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# REPORT ON THE PORTUGUESE ECONOMY

## I. Introduction and Summary

Portugal's economic situation must be understood in the broader context of the major upheaval the country went through following 1974. In addition to coping with its domestic changes, Portugal also had to face a much more difficult international economic environment in the 1970's. The success of Portugal's major stabilization program now sets the stage for tackling the longer term development challenges. Portugal's excellent credit rating, large gold holdings and moderate foreign currency reserves, and managable debt, as well as the prospect that the country may soon be a member of the European Common Market, suggest that Portugal's debt servicing burden is not excessive. Servicing the debt would be easier, of course, in the context of an expanding world economy and a modernized and more productive Portuguese economy.

## II. The Immediate Economic Effects of the 1974 Revolution

The 1974 revolution that overthrew a fifty-year old authoritarian regime brought profound changes that have transformed Portugal's political, social and economic institutions.

In addition to labor unrest, worker takeovers of many farms and factories, and widespread disruption of production, the revolution also brought rapid, although temporary, increases in wages and benefits for low income workers. While these increases were desirable and indeed overdue from a social standpoint, they also posed difficulties for the country's economy. The redistribution of income, the uncertainty created by the unstable revolutionary situation and a decline of real interest rates resulted in a sharp fall in domestic savings and private investment, and further widened the country's traditional trade deficit. Portugal's economy, which had been geared to supplying captive colonial markets and satisfying a pattern of demand based on a highly skewed income distribution, lacked the investment necesary to reorient production to meet the new requirements. An increasing proportion of demand, particularly for food, had to be met through imports.

At the same time the country's receipts from exports, tourism and emigrant worker remittances were falling as a result of internal political developments, the decline of real interest rates, overvaluation of the escudo, and the slowdown in European economies following the 1973-74 oil price increase. Emigrant remittances and tourism receipts, which had long offset Portugal's negative trade balances, no longer could cover the widening deficit.

Portugal depends on imported oil to fill more than 30 percent of its basic energy requirements. Crude oil accounts for more than 20 percent of total imports. The sharp OPEC price increases have thus moved the "terms of trade" strongly against Portugal. Prices of other vital imports including cereal grains also rose rapidly after 1974.

In the balance of payments, the current account surplus of $350 million in 1973 turned to a deficit: $820 million in 1975, and $1.5 billion in 1977.

Simultaneously, the Portugese Government was saddled with the heavy burden of resettling at least 700,000 persons who fled the former African colonies after 1975. This refugee group, plus the falloff in traditional worker emigration and stagnating output in the private sector of the economy, made unemployment a serious problem. The government was able to partially relieve this situation through subsidies and expanded public employment, although at the cost of a rapid buildup in the budget deficit.

Revolutionary turmoil also hurt tax collection, adding still further to the budget deficit despite higher tax rates, as rising tax receipts failed to keep pace with rapidly rising expenditures. This deficit rose from $330 million in 1974 to $1,620 million, or 10 percent of GDP, in 1976. The increase in the consumer price index went from a moderate 10 percent in 1973 to 20 percent in 1975 and 27 percent in 1977. Price and wage controls were not effective in restraining inflation.

The government was able to cover both its budget and balance of payments deficits temporarily through drawing down its large foreign currency reserves, by borrowing against Portugal's gold reserves, and by selling a portion of the gold reserves. By early 1977, however, it was clear that a major stabilization program and outside assistance would be required.

## III. The 1978 Stabilization Program

Following extended discussions with IMF, the Portuguese Government adopted a stabilization program in mid-1978. The program, parts of which had been implemented earlier, included a sharp, then continuing devaluation of the escudo and measures aimed at reducing the deficits in the current account and the government budget. By sharply increasing domestic interest rates, the government sought to check inflationary pressures and capital flight. At the most fundamental level, a major aim of the program was to restore Portugal's international competitiveness by changing cost relationships.

Recognizing that IMF resources alone would not enable Portugal to bridge the gap until the stabilization program began to turn the situation around, a group of 14 friendly countries -- including the U.S.-- pledged loans and grants totalling $825 million. The U.S. contributed a $300 million loan to that effort. This assistance temporarily enabled Portugal to finance its deficits and maintain a reasonable level of economic activity during the difficult stabilization period. International organizations such as the World Bank and the European Development Bank have also provided increasing assistance to Portugal through their programs of long-term loans.

The effect of the stabilization program on Portugal's international accounts was dramatic. The current account deficit was almost eliminated in only two years -- from $1.5 billion in 1977 to $770 million in 1978 and $140 million in 1979. Emigrant remittances rose by 108 percent in the same two year period. Tourism responded to the low relative costs brought about by the devaluation and exports grew by 80 percent. Export competitiveness has since been maintained by a "crawling peg" devaluation program.

On the negative side, the government found it difficult to reduce its budget deficit, as it continued to allow government employment to grow, to subsidize consumption goods, to improve social benefits, and to cover the losses of public enterprises.

The growth of the economy slowed during the stabilization program -- from an annual average of 6 percent in 1976-77 to a more sustainable 3.5 percent in 1978-79. Maintaining even limited growth was a respectable achievement, especially given the slow growth in Europe generally.

Although Portugal is being severely buffeted by the new round of oil price increases which began in 1979, the outlook for the economy continues to be relatively favorable. A current account deficit in 1980 of $700 million is in prospect, but this must be weighed against the increase in the country's oil bill of nearly $1 billion this year. In other words, without the oil price increase, Portugal's 1980 accounts probably would have been in balance or in surplus. Exports are continuing to grow strongly, as are emigrant remittances and tourism. For the first 6 months of 1980 (as compared with the corresponding period of 1979) exports of goods and services rose 26 percent; remittances, 23 percent; and tourism receipts 26 percent. These rates of nominal increase compare with consumer price inflation during the period of 20 percent.

## IV. Development Prospects

For the first time since the revolution, and as a result of the legislative elections of December 1979, Portugal has a government with a secure parliamentary majority. The governing coalition increased its majority in the October 1980 elections sufficiently to offer the prospect of reasonably stable government until the next scheduled legislative elections in 1984. The death of Prime Minister Sa Carneiro in a plane crash December 4, 1980 does not appear to have seriously threatened the unity of the governing Democratic Alliance. The combination of domestic political stability, successful economic stabilization and Portugal's anticipated entry in the European Common Market, provides the opportunity to carry out an accelerated development program over the next few years.

The government is now formulating a medium-term development strategy. Although it has not yet been published, we understand the strategy will emphasize private initiative, encourage both domestic and foreign investment, and forsee more rapid growth in output. It provides targets for increasing exports, expanding savings, investment, and employment, and for reducing inflation.

Portugal has a small economy, becoming more open to international competition and dependent on imports for energy, raw materials and capital goods. Thus, an increase in the rate of economic development implies a wider trade deficit. This is true in the short and medium terms even for economic development strategies that emphasize export promotion, because export growth inevitably lags the import of capital equipment necessary for investment. Consequently, the Government of Portugal is planning for an annual current account deficit over the next few years that may reach $1.5 billion in 1983. As part of its development program, Portugal is encouraging foreign direct investment to help finance this deficit. International financial institutions are also expected to provide both loan and grant funds. Recently the European communities agreed to offer a loan and grant package totalling over $300 million for the period leading up to Portugal's accession to the EEC. The Portugese Government considers joining the common market its first foreign policy priority, and negotiations are now entering an active phase. Portugal's negotiating calendar with the common market anticipates formal entry in 1983, but the time table depends on developments within the EEC itself.

Although Portugal expects to be given certain transition periods to allow its economy to adjust to European competition, the major restructuring and modernization required argue strongly for starting the adjustment process immediately. The Portuguese industrial structure has traditionally been oriented toward small domestic markets or formerly captive colonial markets and has been heavily protected against import competition. On the agricultural side, Portugal's productivity is well below European levels and there is a major lack of processing and handling facilities. At present, Portugal must import over 50 percent of its basic cereal grains.

## V. Foreign Debt

On the financial side, Portugal is in a good position to undertake an expanded development program -- even one which involves increasing the level of its international indebtedness.

Table I shows the recent development of Portugal's foreign debt, including both public and private debt as reported to the Bank of Portugal. When debt service is measured against the indicators of debt burden, for example, as a percentage of the country's foreign exchange earnings for goods and services, Portugal's indebtedness is smaller than in other countries at a similar stage of development. With the remarkable success of its stabilization program and an exemplary record of meeting its financial obligations, Portugal enjoys a favorable reputation in international financial circles. Compared to 1977 and 1978 Portugal now receives on its international borrowing longer terms and lower interest margins over the basic rates. Furthermore, as a prospective member of the European Common Market, European bankers consider that Portugal's close ties with Europe are a positive factor. Recent Eurocurrency loans have been negotiated on favorable terms and oversubscribed. For example, on a $350 million loan this year, Portugal paid only 5/8 to 3/4 percent over LIBOR (London Interbank Offer Rate), with a term of 8 years and a 4 1/2 year grace period.

Portugal had foreign exchange and gold reserves of $1,951 million on December 31, 1979, including foreign currency reserves of $931 million and gold holdings of $1,020 million, with its gold reserves valued at the 35 SDR per ounce. This was equal to approximately 3 1/2 months of imports. Portugal's gold holdings amount to slightly more than 22 million ounces. Since April 1980 the Government of Portugal has officially valued these gold reserves at $225 per ounce, or $5 billion. Thus total reserves (even at the conservative official valuation) approximate total foreign indebtedness. If Portugal's gold was priced at $600 per ounce, today's reserves would be over $13 million.

Given the moderate level of Portugal's debt, the country is in a reasonable position to undertake increased borrowings for investment purposes. Moreover, prospects for the productive use of foreign capital are considerably enhanced by the opportunities inherent in the restructuring of the economy as Portugal moves to join the Common Market. Many of these investments, for example in agricultural processing facilities and export-oriented industrial projects, will take advantage of new opportunities presented by European integration. Such productive investments can be reasonably expected to generate or save the foreign exchange necessary to amortize foreign borrowings.

## VI. Debt Service

In addition to the absolute level of debt, the structure of interest and amortization payments must be considered. Recently, the Portugese Government has sought to lengthen the maturity of its indebtedness, with a consequent favorable effect on service payments. Table II is a debt service projection for public and private debt, based on currently outstanding obligations. It is recognized that actual payments will be more as new debt is contracted in the future.

The country's combined foreign exchange receipts from exports, tourism, and remittances is the most appropriate measure as it shows the current inflow of foreign currency available to service debt. On this basis the debt service ratio is 17 percent (excluding short term private trade credits) and is expected to remain below 20 percent over the next few years, as grace periods on several major credits expire and amortization begins (Table II).

In any evaluation of the debt service situation, the diversity of the sources of income is an important factor to consider. Greater diversity reduces the impact of particular unforseen difficulties. Portugal is not highly dependent on any single market for export sales (unless one takes the EEC as a whole) -- the largest share is 12.9 percent for Germany. Moreover, in terms of product concentration, Portugal's situation is moderate, with one product category, textiles, accounting for 30 percent of total exports, but no other category accounting for more than 10 percent.

Another important factor in evaluating the debt service picture is the recent trend of, and prospects for, foreign exchange earnings. As indicated previously, both exports and tourism have been growing rapidly in the last several years. Portugal is still only a small supplier of goods and tourism services to its major customers, and has only recently begun to recoup the market share it held prior to 1974. Thus, with a reasonable export promotion effort, and continued "crawling peg" depreciation of the escudo, Portugal should be able to expand those markets, especially since relative factor costs continue to favor Portugal. We believe that barring a severe economic recession in Europe -- such as might be caused by another major OPEC price increase -- Portugal can look forward to continued growth in export and tourism receipts.

A very important and potentialy volatile category of foreign exchange income from Portugal is emigrant remittances. Following the sharp increase of Portuguese interest rates in 1977, and adoption in 1978 of a stabilization program agreed upon with the IMF, remittances have since increased rapidly. Portuguese working abroad responded favorably to the higher relative interest rates, the more predictable Portuguese exchange rate policy, and evidence of greater political stability and improved general economic conditions. Emigrant remittances can be expected to continue increasing in the future, though perhaps not at the strong rate of increase of the 1978-80 period, given the one-time nature of several of the causes of the increase during that period.

## VII. Debt Due to the United States

Portugal's outstanding debt to the U.S. Government under AID, PL 480 and CCC program is shown in Table III, and a projected schedule for interest payments and amortization is given in Table IV. Of total assistance to Portugal of $535 million since 1975, $433 million, or 81 percent, is in the form of loans. With one exception, all A.I.D. loans are low-interest and long-term, carrying a 5 percent interest rate, a five year grace period, and an additional 20 year repayment period. The $300 million balance of payments support loan has an interest rate of 8.15 percent, with a three year grace period and additional seven year repayment period. PL-480 loans are also long term dollar credits at low interest, while CCC provides three year loans at market rates.

In addition to demonstrating U.S. support for Portugal's fledgling democracy, A.I.D. project loans and housing guarantees provided badly needed foreign exchange, enabled Portugal to undertake social infrastructure activities in the fields of education, health, sanitation, and housing which otherwise would not have been possible, and assisted the ailing construction industry. PL-480 and CCC credits allowed Portugal to increase its imports from the U.S. of badly needed foodstuffs and animal feedgrains at a time when demand was growing and domestic output failing in Portugal. The balance of payments loan in support of the stabilization effort provided foreign exchange and timely U.S. support for fiscal and monetary reform measures which achieved a dramatic improvement in the economic situation.

As Table IV demonstrates, annual payments to the U.S. (other than for shorter-term CCC credits) will increase to about $84 million over the next few years as the grace periods of loans expire. The debt repayment burden to the U.S. drops sharply, however, by 1988 and 1989 after amortization of the large balance of payments loan.

The U.S. Government's share of Portugal's total debt is relatively modest, and the longer maturity structure of these obligations, as compared to other foreign debts, is highly favorable to Portugal.

TABLE I

Portugal: External Debt
(Billions U.S. $)

| As of December 31 -- | 1976 | 1977 | 1978 | 1979 | |
|---|---|---|---|---|---|
| Public Sector | 0.6 | 0.8 | 1.5 | 1.3 | 3/ |
| Bank of Portugal | 1.2 | 1.7 | 1.9 | 1.6 | |
| Private Sector 1/ | 1.1 | 1.9 | 2.0 | 3.7 | 2/ |
| TOTAL | 2.9 | 4.4 | 5.4 | 6.6 | |

Source: OECD/Bank of Portugal

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1/ Includes public corporations; excludes short term trade credits.

2/ Includes $3.2 billion debt of public corporations.

3/ Includes only direct public debt of the Government of Portugal.

TABLE II

Portugal: Projected Debt Service Payments
(Millions U.S. $)

| | 1980 | 1981 | 1982 | 1983 |
|---|---|---|---|---|
| On debt outstanding, Dec. 1979 | | | | |
| A. Interest | | | | |
| Government | 154 | 157 | 160 | 154 |
| Bank of Portugal | 137 | 81 | -- | -- |
| Private Sector | 284 | 188 | 155 | 104 |
| Total | 575 | 426 | 315 | 258 |
| B. Amortization | | | | |
| Government | 26 | 32 | 44 | 213 |
| Bank of Portugal | 425 | -- | -- | -- |
| Private Sector | 478 | 454 | 370 | 313 |
| Total | 929 | 486 | 414 | 526 |
| C. Total (A + B) | 1,504 | 912 | 729 | 784 |
| D. Debt Service as % of Foreign Exchange Earnings | 17% | 8% | 5% | 5% |

Source: Embassy/Bank of Portugal estimates.

Note: Actual future payments will also depend on:

(a) International interest rates (floating loans).
(b) Future borrowing and advanced amortizations, if any.
(c) Trade credits, depending on the level of trade.

TABLE III

Portugal: Outstanding AID, PL-480, CCC Loans
(Millions U.S. $)

| As of December 31 -- | 1977 | 1978 | 1979 | 1980 1/ |
|---|---|---|---|---|
| AID | | | | |
| Balance of Payments, Support Loan | -- | 300.0 | 300.0 | 300.0 |
| Project Loans (Total) 2/ | 8.1 | 22.9 | 42.6 | 59.2 |
| PL-480 | 104.3 4/ | 103.0 | 136.8 | 163.1 |
| CCC | 162.0 | 305.5 | 323.0 | 216.0 |
| TOTAL - Loans | 274.4 | 731.4 | 802.4 | 738.3 |
| Housing Guaranty Projects 3/ | 10.0 | 30.0 | 40.0 | 40.0 |
| TOTAL - Loans and Guarantees | 284.4 | 761.4 | 842.4 | 778.3 |

Source: U.S. Embassy Lisbon

1/ Estimated.

2/ Includes housing for low-income families, school construction, health sector support, rural vocational education and consulting services.

3/ Financed by Federal Home Bank of New York, guaranteed by A.I.D.

4/ Includes outstanding amounts from 1973 and 1976 deliveries.

## TABLE IV

Portugal: Debt Service on AID, PL-480, and CCC Loans
(Millions U.S. $)

| | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|---|---|---|---|---|---|
| AID | | | | | | |
| Balance of Payments, Support Loan | 24.5 | 54.2 | 54.2 | 54.2 | 54.2 | 54.2 |
| Project Loans (Total) 1/ | 2.5 | 4.0 | 4.9 | 5.6 | 7.0 | 7.2 |
| PL-480 | 16.9 | 18.9 | 20.7 | 22.6 | 21.9 | 21.2 |
| CCC | 50.5 | 140.8 | 40.9 | -- | -- | -- |
| TOTAL - Loans | 94.4 | 217.9 | 120.7 | 82.4 | 83.1 | 82.6 |
| Housing Guaranty Projects | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 |
| TOTAL - Loans and Guarantees 2/ | 96.1 | 219.6 | 122.4 | 84.1 | 84.8 | 84.3 |

Source: Embassy estimates

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1/ Includes housing for low-income families, school construction, health sector support, rural vocational education and consulting services.

2/ Tables may not add due to rounding.