PORTUGAL: Report on Economic Conditions & Debt Repayment Prospects

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[1985]

I. EXECUTIVE SUMMARY

BACKGROUND. The revolution of 1974/75 brought independence to Portugal's former colonies and democracy to the political and economic life of the country. It also brought along with it elements of instability. Repatriates swelled the labor force (representing a 10% increase), most of whom could not be immediately employed. The government undertook large structural transformation in industry and agriculture which with uncertain political conditions depressed private investment and led to a decline in output. Government policy also sought to expand consumption and living standards through transfer payments and enlarged fiscal deficits. The unemployed pool of returnees were put to work through an expansion in the public sector. Private investment investment fell. In 1975, GDP dropped by 4% and output did not recover its 1974 levels until 1978. In the external sector, Portugal's current account deteriorated from a surplus in 1973 to a $1.5 billion deficit in 1977.

Debt Repayment Capacity. Since its first stabilization program begun under the auspices of the IMF in 1978, the government has successfully implemented several programs to restore stability in its external accounts. These have been successful in increasing exports, restoring price competitiveness in the tradeable goods sector thru exchange rate depreciation and limiting wage increases. Inflation rates have stabilized, although at high levels at around 20 % per year. Foreign exchange reserves have been restored to working levels compatible with an expanded foreign trade and entry to the European Common Market. After a near doubling in external debt from 1979 to 1982, jeopardizing the country's creditworthiness rating, the government has managed to control the rise in foreign indebtedness.

While the 1984 debt service ratio had reached a high point of over 35%, preventing some enterprises from financing capital expansion through foreign borrowing, the ratio is estimated at the end of 1985 at just under 32%. Under a future projection scenario assuming continuing prudent economic policy management, the debt service ratio by 1988 is expected to stabilize at just about 30% of its current receipts from exports of goods and services.

Domestic Economic Conditions. However, domestic stabilization programs have not been without cost. The 1983 improvements in the external accounts entailed painful adjustments. GDP declined in real terms in 2 successive years, 1983 and 1984. No real growth is expected in 1985 (see below for chart on GDP growth). Unemployment rose from an annual rate of 8% over the 1979-82 period to 10.5% in 1984. Neither growth nor employment prospects in 1986 are likely to vary from this austerity trend.

Throughout the several years of intermittently carrying out austerity measures, Portugal has kept in place a system of subsidies and administrative controls over economic decision making, preventing a more efficient economy from emerging. Without undertaking basic reforms to revamp its industrial structure, encourage more efficient means to channel savings into productive investment, expand the scope for private sector investments and reshape public sector investment plans to activities in line with the economy's comparative advantage, efforts at reflating the economy, reducing unemployment, and raising living standards will run up against balance of payments constraints.

The large swings in output followed by balance of payments instability and increased external debt reflect the structural rigidities which restricts the scope for expansionary stimulative economic policy measures. Under the present economic structure, increases in domestic output are accompanied by even larger percentage increases in imports. Public sector firms find access to internally generated funds precluded by government restrictions on output pricing. Large fiscal deficits and undeveloped financial markets crowd out both public and private industrial firms from seeking investment funds domestically. To get around these restrictions, public sector firms have resorted to large overseas short-term loans

These problems suggest that government controls which severely impair the financial viability of public sector enterprises should be lifted. Greater freedom to set prices and take other important financial decisions would permit the industrial sector to generate internally a greater share of investment requirements. These measures would also help safeguard Portugal's external credit rating.

Recent actions by the government appear to point to a more aggressive stance in stimulating the economy. At the end of November, 1985, the crawling peg regime, under which the exchange rate was devalued up to one percent monthly, was suspended, and domestic interest rates were reduced by 4 points to stimulate investment. The measures undertaken under the two year austerity program begun in 1983 appear to be loosening. This switch in policy runs the same risk encountered under previous expansionary programs .

Improving agricultural production is an especially critical action which needs to be taken in light of Portugal's entry into the Common Market. Adoption of the EEC's Common Agricultural Policy, under which EEC suppliers with their higher prices receive preference over non-EEC suppliers, will compel greater foreign exchange expenditures for a given level of food imports.

In addition, a manufacturing industry more responsive to competitive pressure will be essential if Portugal is to take advantage of market opportunities opened by Common Market membership. At present, the pricing and cost structures of many manufacturing firms are strongly influenced by government administered price controls, investment incentives, and labor legislation. Among public sector enterprises, capital intensive investments have predominated. Diversification, growth, and greater foreign investment in manufacturing (especially for export) call for a relaxation of government controls and a shift towards less capital intensive manufacturing .

Although a lengthy transition period can be expected before full application of Common Market provisions will be required, nonetheless, structural reform in both the agricultural and manufacturing sectors can germinate and bear fruit only in the medium to long term. Thus, from the vantages of both increasing discretionary foreign exchange resources and preparing for EEC entry, Portugal cannot afford to defer major structural reforms.

There is the danger that with excessive expansionary measures unaccompanied by progress on basic reforms, the economy will continue to experience alternating cycles of boom and stagnation: domestic expansion followed by current account deficits which bring on demand restraining measures on income, consumption and investment. Unless structural changes are made to mobilize domestic resources according to sound economic criteria, economic development will depend upon an excessive share of foreign financing and endanger the country's external credit standing.

OUTLOOK. Portugal's entry into the European Economic Community makes these reforms more urgent if the economy is to realize the potential for increased exports which entry offers. Future external stability and stable growth depend on the government's willingness to modernize its manufacturing and agriculture sectors and reform its budgetary and financial practices. Reducing subsidies and the access of public sector enterprises to the national budget would help contain fiscal deficits. Without these measures reducing structural imbalances in the financial and industrial sectors, external stability can only be maintained at the cost of stagnation in domestic growth.

Under a scenario assuming most favorable projections of growth in international trade, but with an unchanged domestic economic policy environment, stability in external accounts is maintained only with a low growth rate of under 4% during the 1986-1988 projection period (see balance of payments table). Assuming no faster growth, and with no structural reforms in the economy, the current account deficit climbs to about 5 1/2% of GDP by 1988. Outstanding external indebtedness grows at less than 10% annually during the projection period. Total debt to GDP is maintained at under 45% and the debt service ratio drops to just over 30%.

However, a higher growth rate will be needed to make a dent in the unemployment level and improve living standards. It is unlikely that domestic political considerations can permit a government to sustain an activity level which does not do more to alleviate severe unemployment and poverty problems. These issues cannot be addressed without endangering external creditworthiness if the structural reforms are not in place.

II. ECONOMIC PERFORMANCE:

Background: Economy Before the 1974/75 Revolution

In the five years prior to the 1974 Revolution, the Portuguese economy grew rapidly with GNP increasing at an average annual rate of 7.5%. A high rate of investment (over 20% of GNP), particularly in manufacturing, made this growth possible.

After tne Revolution in Portugal, in 1974, real wages rose sharply, increasing 26% in 3 years, while real output slumped. Unemployment increased, and the current account deficit rose. This was, in part, due to increases in oil prices. However, the oil price shock, the world recession, and the increase in Portugal's work force caused by decolonization called for a fall in real wages at a time when they were rising 25 percent. Beginning in 1975, public spending increased to maintain employment and offset the decline in GDP. This led to an expanding current account deficit. The government devalued the currency in early 1977, and beginning from the middle of 1977 and continued intermittently since then, allowed it to crawl in line with the differential between domestic and world inflation.

III THE EXTERNAL DEFICIT

The devaluation, together with wage controls, helped to reverse the trend in real wages, but the current account deficit continued to rise. The problem had become one of excess demand fostered by overexpansionary monetary and fiscal policies. In 1978, as real wages continued to fall, the government tightened credit and cut the budget deficit, which produced slower output growth but moved Portugal closer to external balance.

Successes of 1977 Stabilization Program. The 1977 stabilization program included monthly depreciation, mandatory ceilings on wage increases, and higher real interest rates on savings deposits. The program was successful in both reducing real wage costs, in making Portuguese exports competitive, and in improving the balance of payments by shifting consumer demand away from potential exportables, and in raising worker remittances. The current account deficit was reduced from $1.5 billion in 1977 to $52 million in 1979.

The Return to External Imbalances: 1980-1982 The program was less successful in tightening control over government budget expenditures. The cumulative stimulative effect of these deficits raised private consumption by 5% in 1980, the steepest annual rise since the Revolution. Exports also continued to expand adding to growth in incomes, but when combined with stimulative government budget deficits and subsidized consumer prices expanded economic activity. Development gave way to a dramatic rise in imports of 42% in 1980. The current account deficit rose to $1.2 billion.

These adverse impacts were compounded by the failure of Portuguese authorities to depreciate sufficiently to maintain relative cost parity in Portugal's key Western European markets. As a result, merchandise exports fell by 11% in dollar terms in 1981. The combined effect reduced GDP growth and with the need for additional food imports to make up for shortages caused by poor harvests, the current account deficit jumped to 13% of GDP in 1981.

In 1982, agricultural output recovered from the depressed drought-caused levels of the previous year Merchandise exports posted a modest 1% rise in dollar terms, and served to provide some stimulus to industrial production. The government continued to hold a cap on wage increases to below the rate of inflation and real wages dropped by 2% over the year. However, rises in transfer payments and budget expenditures expanded disposable income. Budget deficits in relation to GDP exceeded 10 % from 1980 thru 1982. In addition, the government's monetary policies encouraged large expansion in emigrant deposits, which had grown by 180% from 1980 to 1982. Without offsetting policies to sterilize the impact of these deposits on the money supply and consumer incomes, disposable incomes in 1982 rose in real terms. Due to the import bias in the economy,expenditures spilled over to the external sector. Imports rose in real terms by 5%.The current account deficit, as a result, widened by nearly $400 million and came to over 13% of GDP.

Other signs clearly indicated that major changes were required. Exports, in dollar terms, were stagnant for two years; by 1982 external debt nearly doubled from 7.3 billion in 1979 to $13.5 billion. Interest payments on external debt absorbed 30% of merchandise export receipts . The short-term portion rose to an excessive share of the total debt.

PORTUGAL BALANCE OF PAYMENTS, 1982-85, &1986-88 Projected

THE BALANCE OF PAYMENTS, DEBT & EXTERNAL RESERVES OF PORTUGAL, 1982-85
(IN MILLIONS OF DOLLARS)

BALANCE OF PAYMENTS	1982	1983	1984	1985 (est)	1986	1987	1988
					projected—		
EXPORTS	4,108	4,569	5,210	5,430	6,044	6,793	7,635
IMPORTS	8,941	7,644	7,241	7,240	8,557	10,113	11,953
MERCHANDISE TRADE BALANCE	(4,833)	(3,075)	(2,031)	(1,810)	(2,513)	(3,320)	(4,318)
SERVICES							
Tourism, net	609	591	727	750			
Investment income,net	(1,269)	(1,250)	(1,200)	(1,300)			
other	(432)	(77)	(194)	(120)			
Sub-total, services	(1,092)	(736)	(667)	(670)	(704)	(739)	(776)
TRANSFERS							
Emigrants' remitt.	2,599	2,151	2,155	2,030	2,091	2,175	2,262
other	81	20	23	0			
Sub-total transfers,net	2,680	2,171	2,178	2,030	2,091	2,175	2,262
CURRENT ACCOUNT BALANCE	(3,245)	(1,640)	(520)	(450)	(1,126)	(1,885)	(2,832)
as percent GDP	-13.2%	-7.2%	-2.3%	-2.3%	-3.1%	-4.3%	-5.4%
CAPITAL ACCOUNT							
Medium,long-term	2,585	1,466	1,273	1,300	1,595	2,034	2,639
'Short-term, incl e&o	783	(649)	(385)	(60)	(350)		
	3,368	817	888	1,240	1,245	2,034	2,639
Overall balance	123	(823)	368	790	119	150	(192)
Change in Foreign Assets							
Official Reserves	108	1,066	195	N.A.			
Commercial Banks	15	243	173	N.A.			
Official Reserves							
Gold	5,631	5,209	5,174				
Foreign Exchange	391	353	475	1,265	1,384	1,534	1,341
Non-gold official reserves as % of imports (months)	0.5	0.6	0.8	2.1	1.9	1.8	1.3
Outstanding External Debt	13,661	14,485	14,938	15,388	16,514	18,399	21,230
Short-term	3,862	3,422	3,016				
Medium, Long-term	9,799	11,063	11,922				
short term as percent of total	28.3%	23.6%	20.2%				
Debt Service							
Principal payments	942	1,161	1,985	2,457	2,637	2,938	3,390
Interest	1,390	1,196	1,348	1,385	1,321	1,472	1,698
Sub-total,	2,332	2,357	3,333	3,842	3,958	4,409	5,088
Debt Service, as% xgfs	27.1%	27.6%	35.5%	31.6%	28.4%	30.2%	30.4%
GDP, $ billion		20.5	25.2	30.3	36.3	43.6	52.3

Sources: IMF Staff Report

NOTE: Projections based on IMF forecasts on optimistic projections of international trade and development. Portugese policies are assumed to maintain the current account deficit to not exceed 6% of GDP. Under this scenario it is assumed that governemnt policy maintains the competitiveness of Portugese exports by adjusting the exchange rate, and encouraging foreign private investment. These policies are assumed to have the following impacts:

exports: 7% real growth in goods,5% growth in services and 3% (value)in remittances. Prices increase by 5% per year. Impact of accession to the EC reflected in an increase in official transfers ($100million per year) and an increase in foreign private investment (15% per year).

Import growth gradually declines from a high of 11.5% in '86 to 5% by 1988

Additional borrowing is undertaken to cover the current account deficit, and provide an increase in exchange reserves of $100 million/year

The increase in foreign exchange inflows is assumed to meet the government's GDP target growth rate of 3 1/2 to 4% growth over the period.

Debt Service: Interest assumed at 8%, amortization includes debt borrowed to cover current account deficit.

Portugal's external payments stability directly mirrors government economic policy. The policy trend has been to stimulate economic expansion and simultaneously increase transfer payments. An inward looking economy, without sufficient external earnings of its own to support investment and consumption targets depends upon large amounts of foreign financing to sustain economic growth and living standards. Eventually, reserves and foreign debt become major constraints to continued expansionary policies, forcing policy makers to adopt austerity measures curtailing the gains obtained in the previous cycle.

In 1983, the Government of Portugal took a number of steps to correct both the external imbalance and the growing budget deficit. After taking office in June 1983, the newly installed government put into place a major stabilization program in preparation for of an IMF Stand-by Agreement. The new government pledged to continue the 1% monthly depreciation of the exchange rate and reaffirmed the previous government's commitment to maintain real rates of interest. Prices of many agricultural raw materials and foodstuffs were also raised. The import surcharge was raised and the monthly depreciation of the currency was stepped up from 0.75% to 1.0% per month. The interest rate on one year time deposits and commercial lending rates were raised to real positive levels.

The counterpart to domestic economic contraction was the improvement in the trade deficit. The currency devaluations coupled with restraints on growth in aggregate domestic demand led to sharp improvement in Portugal's external accounts. The current account deficit declined from its high point in 1981-82 of 20% of GDP to 6% in 1984 and an expected 2% in 1985. Merchandise exports increased in real terms while merchandise imports declined by roughly 5% annually. Workers' remittances rose but slightly from the 1982 level due to inadequate domestic interest rates. Exports grew by an annual average of over 15% in the two year period 1983-84. However, industrial investment was only modestly affected since export expansion was taken up by idle industrial capacity in the manufacturing sector.

IV. SUMMARY OF ECONOMIC DEVELOPMENTS

A. Domestic Demand & Production

As seen below, Portugese economic performance over the past five years reflects the balance of payments constraints to pursuing domestic economic goals. Government policy has avoided tackling major structural imbalances and concentrated on monetary controls to correct balance of payments deficits. To counteract the repressive influence of restrictive credit and high interest rates on economic activity the budget deficit has expanded. Thus domestic growth stimulated by large budget deficits has usually been accompanied by double digit domestic inflation and large percentage increases in imports. As a consequence, sole reliance on restrictive monetary policy to improve the balance of payments and curtail import demand has also hampered investment and growth of the domestic economy.

The resulting instability over the past five years is demonstrated by the sharp fluctuations in output growth and continued stagnation in investment . Gross fixed investment declined in real terms in 1984 contrasted with a 2 year consecutive increase of 14.5% in 1981 and 1982. In 1985, public consumption is expected to drop, reflecting the government's success in slowing down new employment .

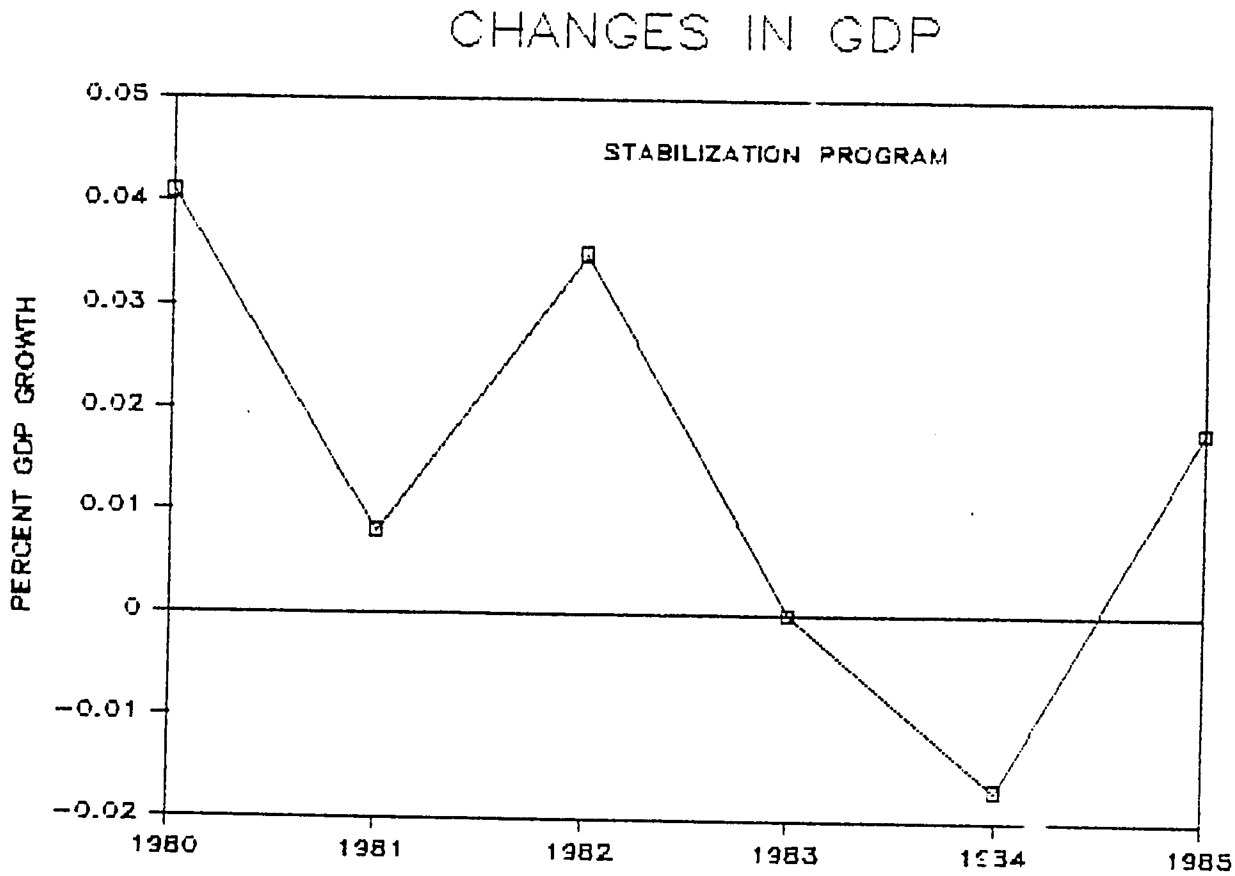
B. Sectoral Output

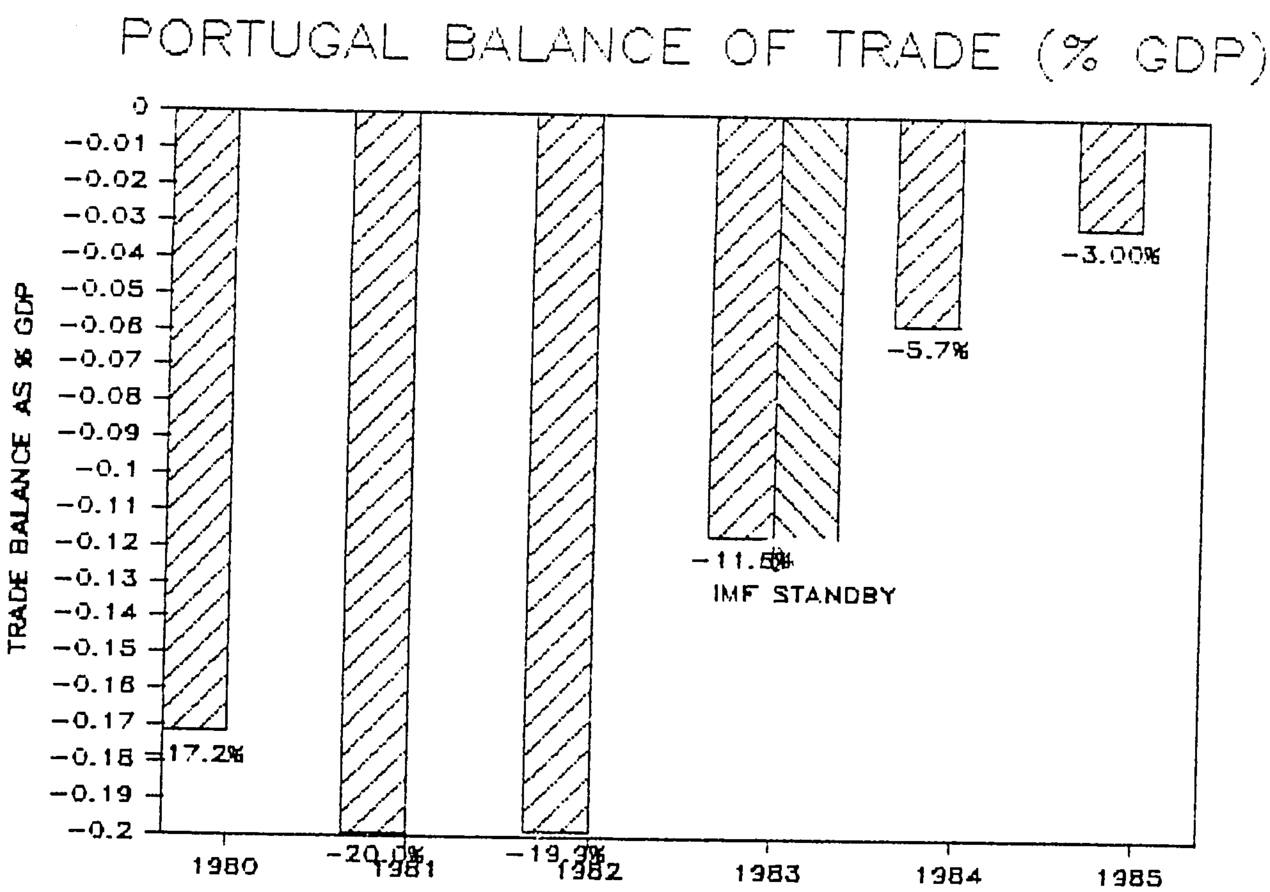
The changes in the major sectoral components of the economy mirror the turns in government economic policy.

Agricultural production has stagnated since 1981. Annual output declined by an average 3% in real terms over the 1981-84 period. Production rose by over 4% in 1982 due to improved weather conditions. Aside from the year-to-year variability in individual harvests due to the weather, productivity has also declined since 1981.

PORTUGAL NATIONAL ACCOUNTS, 1980-85

IN BILLIONS AT 82 PRICES	1980	1981	1982	1983	1984	1985
GROSS DOMESTIC EXPENDITUR	2072.8	2139.1	2212.4	2020	1917.4	
CONSUMPTION	1454.1	1497	1530.8	1528.9	1495.3	
PRIVATE	1210.9	1238.7	1263.5	1250.9	1213.4	
PUBLIC	243.2	258.3	267.3	278	281.9	286.1
Gross Domestic investment	618.7	642.1	681.6	531.1	422.1	
fixed capital formation	542.2	567.2	583.6	539.8	442.6	414.7
inventory change	76.5	74.9	98	-8.7	-20.5	
Trade balance, gdfs	-303.8	-355.9	-366.8	-214.4	-103.2	
exports	471.7	462.3	492.3	576	659.5	
imports	775.5	818.2	859.1	790.4	762.7	
Gross Domestic Product,mp	1769	1783.2	1845.6	1845.6	1814.2	1846.9
annual percent change	4.10%	0.80%	3.50%	0.00%	-1.70%	1.80%
AS PERCENTAGE OF GDP			4.5%			
CONSUMPTION	82.2%	84.0%	82.9%	82.8%	82.4%	
PRIVATE	68.5%	69.5%	68.5%	67.8%	66.9%	
PUBLIC	13.7%	14.5%	14.5%	15.1%	15.5%	
Gross Domestic investment	35.0%	36.0%	36.9%	28.8%	23.3%	
fixed capital [illegible]mation	30.7%	31.8%	31.6%	29.2%	24.4%	
inventory chan[illegible]	4.3%	4.2%	5.3%	-0.5%	-1.1%	
Trade balance, gdfs	-17.2%	-20.0%	-19.9%	-11.6%	-5.7%	-3.00%
				-12.5%		
exports	26.7%	25.9%	26.7%	31.2%	36.4%	
imports	43.8%	45.9%	46.5%	42.8%	42.0%	
Gross Domestic Product,mp DEFLATOR	19.3%	18.1%	21.4%	24.0%	25.5%	20.7
Real Effect Exchange Rate ('1979=100)& 79/80weights	102.4	107.6	105.8	97.2		


CHANGES IN GDP
STABILIZATION PROGRAM
PERCENT GDP GROWTH
0.05
0.04
0.03
0.02
0.01
0
−0.01
−0.02
1980
1981
1982
1983
1984
1985


PORTUGAL BALANCE OF TRADE (% GDP)
TRADE BALANCE AS % GDP
0
−0.01
−0.02
−0.03
−0.04
−0.05
−0.06
−0.07
−0.08
−0.09
−0.1
−0.11
−0.12
−0.13
−0.14
−0.15
−0.16
−0.17
−0.18
−0.19
−0.2
17.2%
−20.0%
−19.9%
−11.5%
IMF STANDBY
−5.7%
−3.00%
1980
1981
1982
1983
1984
1985

Industrial and manufacturing output had been the main beneficiary of government expansionary policies in the 1980 - 1982 period. Although benefitting somewhat from the expansion in export demand in the last 2 years, the contractionary stabilization policies inaugurated in 1983 severely limited the growth of the domestic market. Industrial production has been sluggish. Output of manufactured products grew by 1% in 1983 and declined somewhat in 1984, compared with an average annual rate of growth of 4.7% between 1978 and 1982. At the same time, those industries geared to the export market exhibited high growth.

C. Employment, Wages and the Labor Force

Since 1976, the government has recognized that wage restraint is central to stability in the balance of payments. Since that year, some form of wage restraint has been part of the government's macro policy program. Wage settlements since 1980 have been held to 19% per annum. As the annual inflation rate has averaged over 21 % during the period, real wages have declined by about 15 percentage points over the 4 year period 1981-84.

Despite the decline in the real wage rate, unemployment remained at about 10% over the past five year. The civilian labor force grew at an average annual rate of 1 percent while total employment expanded at a somewhat higher rate of 1.2%, just about taking up the increases in the labor force caused by a higher participation rate. In 1983, a new more accurate survey indicated an unemployment rate of about 10% Meanwhile unofficial, non-government sources, report a still higher level of 13%.

The construction sector has been particularly affected by sluggish domestic growth and government regulations. Actions such as rent control and a freeze on rent levels act to intensify an acute housing shortage as well as restricting construction activity and employment growth in the sector.

In Portugal as in many developing countries, the rate of unemployment is only the most visible part of a much larger employment problem. Government regulation of prices, employment and investment decisions, acts as disincentives. Responding to subsidies and a distorted domestic price structure, investment takes place in industries with a high capital and import component and for which external demand is slight or production not internationally competitive. As a consequence of the government's failure to create an environment which channels investment according to sound economic criteria, and sluggish demand for output, unemployment coexists with underemployment. Return on investment is relatively low and results in relatively low output.

D. INFLATION

Between 1980 and 1984 consumer prices grew at an annual average of 23%, one of the highest rates in Western Europe. While there are some indications that the rate may have slackened off in 1985, a persistent feature of Portugal's economy in recent years has been the inability of the government to depress the rate of inflation much below 20%. Without greater control on the fiscal deficits, the economy will continue under the pressure of excess demand.

Price increases over the past 3 years, are largely associated with changes in administered prices. The pervasive system of direct and indirect price controls subject about one-half of the items on the consumer price index to some form of price fixing. Thus substantial increases in government administered prices, e.g., utility tariffs, and basic food items, which had not kept pace with market trends, accounted for about one-third of the increase in the housing and the food component of the price index in the second and third quarters of 1984.

Likewise, delays in raising administered prices in the latter part of the year contributed to the slowdown in the rate of inflation. In order to make up for past pricing mistakes, the government continues to adjust relative prices by gradually raising administered prices to market levels usually when pressured by external deficits. In line with this policy, the government in early December, 1985, announced price increases covering fuel products, transport prices, telecommunications, fertilizer, and basic foods. Including these increases, the government has optimistically projected a 14% inflation rate for 1986.

In 1985, continuation of contractionary policies, together with a levelling off in the growth of domestic credit and a further drop in the real wage component, probably held inflation to about 20%, below recent levels. Portugal's inflation rate also reflects the importance of "imported" inflation. The large and growing imported share of food and fuel products has made the price level sensitive to external market trends. In addition a deterioration in the terms of trade has contributed to the pressure for successive currency devaluations which have added upward pressure to the price level.

Government Fiscal Ratio's

As Percent GDP	1980	1981	1982	1983	1984	1985 (es
Revenues	31.50%	31.40%	31.30%	34.30%	32.70%	32.30%
Expenditures	41.40%	42.20%	41.70%	42.70%	41.80%	42.80%
Cash Deficit	20.60%	21.60%	23.30%	15.10%	17.60%	17.40%
Money Supply, % Change, M2	34.80%	28.60%	26.40%	19.90%	27.10%	28.40%
GDP Deflator	19.30%	18.10%	21.40%	24.00%	25.50%	20.00%

E. Government Finances

Throughout the post-1974 period, the major weakness in economic policy has been large fiscal deficits. The overall budget deficit grew from 7 percent of GDP in 1977 to over 10 percent in the 1980 thru 1984 period. The deficit in 1985 again was probably over 10 percent of GDP. There have been three major reasons for the deterioration:

--the growth of public sector employment, by more than 50 percent since 1974;

--budget subsidies and deficits of public enterprises unable to internally generate sufficient revenue to cover costs due to government imposed price ceilings;

--a large and rapidly growing element of transfers and welfare payments in the budget.

Expenditures. In the period following 1974, fiscal policy was mainly shaped by welfare considerations. The public sector assumed the primary responsibility for employing Portugese nationals returning from the colonies and improving their social condition thru transfer payments. Following the serious balance of payments crisis of 1977, and consequent deterioration of Portugal's external credit rating, the government took concrete steps to reduce these transfer payments. However, the expenditure level is so high and the fiscal gap so large that the political feasibility of reducing government expenditures is questionable so long as unemployment remains high and real wage rates are declining.

Current expenditures exceed current revenues by over 20%, one of the highest ratios in OECD countries. Current expenditures as a proportion of GDP are also high relative to comparable economies in the region, and the ratio is rising: from 35.7% in 1981 to a projected 37.6% in 1985. In order to bring budgeted expenditures to the average of countries with a comparable per capita income levels, Portugal would have to reduce current expenditures by over 25%.

The system of subsidies is pervasive throughout the Portugese economy, not all of them reflected in the national budget. One of the first actions of the new government at the end of 1985 was to consolidate into the budget so-called hidden subsidies; this bookkeeping action raised recorded expenditures by about 5% over their previously estimated levels. To avoid a rise in these payments in excess of inflation the government will need to exercise considerable restraint in the face of strong political pressures. Some steps have been taken in this direction.

Taxes. Government tax revenues have been generally at 30 to 31% of GDP. Over the past five years, the relative importance of various taxes has changed. Taxes on income and property have become more important. These rose from 25% of total tax revenues to 28% in 1985. Unfortunately, the general slowdown in economic activity has meant a lower than expected return from these sources.

Although the tax base has expanded and rates have gone up in the 1980-85 period, the response of taxes to GDP growth is generally considered low. This low elasticity, particularly in relation to income taxes is thought to be associated with widespread evasion among self-employed professionals and businessmen. High rates are thought to be a major encouragement to tax evasion and fraud as well as administrative inefficiency. The government was to have introduced a value added tax (VAT) in mid-July, 1985. The VAT has now been postponed to sometime in 1986.

The aim of the tax measures presented in the 1985 budget was to improve tax equity and efficiency rather than raise rates or impose new taxes. Subsequent estimates have projected a decline in revenue receipts from 1984 levels due to the slowdown in domestic economic activity and postponement in price increases for domestic petroleum products. Although these factors decreased revenue generations, the non-interest portion of current expenditures declined somewhat. Nevertheless, the projected budget is larger than original projections. Fortunately, with the slowdown in domestic activity, the increased budget deficit is not expected to adversely impact on efforts to stabilize balance of payments deficits.

Deficit Impact A serious result of the large government deficits is to push up interest rates and crowd out private sector investment in the financial markets. In addition, the government's budgetary deficits soak up domestic savings and force the public sector to finance investment thru external borrowing due to the insufficiency of their own internal cash generation.

As a result of these restrictions, public sector companies took on excessive amounts of short term external debts in the early 1980's. However, as a consequence of severe balance of payments problems in 1982 , and reluctance of foreign banks to continue lending, public enterprise borrowings fell from 11% in 1982 to 6% of GDP in the following year. In 1985, the borrowing requirements of public enterprises is projected to decline from 7.7% in 1984 to about 6 percent .

Despite this improvement, the capital financing requirements of the public sector represents an extremely large burden. The financial deficit of public sector firms absorbed approximately 40 percent of domestic savings in 1978, 20 percent in 1979 but over 50% in 1984.

The 1985 Budget. The government attempted to rationalize its 1985 budget by 1) consolidating many of the hidden subsidies into on-line budget expenditures; 2) maintaining non-interest current outlays constant in real terms; and 3) enacting a range of measures to improve budget management and expenditure control.

The 1985 supplementary budget was made a more realistic document by its inclusion of the operations of all supplementary funds and hidden subsidy elements . In addition, the government made full payment on past arrearages to parastatal organizations . While these adjustments raised the estimated budget deficit by 40%, the resulting figures presented a more accurate picture of government fiscal operations.

F. Resource Mobilization

The large share of the budget deficit in the economy, the underdeveloped nature of Portugal's financial markets and poor financial performance of public enterprises have distorted the allocation of savings in the economy and perpetuated the existing inefficient industrial structure.

The government has primarily relied on the banking system . The commercial banking system thru its widespread network of offices accessible in even small villages, and usually, the only channel available in the rural areas and small cities has been the depository for household sector savings. With the household sector responsible for over 70% of total savings, the public sector deficits have been financed from household savings.

In addition to the inflationary imptact which this type of government borrowing imparts to the economy, the non-availability of alternative savings institutions has worked to keep commercial banks' portfolios in short term instruments of one year or less: over four-fifths of commercial bank lending was in this category.

Time deposits as a share of total bank savings are increasing. Thus commercial banks could safely lengthen the maturity profile of their portfolio without adverse consequences. With these deposits representing virtually the sole outlet for financial savings, and with government imposed ceilings on the growth of bank credit, the national treasury has had a captive audience for financing its deficits at relatively low interest rates. (Treasury deficits have been traditionally financed by the Bank of Portugal which in turn sells government paper to the banks to absorb a large part of the excess liquidity. Typically, rates in the interbank bond market have been negative in real terms.)

As a first step in a reform process, the government recently announced a package of measures aimed at reducing the cost of bank credit to non-government entities who have been crowded out of the savings pool by the deficit financing needs of the government. Short-term government paper was made available for sale to non-bank public and the public sector's arrears to the banking system were consolidated. A main focus of government policy in this area has been to protect the incentives to migrant workers' remittances. These account for almost half of total household savings. To do this requires a two tier policy of low rates on domestic household savings (to protect government access to cheap credit) and real positive rates on migrant worker deposits.

V. EXTERNAL DEBT

With the rapid accumulation of external debt, Portugal's debt service ratio climbed rapidly from 14.6% in 1980 to 27.3% in 1982. After a near doubling in external debt (including short-term) from $7.3 billion at the end of 1979 to $13.5 billion in 1982, external debt rose by less than $2 billion from 1982 to an expected 1985 year end level of slightly less than $15 billion. Short-term debt was estimated to comprise about 27% of total debt in 1983; in amount it is slightly below the peak of almost $4 billion recorded in 1982. Reflecting both the slight reduction in short-term debt and the slowing down of external borrowing, it is estimated that the debt service ratio will rise but modestly in 1985 to under 32% at the end of 1985.

External Debt & Debt Service Payments

	1980	1981	1982	1983	1984
Billions of dollars & percent					
Total external debt	$8.9	$11.0	$13.7	$14.5	$14.9
of which:					
short term	$2.4	$3.3	$3.8	$3.4	$ 3.0
public enterprises	$1.9	$2.8	$2.5	$2.9	$2.7
Debt Service Payments, $	$1.5	$2.1	$2.3	$2.4	$3.3
as % foreign exch (excludes short-term amortization	14.6%	22.7%	27.1%	26.6%	35.5%

Ratio is percent of earnings from exports of goods and non-factor services plus remittances earnings

VI. OUTLOOK

Under its austerity program, the Government of Portugal committed itself to sharp retrenchment in government spending and restrictions on external borrowing. The implied drop in government consumption and fixed public investment will likely lead to further fall in income and output. No new initiatives have been taken by the authorities to suggest a departure from the previous patterns of alternating cycles of growth and retrenchment. With 1985 external deficit returning to manageable levels, the new economic measures adopted by government appear to follow this pattern

Assuming a continuation of the stabilization measures, -- e.g., maintainance of competitive exchange rates, the removal of subsidies , and curtailment in domestic demand -- merchandise imports in 1986 are not projected to exceed 1985 dollar levels. Wage restraint coupled with enhanced export profitability caused by the continuing depreciation can be expected to improve export performance. Economic recovery in Western Europe plus Portugal's comparative cost advantages in tourism are likely to bolster earnings from tourism, while higher interest rates on time deposits, reduced inflation, and a competitive exchange rate will preserve balance of payments stabililty in the medium term. Under these conditions, the current account deficit is unlikely to exceed 5% until 1988.

With the rapid rise in medium and long-term debt and the expiration of grace periods, Portugal's amortization payments on maturities of over one year will be larger in the medium term. To contain further rises in debt service, future external borrowings should be undertaken only after prudent examination and assessment of the productivity from the investment of borrowed funds. The constraint on future external borrowing underlines the importance to Portugal of improving agricultural production and export performance. With the exercise of prudent economic management guidelines, total debt service can be kept at no higher than 30%, a manageable figure.

VII. SUMMARY OF U.S. ECONOMIC ASSISTANCE

From an initial emphasis in 1975 on helping in the resettlement of refugees from Africa, U.S. assistance programs shifted to loan programs for social infrastructure. Between 1975 and 1977 eight loans and two housing guarantees were made in the areas of low income housing, school construction, basic sanitation, and rural health. In support of Portugal's 1977 stabilization program, a loan of $300 million for balance of payments support was extended to Portugal in FY 1978. Since then U.S. assistance has been earmarked to assist development and mutual security interests, through cash transfers Emergency relief was also provided in the wake of the 1980 earthquake in the Azores. PL 480 Title I assistance was extended to Portugal from FY 1976 through FY 1980 in order to help finance needed food imports. The new base right agreement stipulates a doubling in the amount of annual cash transfers to $40 million, commencing in FY 1984, which increased to $80 million in FY 1985. Annual committments of AID and PL 480 assistance to Portugal are shown in the table below:

Summary of U.S. Economic Assistance Committments to Portugal
($ millions)

FY'80	FY'81	FY'82	FY'83	FY'84	FY'85	FY'86 (Request)
20.0	20.0	20	20	40	80	80