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MEMORANDUM TO DR. ZBIGNIEW BRZEZINSKI
THE WHITE HOUSE

Subject: Economic Study, Portugal

Attached is a report in response to the National Security Council memorandum of May 17 asking for a survey of Portugal's future economic needs. The assessment was prepared by the Planning and Economic Analysis Staff of the Bureau of Economic and Business Affairs and coordinated with the Agency for International Development, Embassy Lisbon, and the Bureau of European Affairs.

Peter Tarnoff
Executive Secretary

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NATIONAL SECURITY COUNCIL
WASHINGTON, D.C. 20506

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May 17, 1978

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MEMORANDUM FOR:

PETER TARNOFF
EXECUTIVE SECRETARY
DEPARTMENT OF STATE

SUBJECT: Portugal

Now that the IMF and Portugal have concluded an agreement, permitting the activation of the multi-national consortium, it would be valuable to survey Portugal's future economic needs.

Would you please prepare a study, in coordination with other agencies, that will:

a) assess Portugal's potential economic situation over the medium-term (i.e. for the next 2-3 years);

b) estimate what short-falls, if any, Portugal will experience in foreign exchange during that period, and assess what it could do to meet these short-falls;

c) indicate what kinds of outside assistance might be required;

d) assess what value there would be in directing outside assistance to specific project aid (as opposed to balance of payments support) and specific areas in which such projects would be valuable; and

e) the likely reaction of other nations (e.g. West Germnay) to Portuguese economic difficulties.

You might wish to draw Embassy Lisbon into this study.

We would appreciate a report and any recommendations for U.S. action -- alone or in concert with other nations -- by June 16.

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Christine Dodson
Staff Secretary

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Portugal's Future Economic Needs

Summary

Portugal is the poorest country in Western Europe and cannot sustain the standard of living to which its people became accustomed prior to 1974. The causes of the present economic crisis are many: the sharp rise in world oil prices, the institutional transformation and shifts in ownership which accompanied the 1974 revolution, the return of some 500,000 Portuguese settlers from Africa, the loss of colonial export markets and the effects of lagging European growth on Portuguese exports and the wage remittances of Portuguese workers.

The domestic consequences of the crisis include a deterioration in savings and private investment, budget deficits approaching 10 percent of GNP, inflation of well over 20 percent, low aggregate growth and a significant rise in the unemployment rate. The current account deficit exceeded $1.4 billion in 1977 (9 percent of GDP). Current account deficits have been financed through reserve drawdowns and extensive official borrowings. Valuing gold at official prices, net official reserve assets were negative at the end of 1977 and the debt service ratio is expected to rise to perhaps 25 percent in 1978.

The immediate crisis was resolved when the IMF approved on June 5 of this year a second stand-by agreement. This paved the way for the implementation of a multi-nation lending program to extend $750 million in balance of payments support and the negotiation by the Portuguese government of medium-term loans from private banks totalling $450 million. The stabilization program emphasized tight ceilings on domestic credit and wages and a reduction in the budget deficit to 6 percent of GDP. Growth will be limited to 1 to 2 percent in 1978 and real wages will decline by 2 to 4 percent. Forecasts by Embassy Lisbon and the IMF suggest that, even with an effective stabilization program, the current account deficit will continue to be in the order of $1 billion annually.

The current political crisis, however, makes the Portuguese ability to adhere to the stabilization program uncertain. There will be a period of hard bargaining over a successor government. The ability of an interim government to meet the IMF-agreed targets could be prejudiced if this bargaining goes on for an extended period. Moreover, when the political crisis is resolved, the successor government itself may not have the ability to maintain the stabilization agreement.

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To deal with its foreign exchange shortfalls, Portugal must formulate an economic development program which deals simultaneously with both the short-term stabilization problem and the country's longer-term development needs. The Soares government had committed itself to present at least the outline of such a plan in October. The plan should deal with the need to stimulate agricultural output and private investment and to revive housing construction. An appropriate development plan will provide a basis for the Portuguese government to begin negotiations with the IMF for additional drawings and to approach other sources for external financing.

The Portuguese government should take the lead and call for a Lisbon meeting of potential foreign contributors at which it would present its plans and financial requirements. The World Bank and the European nations are in the best position to provide the bulk of the development financing. The European Community should accept a leadership role by reason of its decision to accept Portugal as a member. U.S. assistance would most appropriately include PL-480 and CCC credits at present or increased levels and a substantial bilateral aid program which stresses program lending rather than conventional project financing.

There is little danger of a further payments crisis in 1978 but we should monitor the situation carefully in the light of the current government crisis. A prolonged crisis will endanger implementation of the politically unpopular wage and credit ceilings contained in the stabilization program, postpone negotiations on EC membership and delay preparation on the medium-term development plan.

Over the next few months, we should:

-- assess the effect of the current government crisis on the economic stabilization program;

-- gain a better understanding of the full impact of the economic stabilization program which will allow us to forecast the current account deficit with more confidence; and

-- evaluate the medium-term development plan as the details become available in the light of the role that alternative types of U.S. assistance could play.

At the same time we will need to give quiet encouragement to the Portuguese government to formulate and aggressively present its plans and requirements and to EC efforts to provide further assistance to Portugal. We cannot play this role effectively unless we can demonstrate that we are willing to provide part of Portugal's financial requirements.

Introduction

Portugal is an underdeveloped country which happens to be located in Western Europe. Its per capita income ($1,500 in 1976) is the lowest in Europe, about one-fourth the level of the Federal Republic of Germany, Sweden and Denmark and considerably lower than even Spain and Greece. Nevertheless, the economy cannot support the standard of living to which it was accustomed before the cataclysms of 1974-75.

In the five years prior to 1974, real GDP in Portugal had increased at an average rate of 7 percent per year. Partly as a result of this rapid rise in real growth, Portugal was able to maintain full employment during the early 1970s. For example, the unemployment rate was only 2.7 percent in 1970 and 3.0 percent in 1973. In addition to high economic growth, two other factors contributed to the achievement of low levels of unemployment during the five years preceding 1973: (1) the rapid growth of the Common Market countries provided a steady demand for Portuguese emigrant workers*; and (2) the increase in the size of the Army which was spurred by rising militancy in Portugal's colonies absorbed potential entrants into the labor force.

Despite rapid growth and low unemployment during the five years prior to 1973, the Portuguese economy betrayed a number of fundamental weaknesses. Consumer prices, which had risen by 6 percent in 1970, escalated to an annual rate of increase of about 10 percent in both 1971 and 1972 and to nearly 13 percent in 1973. Furthermore, although the industrial and construction sectors grew rapidly during 1968-73, the agricultural sector stagnated and agricultural output declined during the period at an average annual rate of 1 percent.

Portugal's precarious domestic economic situation was shaken during the course of 1974 by two major structural shifts.

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* By 1973, nearly one million Portuguese emigrants (or one-third of the labor force) were being employed elsewhere, particularly in France and Germany.

First came the sharp rise in world petroleum prices at the turn of the year, with attendent adverse consequences for the balance of payments situation and second came the revolution of April 1974 with the objective of transferring economic power from the large private industrialists and landlords, to the state, and the redistribution of income to the workers. The first seventeen months following the revolution saw five major changes in government as well as overall conditions of political and economic life which created instability in the economic environment. A substantial transformation of the institutional framework and ownership pattern of the Portuguese economy took place. There was the nationalization of the banking system, the power sector, and insurance, and the take-over by the government of some large industrial groups and major producers in industries such as steel, cement, and petroleum. One of the most important changes was the decision to give independence to the colonies. This resulted in a reorientation of the Portuguese society due to the arrival of more than half a million returnees - or about 5 percent of Portugal's population.

As a result of these structural changes, the annual rate of growth fell to 1.8 percent in 1974, and then actually declined by 4.0 percent in 1975. With increased population, GDP per capita by the end of 1975 was about 10 percent lower than in 1973.

Table I illustrates the extent of deterioration in the economy by major sectors.

Table I: GDP by Sectors of Activity (Percentage Change)

	1968-73	1974	1975
Real GDP	6.9	1.8	-4.0
Agriculture	-0.8	3.3	0.2
Manufacturing & Mining	10.0	2.4	-5.5
Construction	12.5	19.7	-12.0
Others	10.1	6.5	-0.8

The recession in the economy and overall political uncertainties sharply reduced the share of investment in GDP from about 20 percent in 1974 to 10 percent in 1975.

Conversely, savings declined, while private consumption increased rapidly due to income redistribution, and public expenditure rose due to increased civil servants' salaries, expanded employment in the public sector, and larger outlays on transfers and subsidies.

Beginning in 1974, Portugal's current account deficit, which had traditionally been in surplus, moved into substantial deficit. A series of political and economic shocks hit Portugal in the 1974-75 period, including:

-- the quadrupling of world oil prices; the net imports of petroleum and petroleum products increased from $150 million in 1973 to approximately $770 million in 1977;

-- the loss of colonial export markets (12 percent of total exports in 1973) subsequent to the April 1974 revolution; and

-- the world-wide recession of 1974-75 which further depressed Portuguese exports and halted the emigration of workers to Europe.

The current account deficit fell from a surplus in 1973 of $341 million to a deficit in 1974 of $830 million. Subsequent current account deficits in 1975, 1976, and 1977 reached levels of $832, $1,226, and $1,465 million, respectively (see Chart I).

The economic adjustment problem for Portugal is how to revitalize and restructure its economy to provide for both near and long-term growth while reducing the external payments imbalance to a manageable level. The problem is complicated by the major structural shifts which have taken place in the domestic economy and in its external economic relations. In 1973 gross tourist receipts and worker remittances covered 45 percent of imports of goods and services; in 1977 the figures had fallen to 31 percent. The export sector was unable to take up the slack because of the loss of colonial markets, slower growth in major markets and particularly sluggish demand for Portuguese exports such as textiles.

Domestic Economy

Background - An important consequence of the sharp deterioration in savings and private investment was an increased budget deficit. The latter, in turn, was a result of increased expenditures reflecting the influence of several factors: (1) increased government capital investment to fill some of the slack caused by the decline in private investment, (2) the protection by the government of nominal wage increases by subsidizing the prices of essential commodities and instituting general price controls, (3) higher salaries for civil servants, and public expenditures to maintain employment, and (4) expenditures on returnees. As a result of these factors, the budgetary gap increased as follows:

Table II: Budget Gaps 1972-76 (Percent of GDP)

	1972	1973	1974	1975	1976	1977
Total Expenditures	17.7	17.4	18.7	23.4	26.5	
Total Receipts	16.6	16.1	15.4	15.6	16.6	
Budgetary Gap	1.1	1.3	3.3	7.8	9.9	8.0

Portugal's growing budget deficits have been financed through increased credit to the government, namely, through the creation of money. The effect of changes in the money supply on the price level - for both developed countries and LDCs - usually appears with an average lag of about a year. Portugal is no exception as the following table indicates:

Table III: Money Supply Changes* and Inflation (Percentage Changes)

	1971	1972	1973	1974	1975	1976	1977
Money Supply	13.2	16.4	28.3	10.2	24.0	10.1	26.0
Consumer Prices	9.8	10.6	12.8	25.2	15.2	21.6	24.0

* M_1 (demand deposits plus currency)

It should be noted that the relatively low 1975 inflation rate of 15 percent was due not only to the moderation of money growth the previous year, but also to the implementation of an extensive system of price controls and subsidies introduced in July 1974. However, these subsidies led to a further budget deficit that had to be financed through money growth. Thus, the acceleration of the money supply in 1975 rekindled inflation for 1976.

Meanwhile, during 1976, real GDP growth recovered and rose by 8.6 percent. However, the unemployment rate reached 7 percent (the official figure probably understates significantly actual unemployment). Contributing to this high rate of unemployment was: (1) the overall low level of economic activity itself due to low investment, and in part to the disruption of the private sector as a result of the revolution, (2) the increased size of the labor force due to the returnees from the colonies and demobilization of the Army following the end of the colonial wars, and (3) the decreased demand for migrant workers due to declining economic activity in Northern Europe.

Prospects - Restrictive external sector measures taken early in 1977 did not prevent real GDP from growing 6 percent in 1977, the same as the year before. This buoyancy was primarily due to a resurgence in stockbuilding and a revival in domestic fixed capital formation. However, the continued high rate of economic growth did not lead to any significant improvement in employment opportunities as the increase in output was achieved largely through higher productivity. As a result, the official unemployment rate continued to be about 7 percent, although the Amembassy reports that figure may be twice as high.

The Portuguese authorities have taken a number of policy measures, as part of the stabilization programs negotiated with the IMF, in order to deal with the balance of payments difficulties. In order to achieve the desired improvement, both monetary and fiscal restraints will be emphasized. In conjunction with the former, an increase in the average annual money stock of 18 percent is planned in the year through 1979. This is thought to be consistent with an inflation rate just below the 1977 rate of 24 percent. In order to limit the demand for money and credit, the discount rate was raised by 3.5 percentage points to a level of 20 percent in May 1978 following earlier increases in 1977. The monetary authorities have also introduced credit ceilings for banks and have set quarterly targets for that expansion of the monetary base thought consistent with the aims of credit policy.

During 1977, the deficit for the public sector was reduced to 8 percent of GDP. Fiscal measures have recently been introduced to further reduce the deficit. Additional tax measures have been implemented (including a 10 percent surcharge on earned income) while public consumption is expected to remain constant in real terms. As a result, the overall public sector deficit could decline as a percentage of GDP from 8 to 6 percent.

Under the stabilization program outlined above, gross domestic product could rise by 1 to 2 percent in real terms in 1978 with price inflation of between 22 and 24 percent. In order to limit cost increases, wage policy will remain firm, with increases in contractual wages limited to 20 percent. Real wages declined by 7 percent in 1977, and with the expected consumer price increase of 22 to 24 percent in 1978, real wages may decline by an additional 2 to 4 percent. In 1977, real growth would be about 2.5 percent with inflation moderating slightly to 18 to 20 percent.

Balance of Payments

Background - The current account deficits (approximately 6 percent of Portugal's GDP in 1974 and 1975, 8 percent in 1976 and 9 percent in 1977) were largely financed through reserve drawdowns and, in 1976 and 1977, through extensive official borrowings, including SDR* 250 million from the IMF. The cumulative 1974-1977 current account deficit was $4.4 billion. Private capital flows financed 22 percent of this deficit with official borrowings and drawdowns of reserves financing 78 percent. Over the four-year period, Portugal's gross international reserves fell from $2.9 billion at year-end 1973 to $1,377 million at year-end 1977.** Net official assets fell from $2.8 billion at the end of 1973 to approximately -$500 million at year-end 1977. At the end of 1977, medium and long-term external debt was over $1.9 billion. Short-term debt was estimated at $700 million. The debt service ratio in 1977 was about 19 percent, which given the increase in short-term debt, is expected to rise to perhaps 25 percent in 1978.***

Substantial borrowing from the IMF slowed the loss in reserves over the two-year period 1975-1976. The gold tranche totaling SDR 29.25 million was borrowed in July and December of 1975. Borrowings from the oil facility totaled SDR 114.8 million in the first half of 1976. A loan of SDR 58.5 million was negotiated under the compensatory financing facility in July of 1976. These borrowings totaled SDR 202.55 million by the end of 1976. The deterioration of Portugal's current account required Portuguese authorities to request a stand-by arrangement with the IMF of SDR 42.4 million and to implement a stabilization program. When this initial program failed to immediately improve Portugal's

* An SDR equals $1.22

** The analysis assumes that gold is valued at official prices not market prices.

***The debt service ratio could fall as low as 19 percent depending upon the success of the rescheduling efforts in 1978.

1977 external balances (instead of falling to $800 million as forecast, the current account deficit increased to $1,465 million), a second set of stabilization policies were introduced in August 1977 and a second stand-by arrangement with the IMF of SDR 57.35 million was negotiated. The second agreement was approved by the IMF Executive Directors on June 5, 1978 and has been partly disbursed. The U.S. and other governments then moved forward with a multi-nation lending program to extend a total of about $750 million in balance of payments support to Portugal over the period ending in 1978. Subsequent to this agreement, two consortia of private banks put together loans of $450 million of seven-year money.

Stabilization Programs - The initial stabilization program implemented in the early months of 1977 sought to reduce the current account deficit from its 1976 level of $1.2 billion to approximately $800 million which, coupled with a $175 million net private capital inflow, would have resulted in an official reserves balance of $625 million. The stabilization package involved a 15 percent devaluation of the Portuguese escudo, the imposition of quotas and surcharges on a variety of imports, the lifting of price controls on many commodities and the limiting of wage increases to 15 percent per year. Targets for public sector borrowing and overall credit expansion were set and the Central Bank discount rates were raised from 6.5 percent per year to 8 percent per year.

The performance of the Portuguese economy through the first half of 1977 suggested that the external targets called for under the first stabilization program would not be met. The current account deficit through June of 1977 was already $750 million with net private capital inflows financing approximately $300 million of the deficit. The second half of the year showed little improvement with the complete 1977 figures showing a current account deficit of $1,465 million financed in part by a $706 million net private capital inflow. This left an overall deficit of $759 million which was financed through gold sales and official borrowing. While gross reserves rose slightly to $1,377 million, net reserve levels became negative.

Once the need for further policy measures became apparent, a supplementary policy package was developed and introduced in August 1977. Domestic credit expansion was tightened again and the Central Bank discount rate was raised to 13 percent per year.* Planned public sector spending was reduced in 1977 and 1978. Finally, the escudo was devalued again in August by 4 percent and allowed to depreciate by at least 1 percent per month thereafter. Also a forward exchange market was established. The average July 1978 exchange rate of the escudo has been 45.2 per dollar, a devaluation of 16 percent since August 1977, and 13 percent since January 1978.

The failure of the initial program to meet the criteria that had been established resulted mainly from the political crisis that occurred in late 1977. The new stabilization program is believed by the IMF and by us to lay the groundwork for a successful restructuring of the Portuguese economy. (Whether the criteria of the new program can be met is questionable now because of the political crisis.) In any case the impact of the program, as distinct from the policy criteria established under the program, must be given a reasonable time to display its effect. The greatest impact of the policies that are now in place on the current account will most likely show up in late 1978 and more prominently in 1979.

Preliminary figures available for money supply growth, public sector deficits and wage increases indicate these program targets are being met. The divergence between the program forecast and the actual results of 1977 occurred in the external balances. The trade and current account deficits worsened in 1977 compared to both the 1976 levels and official 1977 forecasts. The trade deficit in 1977 was $2.5 billion compared to a 1976 deficit of $2.1 billion and a forecast for 1977 of $1.8 billion. The current account deficit in 1977 was $1.5 billion compared to a 1976 deficit of $1.2 billion and a forecast for 1977 of $812 million.

Exports of goods and services, expected to grow in real terms by 15 percent in 1977, only grew by 10 percent. Leading export categories included textiles, wood and cork, wine and timber. Imports of goods and services, expected to <u>decline</u> in real terms by 2 percent in 1977, <u>grew</u> instead by <u>14</u> percent. Major imports were foodstuffs (including grain), petroleum and capital equipment and intermediate goods. Tables III-V contain further detail on Portugal's trade account. Clear explanations for these surprising trade developments are not readily available. Three

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* The discount rate was raised further in May 1978, to a level of 20 percent.

factors, however, may partially explain these developments:

-- The impact of Portuguese inflation (24 percent in 1977) on relative prices may have negated much of the increased price competitiveness of Portuguese exports achieved through escudo depreciation.

-- A currency depreciation often initially results in a worsening of a country's balance of trade even though, over time, the expected improvement in the balance of trade results (the "J-curve effect").

-- Portuguese consumers and firms engaged in speculative short-run purchase of goods and services in anticipation of future shortages of goods and lower real incomes (total domestic expenditures on goods and services grew by 6 percent in 1977 compared to a forecast of 2 percent and a 1976 growth rate of 7 percent). This was additional to normal rebuilding of inventories.

Prospects - If indeed J-curve effects and speculative buying were responsible for the disappointing performance of Portugal's current account in 1977, then continued adherence to the stabilization program should improve both the trade and current account balances in 1978 and 1979. The effects of continued escudo depreciation should take hold and reverse the perverse J-curve effects particularly if inflation slows (responding to a reduction in public expenditure and money growth). Speculative stockbuilding should also begin to yield to the reality of falling real wages.

The U.S. Embassy in Lisbon has made balance of payments forecasts for calendar 1978 to 1982 and the IMF has a forecast for the program year ending March 1979 (see Table II).* Both forecasts see a trade deficit on the order of $2.3 billion and a current account deficit of $1.2 billion for 1978. The Embassy sees surprisingly little improvement in either account for 1979. The trade balance deteriorates while the current account improves by only a modest amount. The 1978 current account deficit can be financed easily because of the $750 million loan from the multi-nation consortium and gold sales. The Embassy forecasts an official reserves deficit of $753 million in 1979 which must be financed essentially by gold sales or foreign official borrowings.

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* The difference between Embassy Lisbon's figure of $278 million for the official reserve balance and the IMF's figure of $800 million lies in the IMF's decision to include Portuguese government nationalization projects as a short-term capital outflow. The forecasts do not fully reflect recent agreements with private banks.

The IMF sees Portugal as achieving its target (set in May 1978) of a current account deficit of about $1 billion for the fiscal year April 1978 through March 1979. Included in this target is the assumption that real imports will decline by 3.5 percent over this period, while real exports will rise by 7 percent. The IMF believes that the export target might actually be surpassed if Portugal is successful in its efforts to expand trade with its former colonies and with Eastern European countries.

The implication of these forecasts is that the stabilization policies introduced in 1979 will reduce Portugal's current account deficit by no more than $400 million in three years. It is not clear that the forecasts correctly anticipate the full impact of these stabilization policies. IMF studies indicate that relative current labor costs adjusted for changes in the effective exchange rate, a measure of competitiveness which were nearly 40 percent higher over 1973 in the 1975-76 period, are now in mid-1978 below their 1973 level. Prolonged political instability, economic mismanagement or new external shocks, on the other hand, could make the forecast appear optimistic in retrospect.

Meeting Foreign Exchange Shortfalls

Available information suggests the following tentative conclusions about the magnitude of foreign exchange shortfalls:

-- Portugal will have little difficulty in covering its 1978 financial gap (estimated by the Embassy at $364 million).

-- Portugal faces a larger potential financing gap (estimated by the Embassy at $753 million) in 1979 and will have to seek additional external assistance to close it.

-- Even with an effective stabilization program, the current account deficit could continue to be on the order of $1.2 billion annually for the forseeable future (the Portuguese government is unlikely to be able to continue to restrict real growth to the 2 percent or less expected in 1978 in the face of approaching elections and the structural investments necessary for sustained growth and longer-term external equilibrium will require imported inputs).

There are a number of downside risks and upside opportunities which underscore the tentativeness of these conclusions.

External risks include the possibility of sharp increases in the prices of imported oil and grain and slower than anticipated growth in Portugal's export markets (largely Western Europe). External opportunities include a more buoyant economic expansion elsewhere in Europe and consequent increased demand for Portuguese exports.

Internal imponderables are perhaps more significant. The general question is whether the Portuguese government can maintain public support for the relatively austere stabilization program. Specifically it must be able to a) hold nominal wage increases to 20 percent even though that implies a 4 to 5 percent decrease in real wages, b) continue to reduce the public sector deficit which will require tightened control over autonomous institutions, c) effectively reduce import demand through credit restraint, and d) avoid further increases in short-term indebtedness. The recent collapse of the Soares' government substantially increases the chances that the stabilization program will fail.

There are also opportunities. The lagged effects on the current account of the stabilization policies introduced in 1977 which included escudo devaluation may be more pronounced than forecast. Speculative stockholding of imports could slow down or be reversed by credit restraints. Continued evidence that the stabilization program is working could slow capital flight and accelerate the inflow of foreign direct investment and private medium and long-term capital. Growing confidence that escudo depreciation will not accelerate could increase projected foreign worker remittances. There is also some possibility that agricultural output and tourism receipts could do better than expected.

To deal with its foreign exchange shortfalls, Portugal must formulate an economic development program which deals simultaneously with both the short-term stabilization problem and the country's longer-term development needs. The multination lending program, the conclusion of a second tranche IMF agreement, and the subsequent negotiation of a medium-term credit from a consortium of private banks provide some healthy space for the development of such a plan provided that a stable government exists which can focus on it.

The Soares government had committed itself to present to the National Assembly in October a medium-term development plan which would indicate how the Portuguese economy should be restructured so as to resolve its chronic payments imbalance and to make viable Portuguese entry into the Common Market. It may not be possible for any Portuguese government to undertake the extraordinary effort between now and October needed to make the plan an effective working document. Unlike past presentations, the plan should outline clear, realistic government policy actions as well as guidelines for the private sector. An appropriate plan will provide a basis for the Portuguese government to begin negotiations with the IMF for an Extended Fund Facility program and to approach other sources for external financing. The next two sections discuss briefly specific economic sectors which should be addressed by any medium-term development plan and the nature of outside assistance which might be appropriate and available.

Investment Priorities

Embassy Lisbon points out that the Portuguese government has consistently failed to take full advantage of available project assistance. An establishment of clear priorities in the medium-term development plan now being formulated undoubtedly will improve Portugal's performance. This section, based largely on information drawn from the World Bank, discusses the problems in three major sectors (agriculture, industry and construction) which should be addressed in any development plan.

Agriculture - Agricultural output (excluding forestry and fisheries) has grown slowly, at little more than one percent a year since the early 1960s including the period between 1968 and 1973 when the economy as a whole grew 7 percent a year. Progress in agricultural output and productivity has been constrained by several factors: a) land tenure conditions which impeded the introduction of modern farming techniques in the north and encouraged poor land use in the south, b) conflicting price policies which often were aimed both at keeping food costs to consumers low and providing incentives to farmers, c) insufficient capital formation and inadequate arrangements for agricultural credit, d) lack of effective extension services backed-up by practical, farm-oriented research, e) limited exploitation of the irrigation potential and insufficient use of the present irrigation facilities, and f) slow modernization of traditional farming practices.

More emphasis should be placed in overcoming these impediments to agricultural growth in Portugal's economic development strategy. The reasons for this are both social and economic - namely the existence of a large rural population without the basic amenities of life and the country's growing reliance on imports of food and agricultural raw materials. Perhaps the most important prerequisite to reviving the agricultural sector is to complete as expeditiously as possible the implementation of land tenure conditions in the north. In addition, a large number of resource development projects offer promise for the long-range expansion of agriculture. Rehabilitation and intensification of existing irrigation projects including tertiary canals and drainage should contribute to sustained and significant increases in output. The use of tractors and earth-moving equipment through producer associations can speed up the development of small irrigation systems and can result in a shift to crops to extensive and irrigated farming areas. Efforts to grow new crops such as sugar beets and tobacco would reduce their imports. Investment in processing and marketing facilities and modernization of slaughter plants could provide prompt benefits to the sector.

Agriculture's share in gross fixed capital formation has averaged only 6.6 percent between 1968-74. Much of the problem is that agricultural credit has been insufficient. Terms which almost always required land as a collateral virtually eliminated most tenants from obtaining production credit. There are nine effective credit sources in Portugal, with the largest three being operated by the Institute of Agrarian Reform (IRA). But the IRA's activities are limited because all applications must be approved in Lisbon, it cannot accept deposits, and it depends on budget transfers and borrowing for its financing. Therefore, a large proportion of credit requested goes unfulfilled. Easier terms of credit are needed, and different credit activities should be integrated or coordinated by a single entity to provide a unified source of credit.

<u>Industrial Sector</u> - The manufacturing sector was the leading sector in the Portuguese economy during the 1960s and early 1970s, growing at an average annual rate of 10 percent from 1963 to 1973. By 1973, manufacturing contributed 36 percent of GDP, employed 25 percent of the labor force and produced over 60 percent of merchandise exports. However, as a result of the 1974 revolution, the growth of industrial output dropped to 2 percent in 1974 and fell by 5 percent in

1975. The breakdown by major sub-sectors is as follows:

Manufacturing Output - Rates of Growth 1968-75
(percentage changes)

Sector	1968-74	1974	1975
Textiles	12	6	-17
Basic Metals	12	-13	-18
Metal Products	13	-1	-13
Foodstuffs	7	13	27
Total	10	2	- 5

The fall in output stemmed mainly from reduced demand and bottlenecks in production. A sharp reduction in investment followed the revolution as real total gross fixed capital formation declined by 3 percent in 1974 and by 39 percent in 1975. Severe declines in chemicals, textiles, and wood products reflected the reduced price competitiveness of Portuguese exports.

Private industrial recovery is essential for Portugal's national economic recovery. The private sector can recover, however, only if adequate financial and technical assistance and credit are made available to enable industry to restructure and modernize. Adequate guarantees for investment and transfer of profits are needed to encourage foreign capital investment. Measures and policies to provide financial and technical support to a large number of small and medium size enterprises are also needed so as to make them more efficient and financially viable. In addition to development of the private sector, investment is needed in the public sector to further train managers so as to achieve greater efficiency and profitability in the enterprises under their management.

Construction and Housing Sector - The construction industry has been one of the more dynamic activities in Portugal's economic development. In 1973, 9.4 percent of the total labor force was employed in construction. The construction industry's share of GDP increased from 5 percent in 1968 to 6.4 percent in 1973 and gross fixed capital formation increased at an annual rate during this period of 16.5 percent. But construction activity dropped significantly in 1974 and 1975 reflecting the deterioration of economic activity. The share of construction activity in GDP fell by about 11 percent in 1975. The number of buildings constructed fell by 23 percent in 1974 and by 55 percent in 1975.

In order to help revive this industry, in the short-run, investment could be concentrated in housing. This would benefit low income families and will also help in the revival of other industries related to construction activity. The other important benefit of renewed housing construction will be to induce household savings. Also, the import content of housing construction is relatively low and, therefore, expanded housing construction can contribute to economic growth and lead to more employment with minimal effects on the balance of payments. Additional measures will have to be taken to revive the construction and housing sector. Incentives to stimulate private investment to meeting housing demand should include: a) provision of facilities for loans for building materials, and b) provision of basic infrastructure facilities like water, sewerage, electricity, and transportation. Care must be exercised to provide credit within the limits of monetary constraint needs to fight inflation and maintain competitiveness of the escudo.

Government housing programs have been subsidizing both direct costs and interest rates for low income families. Because of its large budget deficit, the government needs to review major housing subsidy programs. An alternative to adjustments in interest rates would be to make additional long-term credit available with lower down payment requirements. Funds should also be channeled into labor-intensive and self-help construction methods, low cost indigenous materials, communal rather than private plumbing and sanitary facilities, and higher density construction. These could all lead to higher employment and lower construction costs, and also provide appropriately priced housing to a larger number of people.

External Assistance

The Extended Fund Facility and the Supplementary Financing Facility, assuming that the latter is in effect by early 1979, could provide Portugal with financing equal to 476 million SDRs 580.4 million) over a three year period. If Portugal adheres to the IMF standby conditions and develops a comprehensive medium-term program, the annual drawings from the Fund during the three years beginning April 1, 1979 could reach 159 million SDRs ($194 million).

Satisfactory adherence to conditions for the various IMF facilities has already encouraged foreign banks to provide medium to longer-term financing. The Portuguese government has already negotiated seven-year loans from a U.S. bank consortia for $300 million and from a German consortium for $150 million. Under this scenario, which is by no means assured, there should be a much reduced need need for additional bilateral balance of payments assistance.

The development plan will, however, require foreign official and private financing. The Soares government had been considering the possibility of asking an international institution such as the OECD to organize an assistance consortium for Portugal. Embassy Lisbon suggests that a more effective alternative would be for the Portuguese government to take the leadership and call for a Lisbon meeting of potential foreign contributors to its development program. Foreign government representatives and representation of international institutions such as the World Bank, the EC and EFTA would be invited. Careful preparation would be required in the form of bilateral consultations between Portugal and potential donors in which the government would aggressively present its plans and financial requirements. If these bilateral consultations took place concurrently with the preparation of Portugal's development plan, they could influence usefully the contents of that plan. To be convincing the government must pursue its stabilization program, accelerate the drawdown of available project financing and emphasize its efforts to attract private capital. Another alternative, particularly attractive now that Germany has assumed the Presidency of the EC, would be EC sponsorship of a consultative group on assistance.

The World Bank and the European nations, particularly those in the European Community, are in the best position to provide the bulk of the development financing. The Scandinavian countries, which now extend a modest amount of assistance, would likely increase the amount if Portugal would demonstrate greater absorptive capacity. Western European governments are coming to accept the fact that persistent Portuguese instability and uncertainty is significantly adverse to their interests. The EC Commission report on Portugal's membership application, for example, recommends acceptance of the application as well as the creation of a substantial assistance program. A $200 million credit is now under consideration by EC member parliaments. The EC should be willing to accept a leadership role by reason of its decision to accept Portugal as a member.

Germany, which already maintains an active bilateral effort, would most likely support an EC leadership role.

U.S. assistance would presumably include project assistance already in the AID pipeline (the anticipated drawdown for 1979 is $40 million) and additional PL-480 and CCC credits ($40 and $200 respectively) have been proposed for 1978. Embassy Lisbon suggests that the U.S. provide a bilateral aid program of some $100 million for FY 1980 and that at least part of this assistance might be in the form of a private sector modernization loan as suggested in AID's annual budget submission in June. Additional conventional project financing would only add to the ample pipeline of project credits already available and thus disburse too slowly. A program loan could be directed toward financing needed investment equipment and thus stimulate desired foreign exchange and still disburse fast enough to help fill the financing gap.

Conclusions and Recommendations

The probable need to finance substantial current account deficits over the next two to three years is a major constraint on Portugal's growth. Our estimates of these deficits (approximately $1 billion) are soft. The stabilization program is, on paper, sound but, even if the program is implemented effectively, its full impact may not appear for several months or longer.

There is little danger of a further balance of payments crisis in 1978 unless the current stabilization effort collapses in the face of the current government crisis. Over the next few months therefore we have time to:

-- assess the effect of the current government crisis on the economic stabilization program;

-- gain a better understanding of the full impact of the economic stabilization program which will allow us to forecast the current account deficit with more confidence; and

-- evaluate the medium term development plan as the details become available in the light of the role that alternative types of U.S. assistance could play.

Our political objective is to support and encourage the fragile Portuguese democracy. This will require both an active role in providing assistance to Portugal for its immediate and continuing balance of payments difficulties, and more importantly for efforts by the Portuguese government to restructure the economy over the medium term in order that it can return to a self-sustaining growth path. This will entail bilateral encouragement to the Portuguese government to carefully formulate its development plan and to present the plan and its financial requirements to potential donors. Our leadership in organizing the multi-nation consortium which is now providing balance of payments assistance makes us uniquely qualified for this role. We will also need to encourage the European Community to initiate and take the lead in providing increased development assistance to Portugal. Our own influence in this regard will depend in part on our ability to provide substantial assistance ourselves. We must therefore maintain and increase our PL-480 and CCC programs as well as offer substantial bilateral assistance in FY 1980. (Embassy Lisbon has recommended a $100 million program to include such elements as a program loan for private sector modernization.)

One other issue, not examined in this paper, but which bears examination in the coming months is access to markets for Portugal's exports. The IMF notes that "Portuguese exports have been barred by protective barriers in a number of foreign markets, including those of countries that are currently providing balance of payments assistance." The plan to conclude the Multilateral Trade Negotiations by the end of the year gives us a golden opportunity to work with the Europeans to liberalize trade barriers of interest to Portugal. Again, however, this is largely a European problem which must be resolved as part of the EC accession negotiation.

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TABLE I

Portugal Balance of Payments
(Millions of U.S. Dollars)

	1973	1974	1975	1976	1977
Trade Balance	-910	-1995	-1671	-2095	-2474
Exports of Merchandise (FOB)	1843	2289	1935	1814	2019
Imports of Merchandise (FOB)	-2753	-4284	-3606	-3909	-4493
Service Balance	154	56	-194	-104	-124
Exports of Services	1248	1369	1053	809	895
Imports of Services	-1094	-1313	-1247	-913	-1019
Net Transfers	1097	1110	1033	973	1133
Current Account Balance	341	-830	-832	-1226	-1465
Financed By:					
Net Private Capital Flows	13	240	-211	213	706
Long Term Capital	-141	272	-90	12	136
Direct Investment	51	69	109	55	57
Short Term Capital	-135	-26	-205	107	506
Errors and Omissions	263	-6	84	94	67
Reserve Changes (- = Loss of Reserves)	+328	-590	-1043	-1013	-759

Source: IMF International Financial Statistics, July 1978

TABLE II

Portugal Balance of Payments Forecasts
(Millions of U.S. Dollars)

	IMF	American Embassy Lisbon				
	1978	1978	1979	1980	1981	1982
Trade Balance	-2300	-2380	-2460	-2550	-2575	-2565
Exports of Merchandise	2430	2250	2540	2950	3420	3970
Imports of Merchandise	-4730	-4630	-5000	-5500	-5995	-6535
Service Balance	0	-160	-150	-170	-155	-65
Net Transfers	1300	1250	1400	1510	1630	1760
Current Account Balance Financed By:	-1000	-1290	-1210	-1210	-1100	-870
Net Private Capital Flows	200	926	457	456	418	309
Long-Term Capital	498	726	457	456	218	59
Short-Term Capital	-298	200	-	-	200	250
Official Settlements Deficit Financed By:	-800	-364	-753	-754	-682	-561
Net Official Borrowings		625	-396	-341	-528	-385
Reserve Changes (- = Loss of Reserves)		261	-1149	-1095	-1210	-946

* Fiscal year ending March 1979.

** Includes $635 million of the $750 million from the 14 Nation Consortium.

Source: Embassy cables and IMF Documents.

Table III

Imports (CIF) By SITC
(Millions U.S. Dollars)

	1971	1972	1973	1974	1975	1976	Rate of Growth 1973-76	Percentage of 1976 Total
Total Imports	1823.0	2227.2	2908.3	4581.5	3839.6	4315.9	14.0%	100
Food and beverages	232.9	306.9	402.0	777.2	765.6	742.6	22.7%	17.2
Basic materials	370.8	443.5	594.1	1084.6	1009.9	1213.7	26.9%	28.1
Manufactures								
Chemicals	177.8	216.2	312.2	458.8	348.8	507.2	17.6%	11.8
Goods classified chiefly by material	374.8	392.5	511.4	861.2	583.6	598.7	5.4%	13.9
Machinery and transport equipment	580.1	759.7	928.5	1179.0	961.0	1065.7	4.7%	24.7
Misc. manufactured goods	86.2	108.8	159.5	220.0	170.4	186.8	5.4%	4.2
Other	0.4	0.5	0.7	0.7	0.3	1.2	19.7%	0.1

Source: OECD Economic Survey

Table IV

Exports (FOB) By SITC

	1971	1972	1973	1974	1975	1976	Rate of Growth 1973-76	Percentage of 1976 Total
Total Exports	1052.2	1293.8	1765.9	2276.3	1939.2	1820.0	1.0%	100
Food and beverages	182.3	229.5	303.3	333.4	300.4	291.0	-1.4%	16.0
Basic materials	159.1	180.4	228.5	350.1	265.6	296.0	9.0%	16.3
Manufactures								
Chemicals	75.0	84.2	103.1	188.4	125.5	95.0	-2.8%	5.2
Goods classified chiefly by material	381.8	458.2	632.3	780.7	664.5	594.0	-1.6%	32.6
Machinery and transport equipment	102.2	152.4	233.1	288.9	256.0	230.0	-0.4%	12.6
Misc. manufactured goods	139.0	179.3	251.1	323.0	312.8	282.0	3.9%	15.5
Other	12.8	9.8	14.5	11.8	14.4	32.0	31.1%	1.8

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Source: OECD Economic Survey

TABLE V

GEOGRAPHICAL BREAKDOWN OF PORTUGUESE

FOREIGN TRADE - 1976

(Percent of Total)

	Exports	Imports
Total	100.0%	100.0%
OECD Countries	80.4%	69.2%
U.S.	6.8%	9.0%
U.K.	18.3%	9.3%
Germany	10.8%	11.7%
France	8.4%	6.3%
Sweden	7.9%	3.1%
Other OECD	28.2%	29.8%
Non-OECD Countries	19.6	30.8%