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SUMMARY OF FINANCIAL MARKETS IN PORTUGAL: SECONDARY SOURCE SURVEY

Bureau for Private Enterprise
U.S. Agency for International Development

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NOTE

This document was prepared by Arthur Young and summarizes existing literature describing the country. Secondary sources were obtained from the International Monetary Fund, the World Bank, the Inter-American Development Bank, the African Development Bank, the Asian Development Bank, the United Nations, and other relevant commercial sources.

PORTUGAL

SUMMARY OF FINANCIAL MARKETS SURVEY

A. ENVIRONMENT

1. Political climate
The right-wing dictatorship of Dr. Caetano overthrown by a military coup in 1974. His predecessor, Dr. Salazar, had held power for 40 years until he resigned due to ill health in 1968. Many changes were implemented immediately after the revolution. The colonies of Angola, Mozambique, Guinea Bissau and Cape Verde were granted independence. Political parties and free trade unions were allowed; censorship was lifted. Major economic changes were also enacted immediately following the coup, including the nationalization of several economic sectors, including banking. The new constitution committed Portugal to socialism.

There have been several changes in leadership since the 1974 revolution, with most of the administrations being socialist in orientation. Dr. Mario Soares, head of the Socialist party, has led a coalition government since 1982. Soares has implemented several measures aimed at strengthening Portugal's economy including negotiating entry into the EEC, implementing a severe austerity program, and opening the banking, insurance, cement and fertilizer industries to the private sector. Soares was re-elected in February, 1986 by a narrow margin. The coalition has held together, but with difficulty, due to dissension within the Socialist Democrat party (PSD) and the necessity of implementing austerity measures.

2. Economic climate

Portugal is the poorest Western European country. Its weak economic position is attributable to internal as well as external factors. The country has a small, open and semi-industrialized economy, and is heavily reliant on energy and raw material imports. Exogenous factors which have affected Portugal's economy include the recent recession in international trade and oil price increases. As Portugal's imports have traditionally been US dollar-denominated, the recent strength of that currency impaired Portugal's terms of trade. Also, high international interest rates increased the country's external debt service. Finally, a severe 3-year drought which began in 1980 increased an already high demand for agricultural and energy imports.

Portugal's economic position should improve considerably in light of the current drastic drop in oil prices (currently aproximately US$14 per barrel, and expected to fall as low as US$10 per barrel; the price was US$30 in September, 1985), falling international interest rates, and the decline in the international market value of the US dollar. These factors should combine to lower Portugal's inflation rate and to lower the cost of servicing foreign debt. Further, as Portugal is now a member of the EEC, the strength of the escudo and the country's terms of trade will be determined more by European currencies than the US dollar.

The current administration is strongly in favor of free market operation of the economy. To this end, GOP has implemented austere policy measures designed to stabilize the economy and to set the framework for a modern market economy and for EEC membership. These measures have been highly successful, although the economy still has some serious structural problems.

3. Stable social climate
   Portugal has a stable, homogenous social structure. The population is predominantly Roman Catholic; Portuguese is the official language.

4. International trade agreements

   - European Economic Community (EEC)
     Portugal became a member of the EEC on January 1, 1986. Accession was originally targetted for January 1, 1984, however negotiations were delayed due to complications with Spain's entry (which created problems for EEC agricultural policy), and to financial crisis within the EEC. It remains to be seen how EEC membership will affect Portugal's economy.

   - European Free Trade Association (EFTA)

   - General Agreement on Tariffs and Trade (GATT)

B. <u>ECONOMY</u>

1. Balance of payments
GOP has made significant progress in reducing the current account deficit through economic stabilization policies. The current austerity program, implemented in conjunction with an IMF stand-by agreement and in an attempt to prepare the economy for EEC membership, included the following measures:

   - devaluation of the escudo 12% in effective terms in June, 1983

   - increase in utilities tariffs to improve the financial position of parastatals

   - reduction of subsidies in an effort to lower the GOP deficit and implement a more realistic price/cost relationship

   - freezing of public sector investment program

   - increase in interest rates to tighten credit expansion

The economy reacted well to the stabilization measures, achieving the principal objectives of the 1983 IMF agreement. The current account deficit was US$1 billion in 1983, well below the US$2 billion IMF target; in 1984 the deficit was US$514 million, less than half of the targetted US$1,250 million.

2. Inflation
Inflation has been a problem in Portugal since the early 1970s. Several factors have contributed to the country's high inflation rate:

- a severe 3-year drought beginning in 1980 reduced crops by 15-20%, increasing an already high demand for imports;

- the strength of the US dollar relative to the escudo increased the price of imports, as most imports were US dollar denominated (as previously mentioned, with EEC membership Portugal will be less impacted by the US dollar);

- the second round of oil price increases;

- GOP reduction of price subsidies in 1982; and

- the continuing depreciation of the escudo.

The inflation rate peaked at 33% in 1984; it is currently estimated to be between 22-25%.

3. Public sector
Since 1974, GOP revenues have grown, but not as rapidly as government expenditure, which grew from 21.6% of GDP in the early 1970s to 36% in 1978. This growth is due to expanded social welfare and education systems; a pricing policy which held public service prices down to contain inflation; policies which bolstered income and employment while the economy was absorbing residents of former colonies; and financial difficulties of nationalized enterprises.

Since 1978, successive governments have attempted to reduce the budget deficit by reducing GOP expenditures; the current administration is tackling the deficit from the revenue side as well with a 30% nominal increase in direct taxes in 1984.

4. Parastatals

a. As discussed in Section A, many industries were nationalized after the 1974 revolution. The current administration has opened the banking, insurance, cement and fertilizer industries to the private sector. GOP has not, however, relinquished control of existing parastatals in those industries.

b. GOP retains control over certain manufacturing sectors; parastatals in these sectors include the following major entities:

- Portucel (pulp and paper)
- Petrofibras (synthetic fibers)
- Siderurgia Nacional (steel)
- Setenave (shipbuilding)
- Quimigal (chemicals)
- two breweries

c. In general, public sector enterprises are characterized by deteriorating financial positions. In order to meet operating expenses, parastatals have been forced to borrow heavily, and recently funds have come increasingly from foreign sources. Public enterprise debt amounted to about US$10.1 billion at year-end 1981, about half from foreign sources. Foreign debt has continued to grow, equalling US$ 8 billion (56% of Portugal's total external debt) in 1983. The decline in oil prices, international interest rates and the international market value of the US dollar will have a positive impact on the condition of Portugal's parastatals.

GOP labor legislation and job protection have been more stringently applied to the public sector than to the private. The resulting increased labor costs combined with the GOP policy of regulated low utility prices has eroded the position of the parastatals.

d. Non-financial parastatals provide 5% of total employment, approximately 13% of total value added to GNP, and almost 20% of total gross fixed investment (based on 1977-82 figures.)

5. Black market
Portugal has a large black market economy, estimated to equal 22% of GDP in 1985. The construction sector, in particular, has a large black market; 40% of the houses constructed in 1982 were built outside the official economy.

6. Labor force analysis

   a. Population: 9.59 million (3rd quarter, 1984)
   Population growth rate: 0.5-0.6% per annum

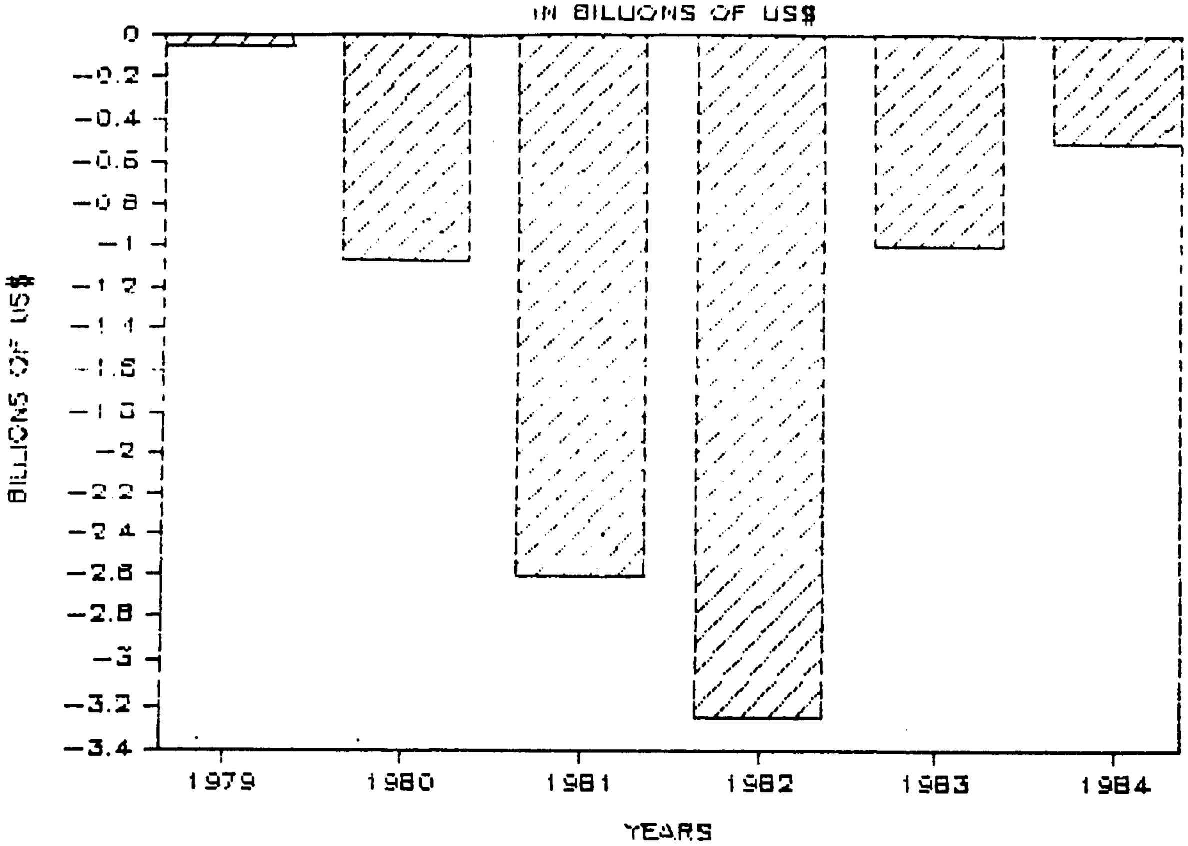
   b. Unemployment
   Unemployment has been rising in Portugal since the 1974 coup when African territories were decolonized. The resulting decrease in the military and influx of refugees from these areas (estimated to be 700,000, and accounting for about 25% of the total unemployed in 1976), combined with the recession in West European economies and resulting decrease in demand for Portuguese emigrant workers significantly increased the work-force. Unemployment reached 10.3% in 1984; this number would be higher if not for GOP policies which have made it virtually impossible to lay off staff in the past. The current administration has lightened controls on lay-offs somewhat; now those enterprises encountering serious difficulties are permitted to lay off employees for up to two years.

   c. The major employers are the agricultural and industrial sectors, accounting for 23.8 and 25.6% of the labor force, respectively.

7. Foreign trade
Portugal has consistently run a trade deficit, but prior to the 1974 coup the deficit was offset by a surplus in invisible transactions and a surplus earned by colonies. The decline in emigrant remittances and tourism earnings, combined with the rapid increase in import prices have seriously deteriorated foreign exchange holdings.

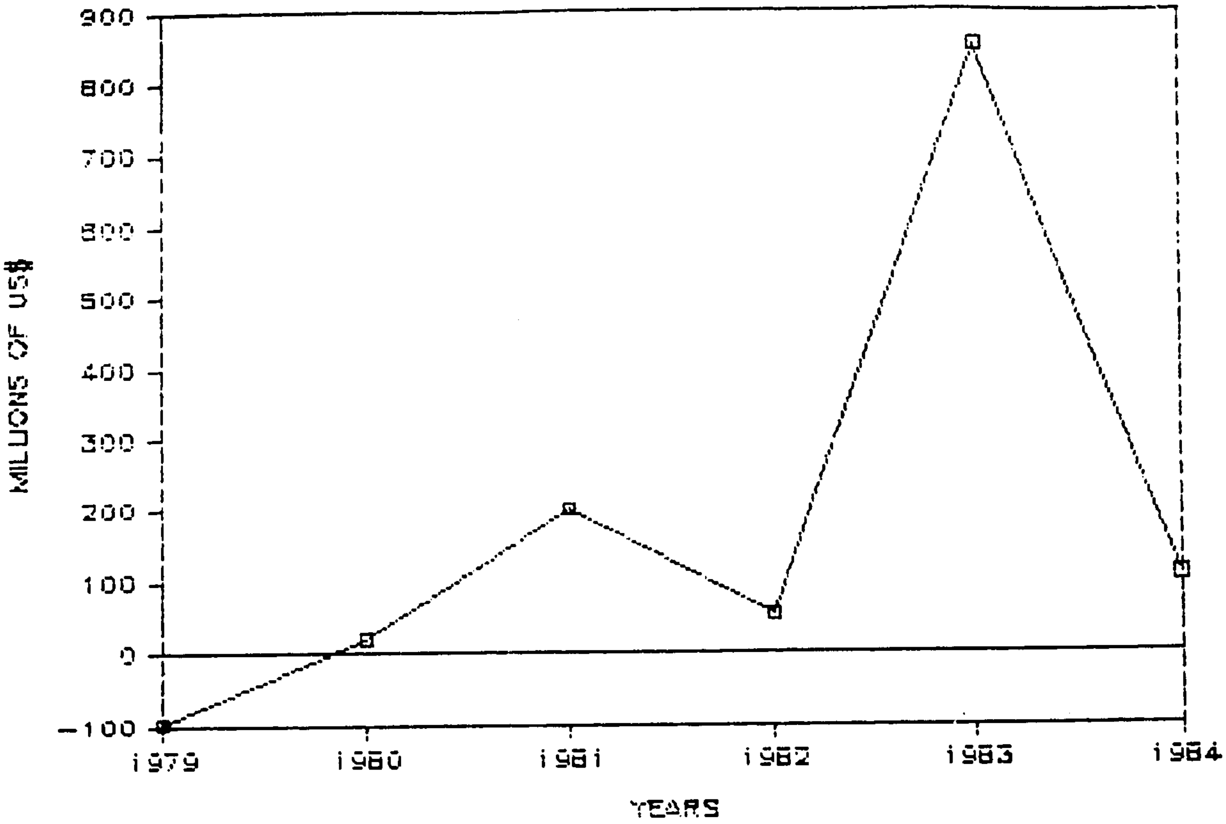
CURRENT ACCOUNT BALANCE

IN BILLIONS OF US$



TOTAL CHANGE IN RESERVES

IN MILLIONS OF US$



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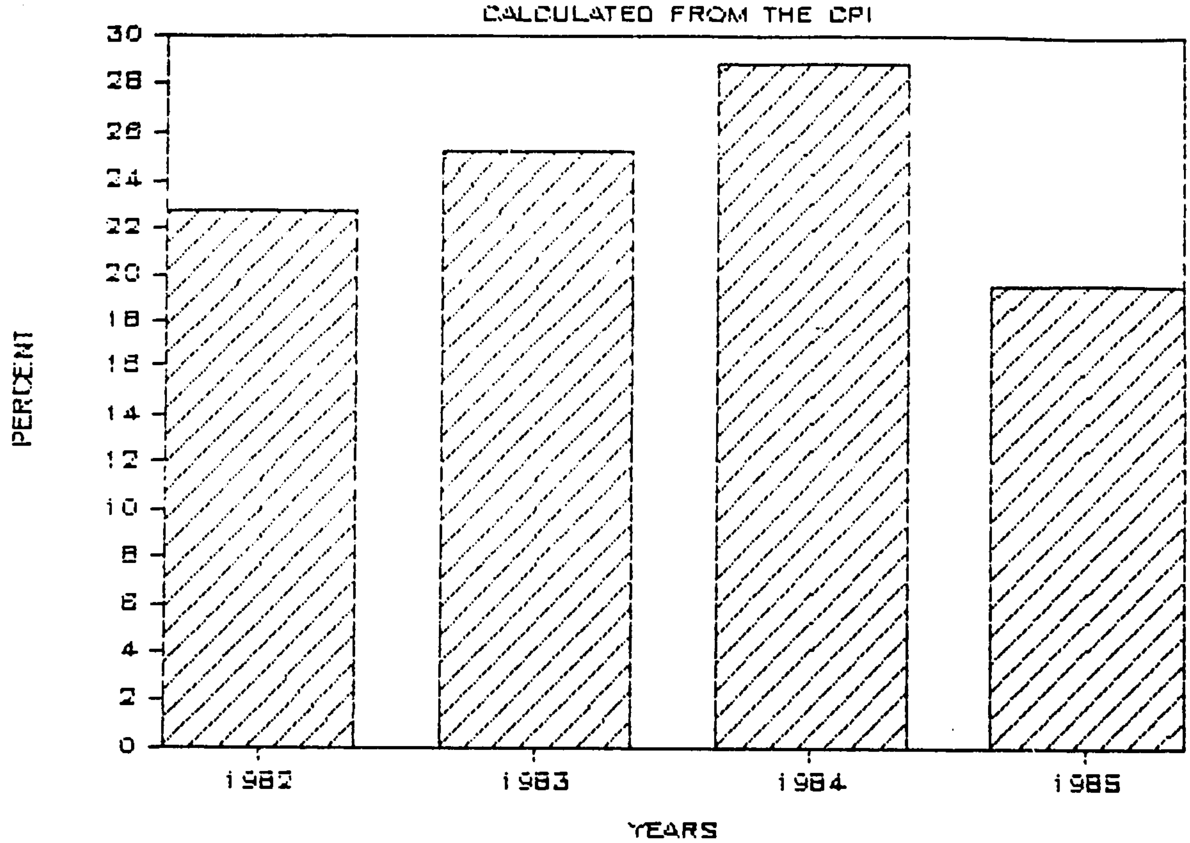
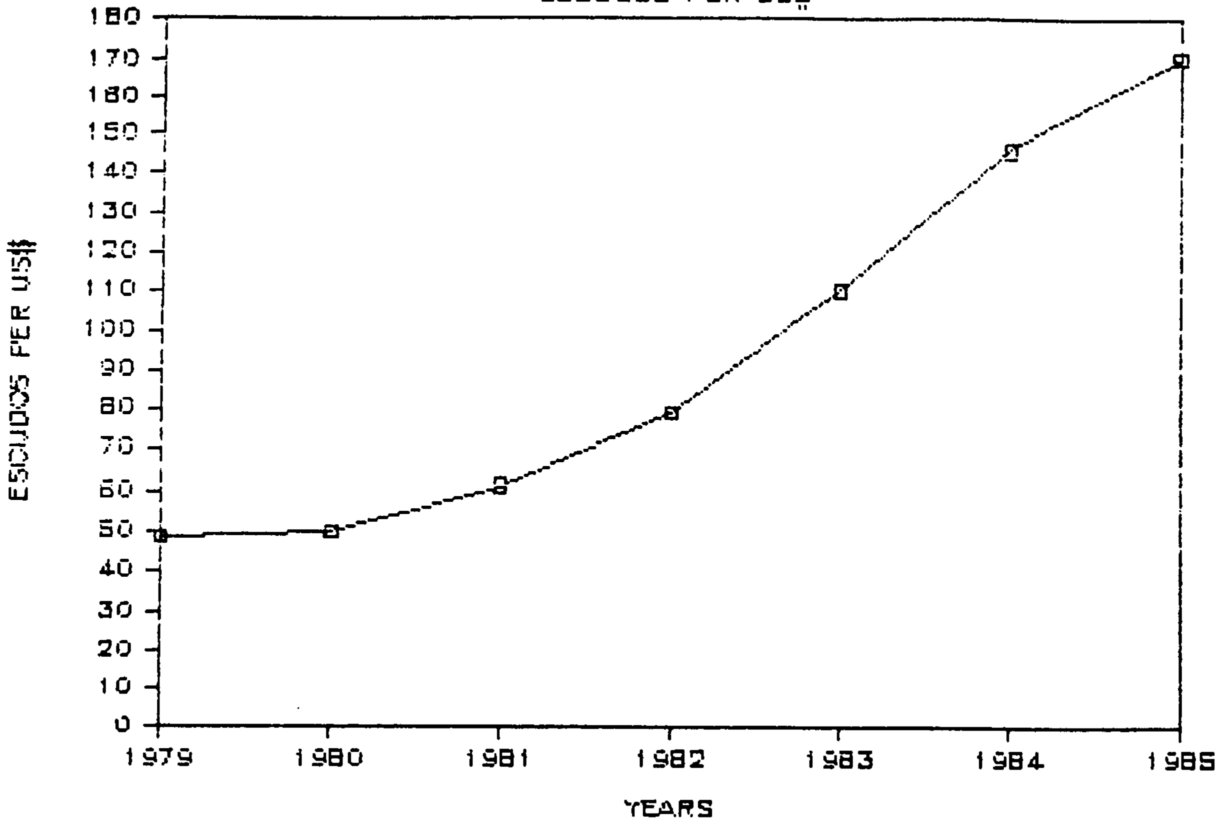
INFLATION RATE

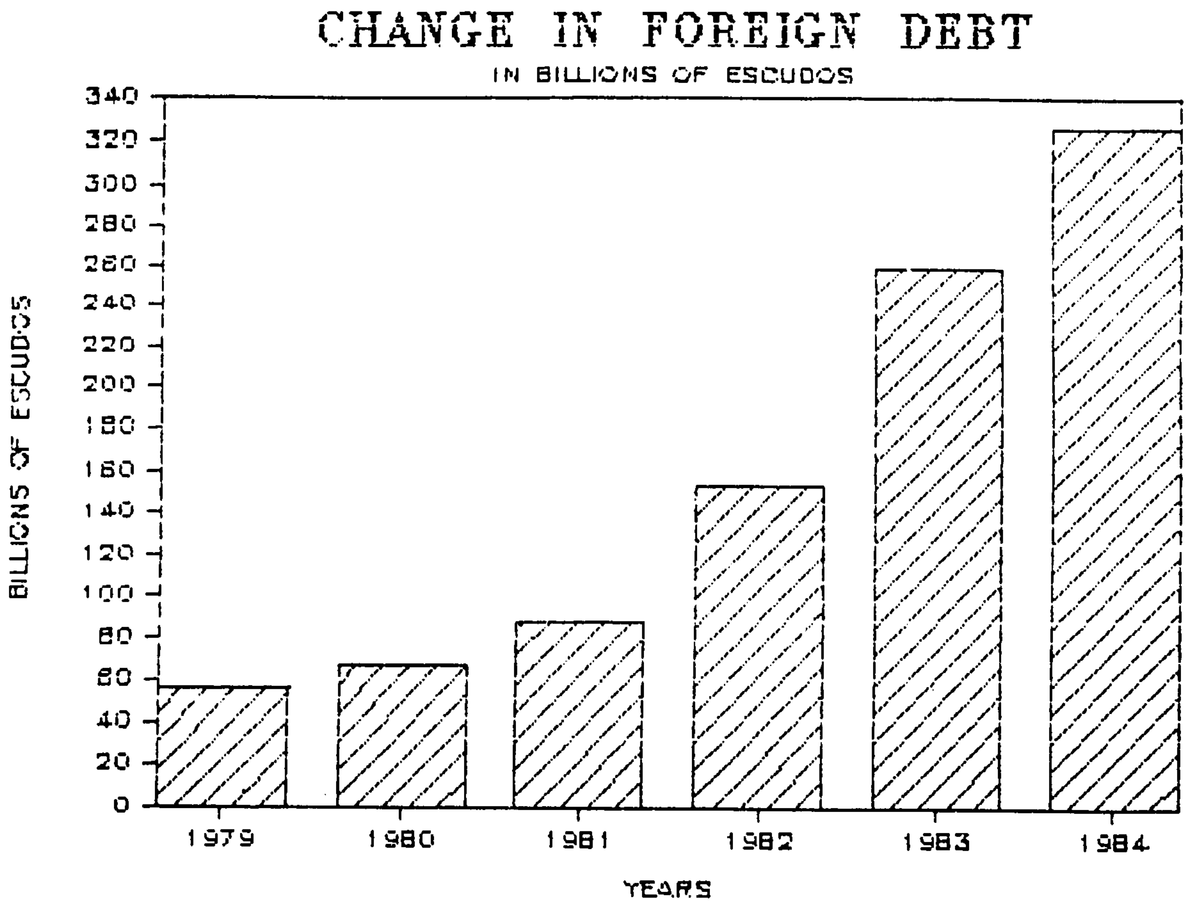
CALCULATED FROM THE CPI



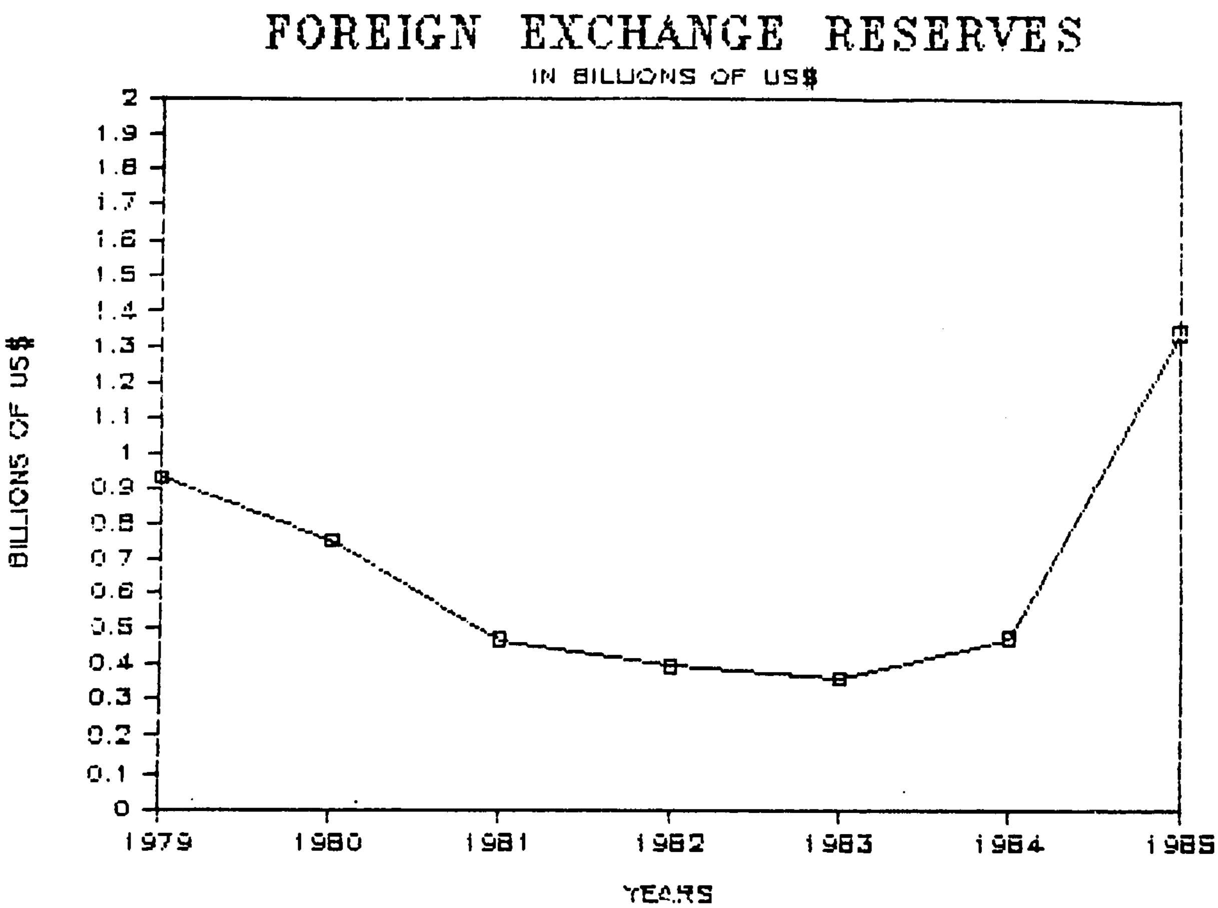
MARKET EXCHANGE RATE

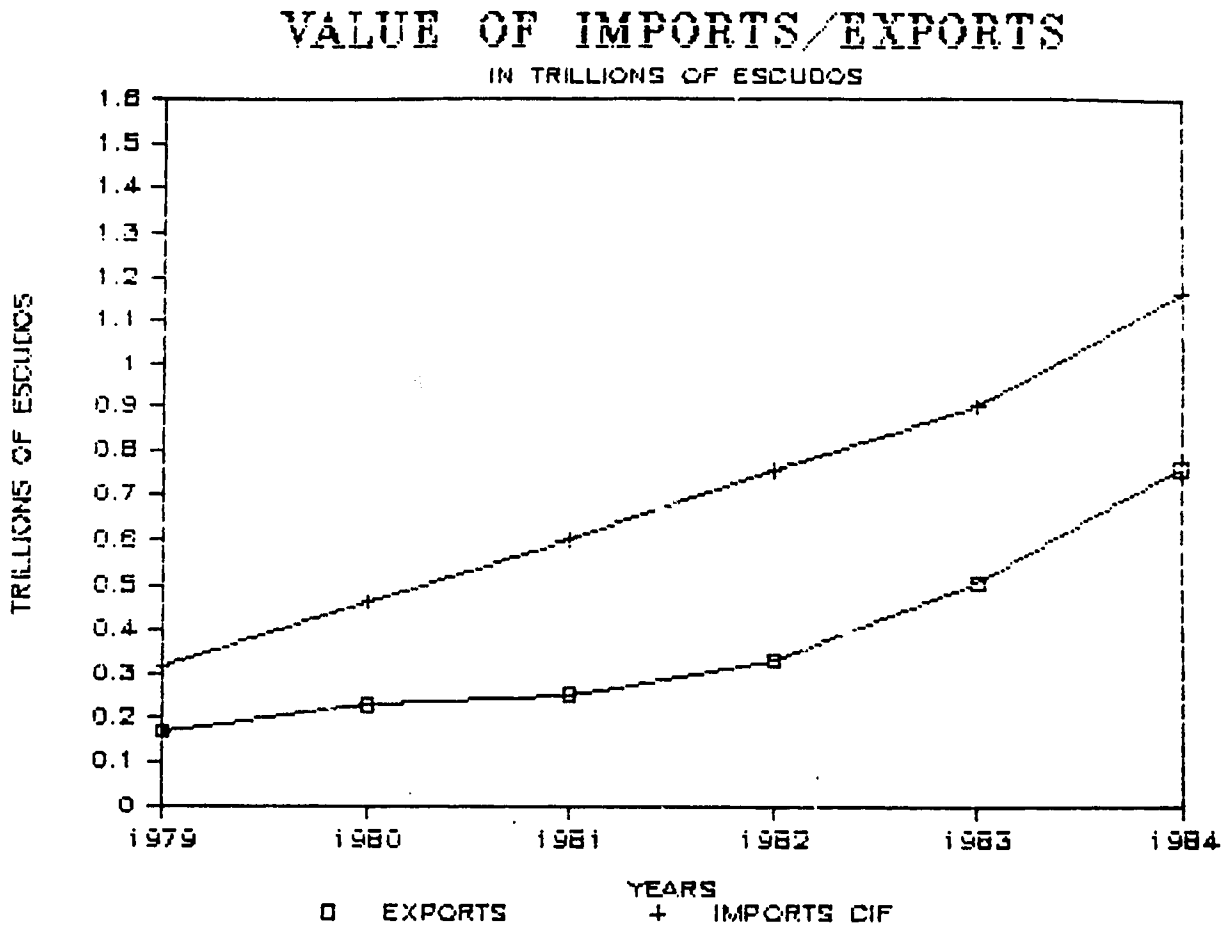
ESCUDOS PER US$



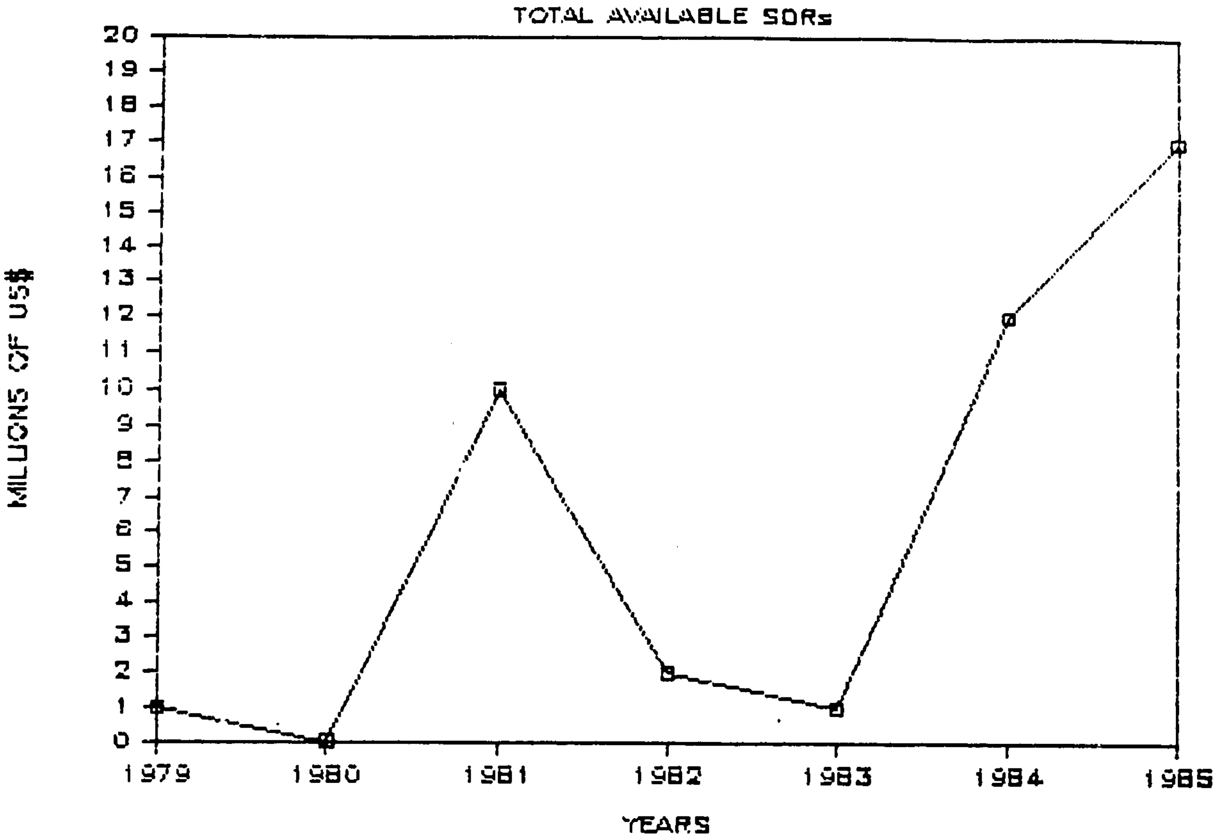

CHANGE IN FOREIGN DEBT
IN BILLIONS OF ESCUDOS
BILLIONS OF ESCUDOS
340
320
300
280
260
240
220
200
180
160
140
120
100
80
60
40
20
0
1979
1980
1981
1982
1983
1984
YEARS

12


FOREIGN EXCHANGE RESERVES
IN BILLIONS OF US$
BILLIONS OF US$
2
1.9
1.8
1.7
1.6
1.5
1.4
1.3
1.2
1.1
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
1979
1980
1981
1982
1983
1984
1985
YEARS


VALUE OF IMPORTS/EXPORTS
IN TRILLIONS OF ESCUDOS
TRILLIONS OF ESCUDOS
1.6
1.5
1.4
1.3
1.2
1.1
1
0.9
0.8
0.7
0.6
0.5
0.4
0.3
0.2
0.1
0
1979
1980
1981
1982
1983
1984
YEARS
EXPORTS
IMPORTS CIF

INTERNATIONAL LIQUIDITY



C. <u>GOVERNMENT ATTITUDES</u>

1. Foreign investment
GOP considers foreign investment important to economic development, and offers tax and non-tax incentives to encourage such investment. However, the system of foreign investment incentives is very complicated and, as such, is something of a deterrent. Currently GOP reviews applications for foreign investment incentives more stringently; specifically, applicants must prove that the investment will benefit the Portuguese economy.

2. Labor legislation
As discussed in Section B, GOP has stringent labor legislation and job protection policies which make it very difficult to lay off employees. These policies have resulted in overstaffing, particularly in the public sector.

D. REGULATORY CLIMATE

1. Exchange controls

   a. All transactions involving foreign exchange require prior authorization. The Foreign Investment Institute (FII) administers capital investment and technology agreements; the Bank of Portugal administers loans; import and export permits are granted by the Direccao Geral do Comercio Externo.

   b. Unlimited transfer of profits and dividends, interest, royalties, and fees is guaranteed for FII approved investments, with certain circumstances requiring Bank of Portugal approval. All transfers relating to an approved investment occur at the prevailing market exchange rate.

   c. Repatriation of capital (including capital gains) is authorized for approved foreign investments five years after entry at a maximum rate of 20% per annum, unless the FII approves a higher rate.

   d. Private individuals are not allowed to take more than Esc30,000 abroad annually without a permit.

   e. In 1980 there were no guarantees against inconvertibility of the escudo.

2. Price controls

   a. Prices have been tightly regulated since the 1974 revolution. Since 1981 price policy has been aimed at liberalizing price controls and reducing subsidies. The current pricing system is still complex, consisting of five general systems:

      - Prices directly fixed or controlled by GOP
        This system applies to certain basic commodities, public utilities, and energy products. These items are highly subsidized; current policy is attempting to reduce subsidies and return to free market pricing of these goods.

      - Declared price system
        This system involves GOP control of prices on an enterprise by enterprise basis for those enterprises holding a large market share.

- Agreed price system
  Groups of enterprises negotiate price increases with the government.

- Unrestricted price system
  These goods and services are exempt from GOP control.

- Price surveillance system
  Enterprises are required to notify GOP of any price increases it cannot oppose.

b. Approximately half the products and services consumed by households are under some form of price control.

3. Import controls
Permits are required for import and export activities, and must be authorized by the Direccao Geral do Comercio Externo in advance. Import quotas exist for certain goods, and it is difficult to obtain import permits for the resale of nonessential consumer products. It is customary, though not required, to engage a local agent to represent a foreign vendor.

E. FINANCIAL SYSTEM

1. Banking system

a. Banking institutions are presented in Appendix A.

b. Nationalization of banking system
In 1975 GOP nationalized all Portuguese-owned banks except for savings banks and agricultural credit institutions. The foreign banks in existence prior to 1974, Credit Franco-Portugais (Credit Lyonnais), Banco do Brasil, and Lloyds Bank International, were not nationalized.

c. Opening of banking system
In order to expand and modernize the Portuguese banking system, and to prepare for EEC membership, GOP opened the banking system to foreign and private competition in 1984. Institutions which have been authorized to begin operations in Portugal are listed in Appendix B.

The Bank of Portugal has control over the admission of the new banks, and has set stringent conditions for entry designed to protect existing banks. Newcomers will be prevented from gaining too profitable a share of the market through a credit ceiling formula which disregards leverage according to capital, but rather weights the system in favor of banks which carry substantial term deposits and grant preferential subsidized credit. As most of the nationalized banks are retail banks, they will feel the impact of the restrictions less than the foreign banks, which will primarily be wholesale banks.

Other restrictions include:

- new banks must have initial capital of Esc1.5 billion;

- at least 10% of net profits must be maintained as reserves;

- Bank of Portugal will determine asset/liability ratios for commercial, investment, and foreign banks;

- Bank of Portugal controls foreign bank resources and fitness for operation by limiting share transfers; and

- Bank of Portugal will regularly review liquidity and solvency, and has the authority to revoke an institution's licence.

As an incentive to new foreign banks, all banks will be allowed to raise capital abroad, provided the term is more than one year; GOP will cover all foreign exchange risks of such new capital.

d. Problems with the existing banking system
The major problem with the Portuguese banking system as it exists today is over-regulation by GOP. As state entities, banks have been forced to lend to ailing sectors of the economy, and to fund the national deficit at below-market rates. Also, as with other public entities, GOP labor policies are more strictly enforced than in the private sector. The banking industry is, thus, incredibly overstaffed; indeed, the banks are the major employers in the economy. The Bank of Portugal has a total staff of 55,000, averaging approximately 40 employees per branch; in comparison, bank branches in Britain, considered to be overstaffed, typically have 16 employees per branch.

e. Changes in the banking system
The advent of the new banks and competition has already initiated changes in the banking system.

- Portuguese banks are becoming more sophisticated, investing in automated teller machines (ATMs) and in centralized data banks to serve the ATMs.

- Competition has ended the traditional practice of requiring pre-payment of interest.

- A wider range of money market instruments and commercial bank services are allowed. In 1981 commercial banks were issuing 3-6 month discounted notes of exchange, and provided promissory notes with withdrawal accounts; the provision of revolving credit was widespread. Information on more recent developments in types of money market instruments provided was not located.

- Two major forms of control have been eased: control of the interbank money market by the Bank of Portugal, and a currency market denominated by the central bank (Bank of Portugal.)

f. Important commercial bank statistics and ratios

Average profit: .3% of total assets
Total intermediation spread: 4.5% of total assets
Net worth/total assets: 2.6%
Profits/net worth: 10%
M1 liquidity ratio: 42%
M2 liquidity ratio: 94%

2. Non-banking financial intermediaries
GOP controls prohibited many types of financial intermediaries for private capital until 1981. Since that time many new financial intermediaries have developed, financed in large part by foreign capital. The impact of the new financial intermediaries has been small in economic terms: the largest investment company, SPI, had total resources of Esc6.7 billion in 1982, as compared to a large commercial bank, Banco Espirito Santo, with deposits of Esc244 billion. The psychological impact is significant, however, as they are restoring the public's faith in private enterprise. Financial intermediaries in Portugal in 1984:

- investment companies - provide medium-term project finance and other merchant banking services; by 1984 there were four investment companies. The investment companies are small, and cannot compete with the banks for private deposits; they do, however, issue debt in the form of easily cashed bonds. Investment companies are excluded from the monthly credit ceilings imposed on new banks.

- leasing companies - have a minimum capital requirement of Esc200 million, half the requirement for investment companies; there were 7 leasing companies by 1984. Leasing companies deal primarily in office equipment, data banks, computers, information systems, copiers, and automobiles. Demand for leasing services has been high: in 1982 new business amounted to less than Esc1 billion, in 1983 the value was close to Esc6 billion.

- insurance companies - the six existing publicly-owned insurance companies held 73% of the market in 1984.

3. Capital markets

a. The Lisbon and Oporto stock exchanges were closed after the 1974 revolution, but were both reopened by 1981; transactions are still below pre-revolution levels. The stock market is not a major funder of business investment, the banks provide most investment resources.

b. The capital market consists almost exclusively (90%) of bond trading due to the lack of credibility of companies. What demand for shares exists is clustered around a few companies.

c. In an attempt to stimulate the capital market, the Banco de Fomento Nacional (BFN), the electricity and telephone utilities, and the state-owned chemical company issued bonds in 1981, the first issued since the revolution. In late 1983 the BFN issued cash bonds. The response to the issues has been good; private companies are now beginning to issue bonds.

d. The flow of issues is fairly regular due to corporate financing and tax incentives which help investors. Corporate bonds usually yield a few percentage points over base rates; interest is paid free of 22% tax levied on bank deposit returns.

e. Maturities are usually in the 5-7 year range. Prior to the recent cash bonds, the stock market was the only source of medium-term fixed rate investment.

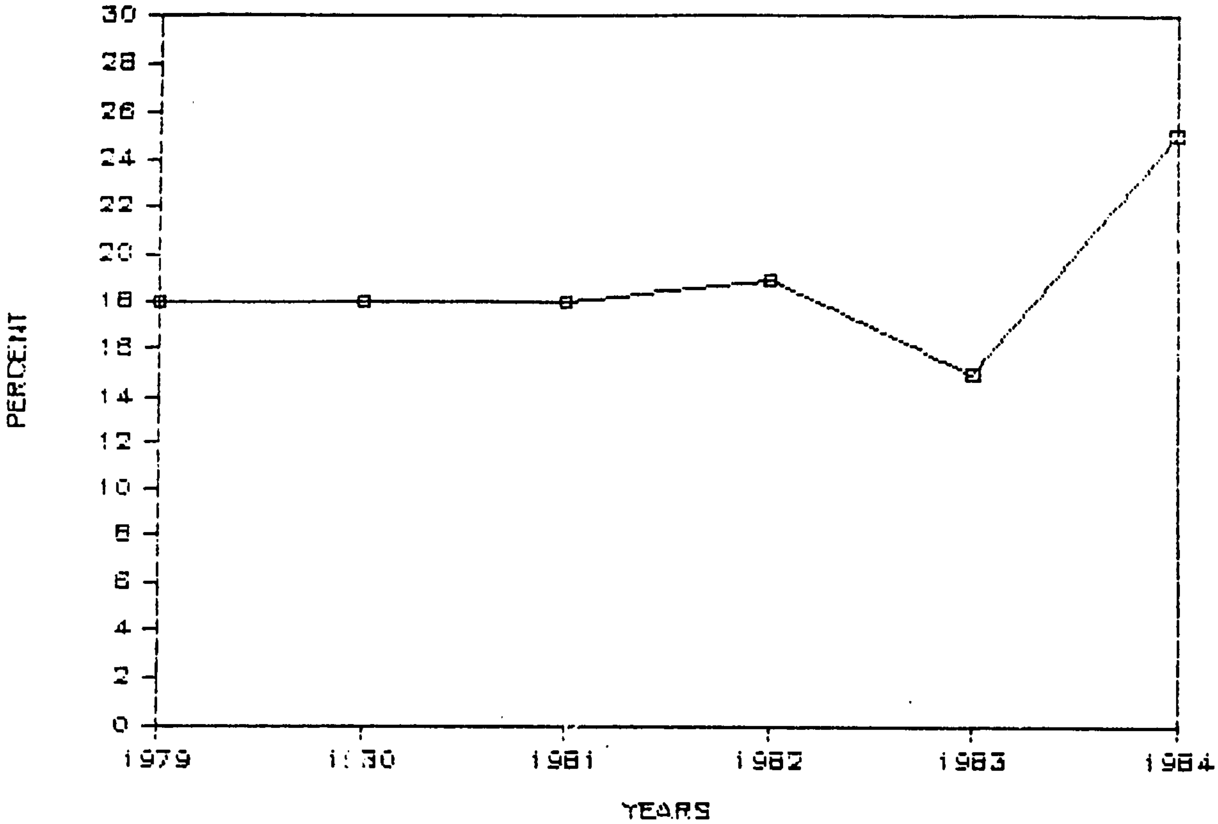
f. New financial instruments have been introduced. New financial instruments in Portugal in 1981 included public and private bond placements, cash bonds and new short-term negotiable treasury bills (GOP's means of financing at flexible interest rates and a boost to the new secondary market.) Other developments include increased activity in the dormant equity market, and a healthy market for fixed rate paper.

g. The parallel market for bond and shares trading is speculated to be significant in Portugal, although no information was located as to its actual size.

h. Foreign companies are allowed to issue capital, though none have done so to date.

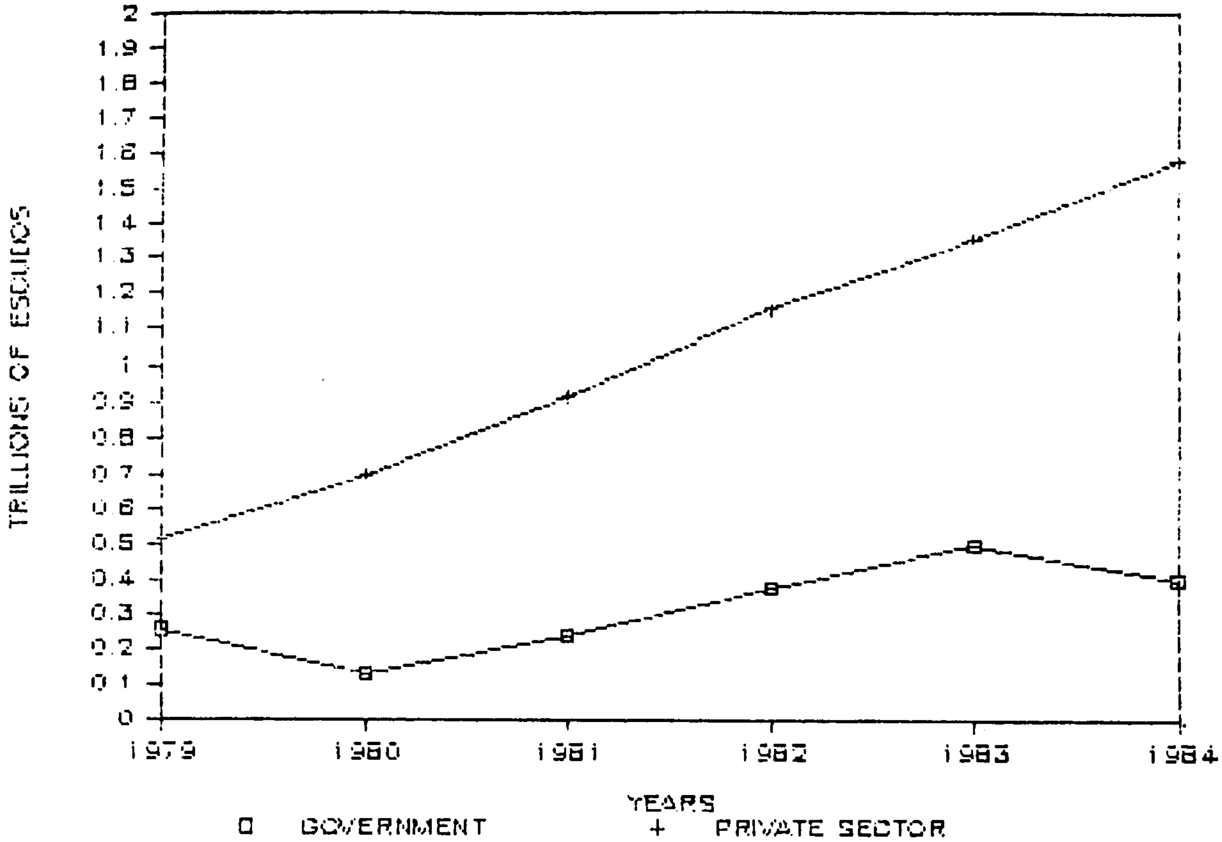
i. Venture capital does not exist as such, however if a project is determined to be of economic value to Portugal, authorities are usually pragmatic in negotiating the financial arrangements.

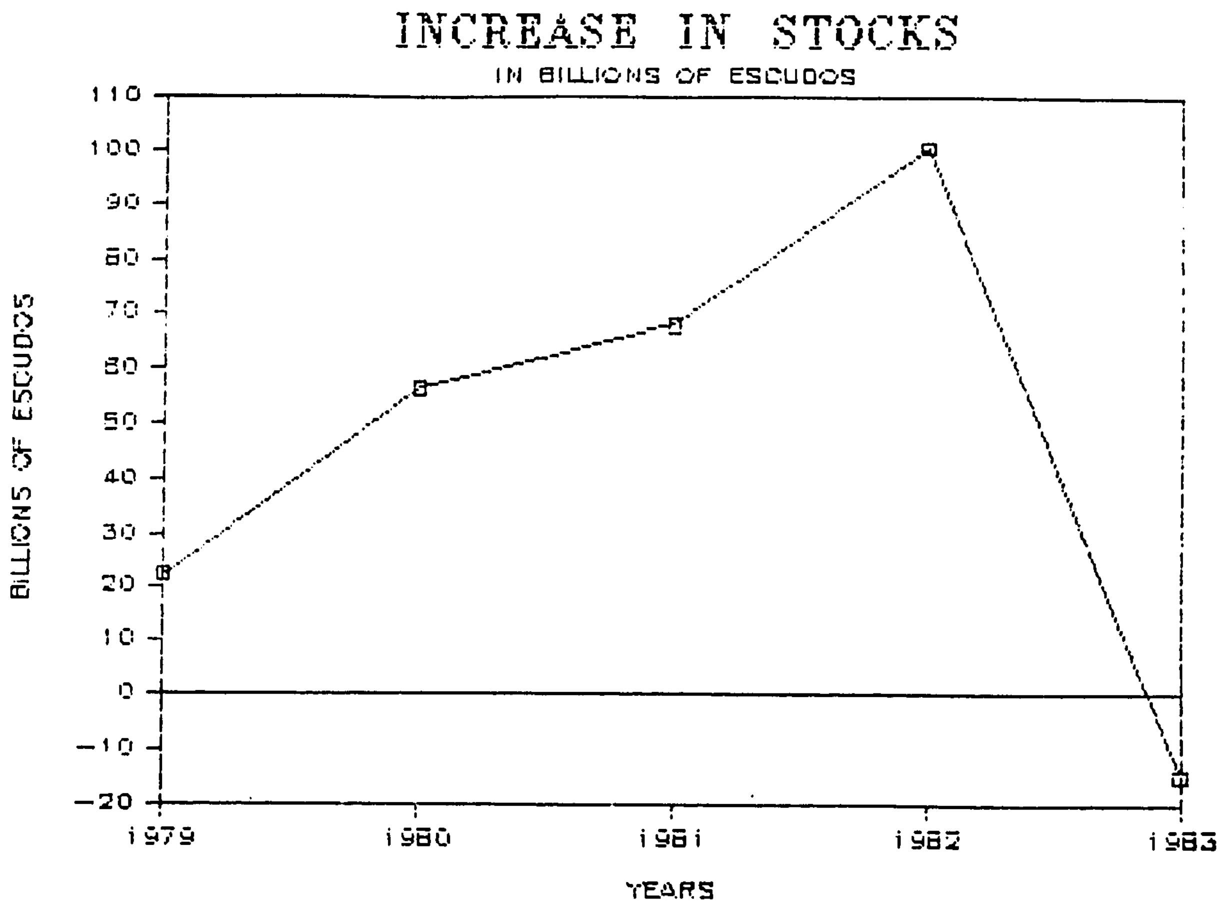
DISCOUNT INTEREST RATE



TOTAL AVAILABLE CREDIT

IN TRILLIONS OF ESCUDOS




INCREASE IN STOCKS
IN BILLIONS OF ESCUDOS
BILLIONS OF ESCUDOS
110
100
90
80
70
60
50
40
30
20
10
0
-10
-20
1979
1980
1981
1982
1983
YEARS

F. TAX SYSTEM

1. The income tax system consists of a unitary tax, a complementary tax (paid on earned and unearned income net of schedular taxes), and a schedular tax (comprised of industrial tax, agricultural tax, professional tax, withholding tax, and real estate tax.)

2. The Portuguese tax system is characterized by a low degree of progressiveness. This is because an unusually high proportion of total tax revenue derived from indirect taxes - in 1981 indirect taxes accounted for 45.1% of total tax revenue, as compared to 30% for other European OECD countries. The major indirect tax is that on transactions, which provides approximately 40% of total indirect tax revenue in spite of being widely evaded.

3. The tax burden on households is moderate, amounting to 5.5% in 1982, 7.8% if social insurance contributions are included.

STRUCTURE OF TAX REVENUE
(Percentage of total tax revenue)

	1978	1982	1983
A. Central Government			
Direct Taxes	35.0	39.2	42.1
Industrial Tax	6.8	10.2	7.8
Professional Tax	11.3	11.2	11.0
Tax on Income from Capital	4.4	10.9	10.5
Complementary Tax	5.2	4.0	3.3
Other Direct Taxes	7.3	2.9	9.5
Indirect Taxes	65.0	60.8	57.9
Customs Taxes	13.1	7.0	6.0
Stamp Duty	11.4	12.0	12.3
Transactions Tax	26.9	25.4	24.0
Car Sales Tax	4.6	6.0	6.2
Tobacco Excise	5.8	6.5	5.9
Other Indirect Taxes	3.2	3.9	3.5
B. General Government			
Direct Taxes	21.5	24.0	24.9
Social Insurance Contributions	26.6	24.3	21.2
Indirect Taxes	45.2	45.1	45.8
Other Receipts	6.7	6.6	8.1

G. ACCOUNTING

1. Corporations and companies are required to maintain a journal, general ledger, minute book of shareholder meetings, and a record of annual financial statements. These books must be stamped by the Camera de Falencias, and must be kept for at least ten years. Records must be centralized under the responsiblity of a registered accountant.

2. Registered accountants
   In order to be registered with the Ministry of Finance, candidates must hold a university degree in law or economics, or have at least five years experience.

3. Registered statutory auditors
   The Chamber of Registered Statutory Auditors, under the jurisdiction of the Ministry of Justice, requires a university degree in economics or law or a technical college accounting diploma, followed by a three year apprenticeship and written and oral examination. Ten years practical experience may be substituted for the apprenticeship and examination.

   By 1980, efforts of the Chamber were devoted primarily to passing legislation to protect the profession, rather than developing accounting and auditing principles.

4. Corporate accounting was traditionally tax-oriented until the national plan of accounts introduced in 1977 emphasized the meaningfulness of published statutory accounts. The plan referred to such concepts as going concern and consistency; defined accounting policies in the fields of foreign exchange, stock valuation, marketable securities, and fixed and intangible assets; and provided for the appointment of a supervisory commission. By 1980, however, the plan seemed to have little effect, as the commission had not yet been appointed; there was no obligation to refer to accounting concepts or policies; and fundamental contradictions between tax allowances and provisions or reserves required under accrual or prudent accounting had not yet been addressed.

APPENDIX A

BANKING INSTITUTIONS IN PORTUGAL

Bank of Portugal
The Central Bank, and the only bank of issue, the Bank of Portugal is responsible for the administration of exchange regulations and the implementation of government monetary policy.

Banco do Fomento Nacional (national development bank)
The Banco do Fomento Nacional provides medium- and long-term credit for industry and commerce, and administers financing facilities provided by EFTA and the World Bank.

Caixa Geral de Depositos (national savings bank)
The Caixa Geral de Depositos has higher deposits than any of the commercial banks. It also grants export credit and medium- and long-term loans up to 20 years to the public and private sectors for economic development and private house construction. The Caixa Geral de Depositos is authorized to place government issues, private securities, etc.

Commercial Banks

Domestic Banks
- Banco Portugues do Atlantico
- Banco Espirito Santo e Comercial de Lisboa
- Banco Pinto e Sotto Mayor
- Banco Nacional Ultramarino
- Banco Fonsecas e Burnay
- Banco Borges e Irmao
- Uniao de Bancos Portugueses

Foreign Bank Branches
- Credit Franco-Portugues (Credit Lyonnais)
- Banco do Brasil
- Lloyds Bank International

APPENDIX B

FOREIGN BANK BRANCHES ESTABLISHED IN PORTUGAL
(as of October, 1985)

Barclays
Banque Nationale de Paris
Chase Manhattan
Citicorp
Generale de Banque
Manufacturers Hanover