659	-1145	1124	1575	1709
4. Balance on non-monetary operations	592	1361	-256	1724	1430	3557

Source: Commission Services

Table 6: **Prices (yearly changes, %)**

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990(1)	1991(1)	1992(1)
Consumer prices													
-average	16.6	20.0	22.4	25.1	28.9	19.0	13.1	10.2	9.7	12.7	13.6	---	---
-end of period	13.1	25.0	18.9	33.9	21.2	16.9	10.6	8.9	11.7	11.6	13.7	---	---
Consumption deflator	21.6	20.2	20.3	25.8	28.5	19.4	13.8	10.0	10.0	12.8	13.2	12.6	11.0
GDP deflator	20.9	17.6	20.7	24.6	24.7	21.7	20.5	11.2	11.6	12.5	13.9	12.6	11.7
Export prices	25.2	18.5	19.8	30.0	30.2	17.6	4.5	11.4	8.9	7.3	7.3	8.3	7.6
Import prices	31.3	25.6	18.1	29.9	31.2	13.0	-6.8	12.6	11.6	8.0	7.2	8.6	6.1

Source: Eurostat
(1) Commission Forecasts October-November 1990

Table 7: **Wages, productivity and terms of trade (yearly growth rates,%)**

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990b	1991b	1992b
Nominal wages/employee (a)	25.6	21.0	21.5	21.8	21.3	22.4	21.6	17.9	13.4	13.0	16.9	15.6	13.7
Real wages (CPI def.)	3.3	0.7	1.0	-3.2	-5.6	2.5	6.9	7.2	3.1	0.2	3.3	2.7	2.4
Real wages (GDP def.)	3.9	2.9	0.7	-2.2	-2.7	0.6	0.9	6.0	1.6	0.4	2.6	2.7	1.8
Productivity in the economy (GDP/total employment)	4.9	0.6	4.1	1.0	-0.4	2.8	7.0	4.8	3.8	3.5	3.5	3.0	3.5
Labour costs per unit produced (total economy)	19.7	20.3	16.7	20.6	21.8	19.1	13.6	12.5	9.3	9.1	13.0	12.3	9.8
Real labour costs per unit produced (total economy, GDP def.)	-1.0	2.3	-3.3	-3.2	-2.4	-2.2	-5.7	1.2	-2.1	-3.0	-0.8	-0.3	-1.7
Terms of trade (goods and services)	-4.6	-5.6	1.4	0.1	-0.7	4.0	12.1	-1.0	-2.4	-0.6	0.1	-0.2	1.4

(a) National accounts definition
(b) Commission Forecasts October-November 1990.
Source:Commission services

Table 8: **Portugal - developments of general goverment receipts and expenditures (as percentage of GDP)**

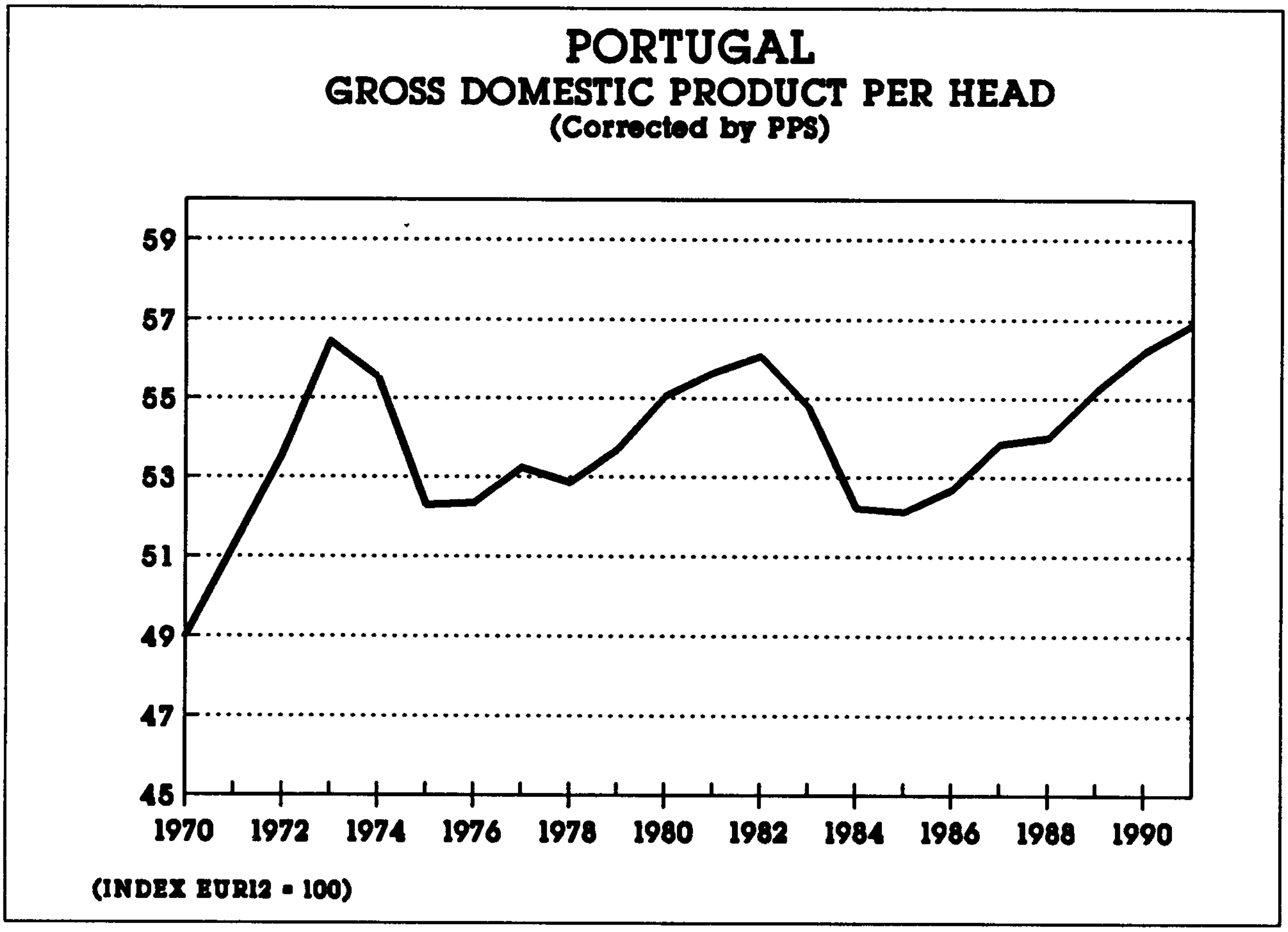
	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989 (1)	1990 (2)	1991 (2)	1992 (2)
TAXES TOTAL	15.98	16.10	16.38	18.67	19.03	18.37	18.52	20.43	21.75	21.81	24.08	23.45	22.46	22.91	21.29	23.62	24.47	23.71	24.35	24.84
INDIRECT TAXES	11.06	11.14	11.02	13.01	13.03	12.27	11.92	14.05	14.24	14.15	15.56	15.15	14.12	16.50	15.35	16.24	15.54	15.06	15.04	15.32
DIRECT TAXES	4.92	4.96	5.36	5.66	6.00	6.10	6.60	6.38	7.51	7.66	8.52	8.30	8.34	6.40	5.95	7.38	8.93	8.65	9.31	9.52
SOCIAL SECURITY CONTRIBUTION	6.71	6.92	9.63	9.58	9.79	9.32	8.96	9.22	9.57	10.15	10.49	9.91	9.67	11.01	11.11	11.47	11.21	11.47	11.49	11.35
OTHER CURRENT RECEIPTS	1.89	1.63	1.35	2.25	1.71	1.77	2.23	1.20	1.09	1.43	2.48	1.20	1.26	3.40	3.80	2.53	2.89	2.19	2.12	1.99
TOTAL CURRENT RECEIPTS	24.58	24.64	27.37	30.51	30.54	29.46	29.72	30.85	32.41	33.39	37.05	34.57	33.39	37.31	36.21	37.61	38.57	37.37	37.96	38.18
CURRENT TRANSFERS	6.82	8.61	12.13	16.73	15.05	15.14	13.98	15.45	16.47	18.22	19.73	20.54	16.25	16.34	15.91	14.94	14.98	15.45	15.66	15.59
TO ENTERPRISES	1.00	2.20	1.96	3.63	3.79	4.58	4.08	4.85	5.51	5.64	6.90	7.56	4.27	3.12	2.75	1.66	1.62	1.47	1.30	1.21
TO HOUSEHOLDS																				
OTHER																				
ACTUAL INTEREST PAYMENTS	0.43	0.45	0.72	1.08	1.72	2.68	2.88	3.13	5.13	5.46	6.38	7.09	7.89	9.22	7.81	7.75	7.26	8.58	8.65	8.21
PUBLIC CONSUMPTION	12.98	14.29	15.17	14.01	14.04	13.93	14.21	14.54	15.05	14.92	15.14	15.03	15.52	15.36	15.20	15.99	15.72	15.76	15.80	15.61
COMPENSATION OF EMPLOYEES																				
PURCHASES AND OTHER																				
TOTAL CURRENT EXPENDITURE	20.23	23.36	28.02	31.81	30.80	31.75	31.07	33.12	36.65	38.60	41.25	42.65	39.65	40.92	38.92	38.69	37.96	39.79	40.11	39.41
EXCLUDING INTERESTS PAID	19.80	22.91	27.30	30.74	29.09	29.07	28.20	29.99	31.52	33.15	34.87	35.56	31.77	31.70	31.11	30.93	30.70	31.20	31.46	31.20
CAPITAL EXPENDITURE	2.78	2.70	3.41	4.55	4.39	4.63	4.77	-8.32	5.04	5.15	4.84	3.91	3.82	3.64	4.11	4.32	4.38	3.54	3.41	3.47
CAPITAL TRANSFER (NET)	0.53	0.42	0.72	1.47	1.38	1.35	1.07	-12.46	0.81	1.75	1.79	1.30	1.34	1.07	1.45	1.38	1.60	0.76	0.61	0.67
GROSS INVESTMENT	2.25	2.29	2.69	3.09	3.01	3.28	3.70	4.15	4.22	3.40	3.05	2.61	2.48	2.57	2.66	2.94	2.77	2.78	2.80	2.80
TOTAL EXPENDITURE	23.02	26.06	31.43	36.37	35.19	36.38	35.84	24.81	41.68	43.75	46.10	46.56	43.47	44.56	43.04	43.01	42.33	43.33	43.52	42.88
BALANCE	1.56	-1.42	-4.06	-5.86	-4.65	-6.93	-6.12	6.04	-9.27	-10.36	-9.05	-12.00	-10.08	-7.25	-6.83	-5.39	-3.76	-5.95	-5.56	-4.70
GROSS SAVINGS	4.34	1.28	-0.65	-1.31	-0.27	-2.30	-1.36	-2.27	-4.24	-5.21	-4.21	-8.08	-6.26	-3.61	-2.72	-1.07	0.61	-2.42	-2.15	-1.23
PRIMMARY BALANCE	1.99	-0.97	-3.34	-4.78	-2.94	-4.25	-3.25	9.18	-4.14	-4.91	-2.67	-4.91	-2.20	1.97	0.98	2.36	3.49	2.63	3.08	3.51

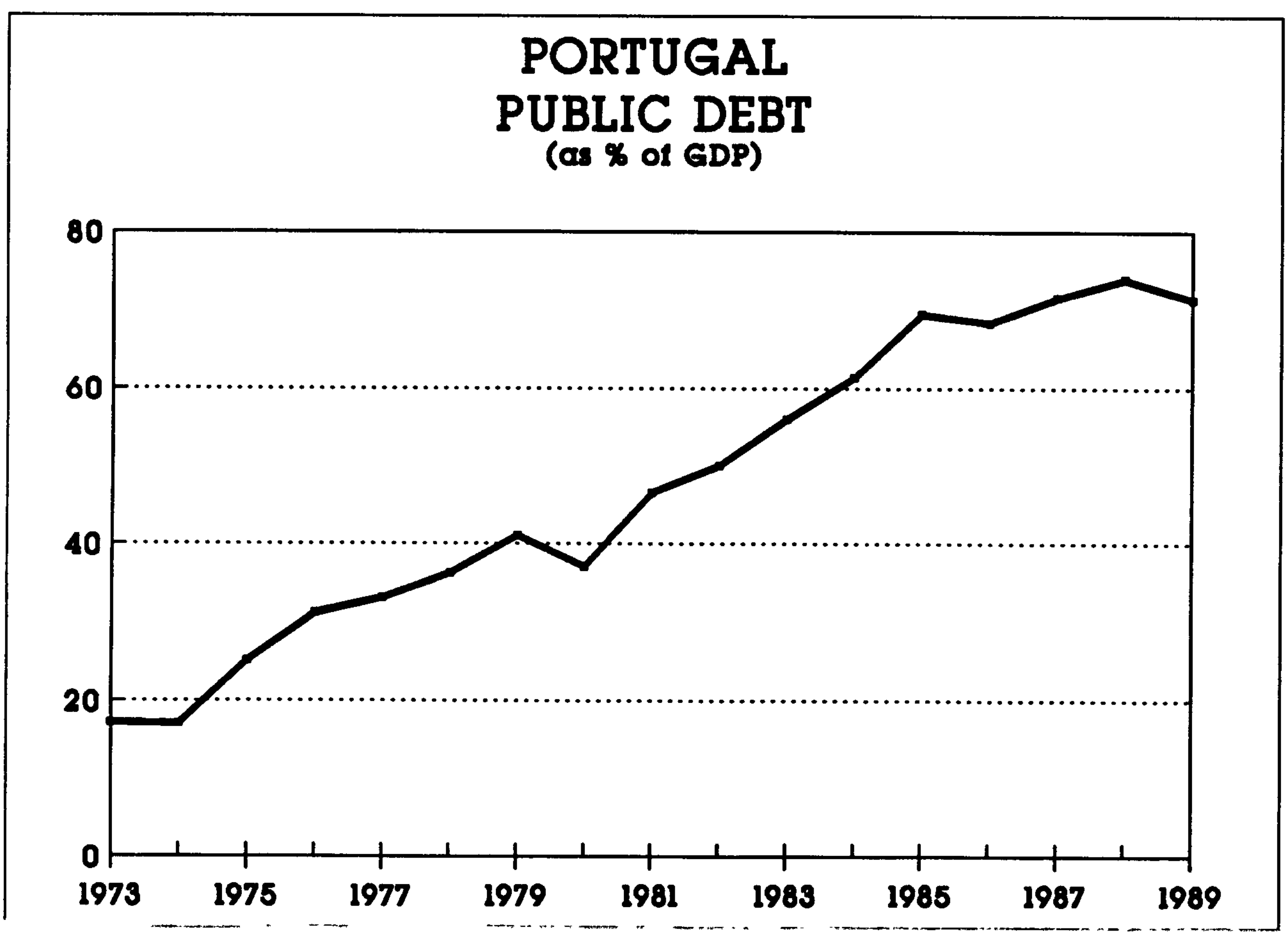
(1) - Commission estimations
(2) - Commission forecasts October-November 1990

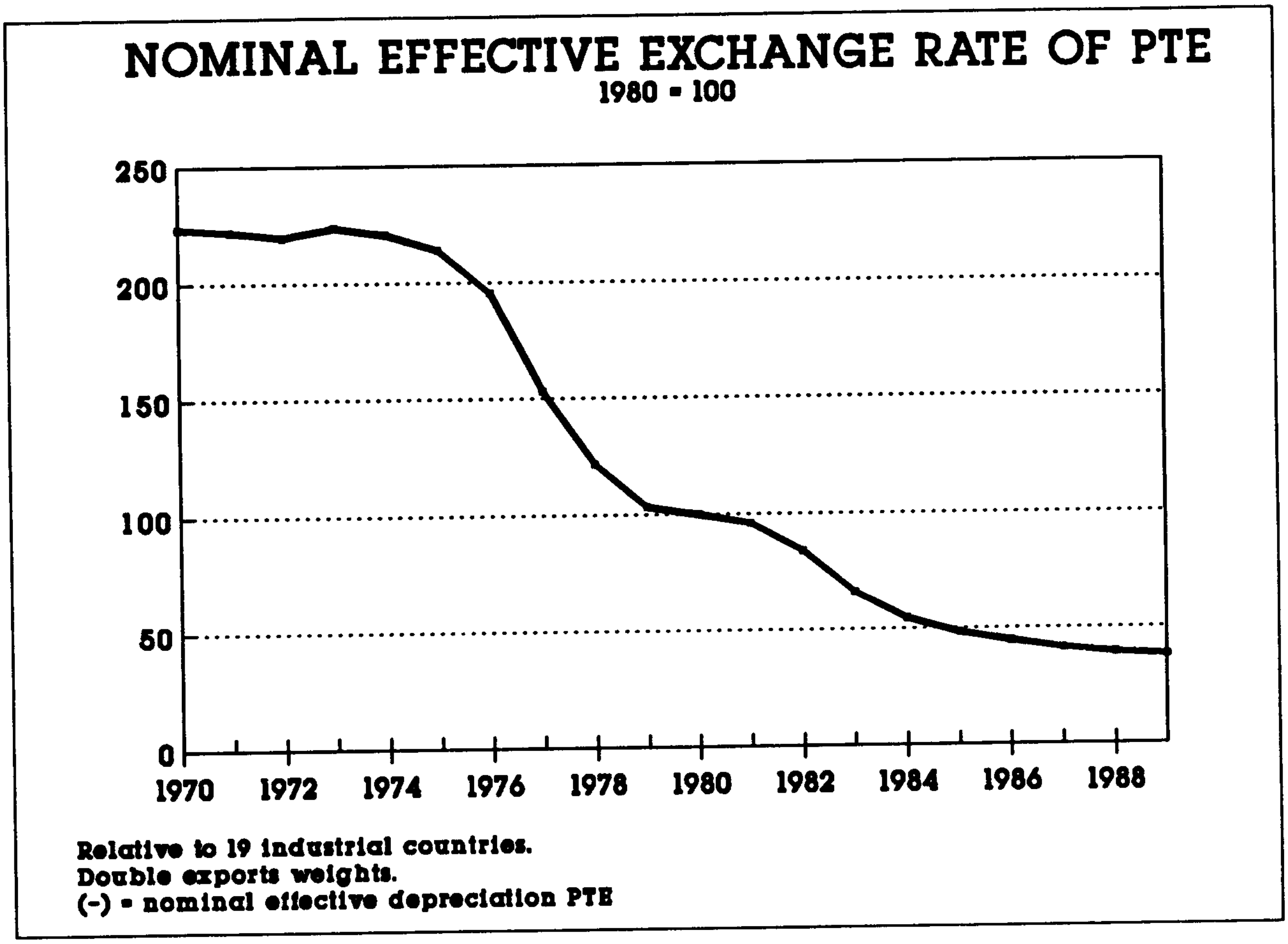
Tabel 9: **Credit and monetary aggregates (annual percentage change)**

	1983	1984	1985	1986	1987	1988	1989	1990 (a)
L (dec./dec.)	20.4	27.7	27.3	22.4	14.2	14.5	9.5	14.9
L- "	16.8	24.8	28.5	26.3	17.5	15.0	7.5	16.3
M1- "	8.7	15.9	26.9	36.1	14.5	12.8	6.1	17.8
Total credit (domestic + external)	19.0	22.3	19.8	13.8	11.0	11.2	3.1	11.7
Total domestic credit	22.6	23.8	19.9	22.4	11.8	11.9	1.6	14.8
-to general government	23.4	29.8	27.3	31.6	26.1	18.8	-2.9	5.9
-to non-financial public entrepises	35.6	33.0	19.9	30.4	-3.2	-6.7	-3.1	---
-to private enterprises and households+NMFI	18.3	17.4	15.6	13.4	7.9	11.5	11.2	---
RATIOS (annual averages)								
								(b)
L-/GDP	-6.1	2.0	2.7	0.7	0.3	-0.8	-9.3	-4.8
L-/ real GDP	17.0	27.2	25.0	21.3	11.6	10.7	2.0	8.4
L-/ price GDP	-6.3	0.1	5.6	4.8	5.7	3.0	-4.4	-0.7

On the basis of corrected aggregates
(a) September 1990
(b) Commission staff forecasts, October-November 1990.
Source:Banco de Portugal


PORTUGAL
GROSS DOMESTIC PRODUCT PER HEAD
(Corrected by PPS)
59
57
55
53
51
49
47
45
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
(INDEX EUR12 = 100)


PORTUGAL
PUBLIC DEBT
(as % of GDP)
80
60
40
20
0
1973
1975
1977
1979
1981
1983
1985
1987
1989


NOMINAL EFFECTIVE EXCHANGE RATE OF PTE
1980 = 100
250
200
150
100
50
0
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
Relative to 19 industrial countries.
Double exports weights.
(-) = nominal effective depreciation PTE

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