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INTERNATIONAL MONETARY FUND

PORTUGAL

Recent Economic Developments

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Approved by the European I Department

October 11, 1995

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Portugal: Basic Data

Total area: 34,312 square miles
Population (1993) 9.35 million
GDP per capita US\$9,410

	1989	1990	1991	1992	1993	1994	1995 ^{1/}
(Changes in percent, except as otherwise indicated)							
Domestic economy							
Real domestic demand	3.5	5.2	4.0	4.5	-2.5	1.4	2.3
Real GDP	5.7	4.1	2.3	1.7	-1.2	1.0	2.8
Real foreign balance (contribution to GDP growth)	1.5	-1.6	-2.1	-3.6	2.1	-0.9	0.2
Employment	2.3	2.2	3.0	-6.3 ^{2/}	-2.0	-0.1	-0.4 ^{3/}
Unemployment rate	5.0	4.7	4.1	4.1 ^{2/}	5.5	6.8	7.0 ^{3/}
Compensation per worker	14.0	17.7	14.2	13.7	7.9	4.7	4.8 ^{4/}
Unit labor costs (manufacturing)	13.9	8.7	16.2	13.1	7.3	2.3	...
Consumer prices	12.6	13.4	11.4	8.9	6.5	5.2	4.0 ^{5/}
GDP deflator	12.0	12.9	14.7	13.1	6.9	5.1	4.4
External accounts							
Export volume	19.8	12.0	1.1	7.4	0.7	14.3	10.0
Import volume	8.3	15.6	7.2	13.4	-5.1	11.2	8.0
Export unit value	6.3	3.5	-0.3	-2.1	2.3	4.6	3.4
Import unit value	7.8	3.4	-0.9	-5.4	2.8	3.0	3.4
Trade balance (US\$ bns, f.o.b.)	-4.9	-6.8	-7.9	-9.4	-6.7	-6.7	-7.1
Transfers (net, US\$ billions)	4.5	5.5	6.0	7.8	6.7	5.4	5.8
Current account (US\$ billions)	0.1	-0.2	-0.7	--	0.8	-1.1	-0.7
In percent of GDP	0.3	-0.3	-0.9	--	1.0	-1.2	-0.7
Nominal effective exchange rate	-3.8	-1.2	0.3	3.7	-7.3	-4.8	3.6 ^{3/}
Real effective exchange rate (CPI based)	4.5	6.6	6.8	9.1	-4.2	-2.1	5.4 ^{3/}
Foreign exchange reserves (end period, in US\$ billions)	10.0	14.5	20.6	19.1	15.8	15.5	16.0 ^{5/}
Public finance (in percent of GDP)							
General government balance	-2.3	-5.4	-6.5	-3.3	-7.0	-5.8	-5.8 ^{6/}
Revenues	37.8	38.5	39.3	42.6	40.3	40.6	40.9 ^{6/}
Expenditures	40.1	43.9	45.8	45.9	47.3	46.4	46.7 ^{6/}
Primary balance	4.0	3.2	1.8	4.3	-0.4	--	-0.4 ^{6/}
Public debt ^{7/}	...	68.1	69.3	61.4	66.6	69.6	71.3 ^{6/}
Of which: external debt	...	7.0	4.7	4.2	7.2	9.4	12.0 ^{6/}
Financial variables							
Liquidity of residents (L-)	10.7	10.9	18.5	13.4	6.2	9.5	9.8 ^{8/}
Domestic credit	5.4	13.5	18.6	16.4	8.6	11.0	15.9 ^{8/}
Of which:							
Credit to the general government	-3.2	11.1	4.1	7.1	2.3	14.9	11.3 ^{8/}
Credit to the private sector ^{2/}	11.1	14.9	26.7	20.4	11.4	10.7	17.6 ^{8/}
Interest rates (end period)							
Overnight rate	13.8	9.5	18.6	14.2	11.2	8.9	8.6 ^{5/}
Treasury bill rate (6-months) ^{10/}	17.5	17.7	18.2	15.6	10.6	10.7	9.7 ^{5/}
Deposit rate, 91-180 days	10.5	11.8	18.2	14.0	10.2	9.3	8.8 ^{8/}
Lending rate, 91-180 days	22.7	21.8	21.2	18.9	15.7	14.7	14.2 ^{8/}

Sources: Bank of Portugal; Ministry of Finance; and Fund staff estimates.

- ^{1/} Staff estimates, unless otherwise noted.
^{2/} The figures for 1992 are not comparable to earlier years due to a change in the survey method.
^{3/} June.
^{4/} Wage increases implicit in collective wage agreements during January-July.
^{5/} August.
^{6/} Data correspond to the budget.
^{7/} Maastricht definition.
^{8/} July.
^{9/} Includes nonfinancial public enterprises and nonmonetary financial institutions.
^{10/} Gross of a withholding tax of 20 percent, introduced in May 1989.

I. The Real Economy

1. Overview

Portugal has achieved significant progress toward convergence with the EU since its accession in 1986. Its GDP per capita increased from 51.4 percent of the EU average in 1985 to 64.4 percent in 1994, while its inflation differential with the EU has fallen to 2.2 percent. The 1993 recession, with a downturn that was deeper and a recovery that was weaker in Portugal than elsewhere, interrupted real convergence with the EU. This did not signify a pause in the structural transformation of the Portuguese economy, however, as evidenced by gains in market share for its merchandise exports and continuing privatization.

In hindsight, the remarkable thing about the Portuguese disinflation is how quick and relatively painless it was. Compared with the Spanish disinflation experience, which was accompanied by unemployment rates exceeding 20 percent, Portugal achieved lower rates of inflation with unemployment rates not exceeding 8 percent. The timing was one factor: Spain and Italy, for instance, disinflated during the early 1980s, when the effects of the earlier adverse oil price shocks were still being felt. In contrast Portugal's disinflation, by contrast, coincided with the "reverse oil shock" of the mid-1980s, and thus benefitted from the lagged effects of lower oil prices. The flexibility of the Portuguese labor market during this period was another important factor, especially the sensitivity of wages to labor market conditions. This kept Portuguese exports competitive, despite a rise in the real effective exchange rate for the escudo, which began shortly after Portugal's accession into the EU. A final factor that has been important in this context is that the real effective appreciation of the escudo coincided with an increase in the equilibrium exchange rate, engendered by EU accession and the structural changes in the economy that this implied.

2. Output

Economic activity in Portugal rebounded weakly in 1994, growing by 1 percent after a fall of 1.2 percent in 1993 (Table 1). The recession in 1993 was deeper, and the recovery in 1994 weaker, than that experienced by the EU as a whole. ^{1/} Thus, real convergence with Europe was interrupted: whereas Portuguese GDP per capita increased from 51.4 percent of the EU average in 1985 to 64.8 percent in 1992, it fell back to 64.4 percent by 1994. The main reason for the relative under-performance of the Portuguese economy can be found in domestic demand, which grew by 1.4 percent in 1994 (compared to 2.5 percent in the EU), after falling by 2.5 percent in 1993 (compared to a fall of 1.9 percent in the EU). Since investment growth,

^{1/} EU GDP grew by 2.8 percent in 1994, after falling by 0.5 percent in 1993. Generally, EU output is a leading indicator for Portuguese output, but the lag has tended to be less than one year.

viewed cumulatively over 1993-94, was substantially the same in Portugal as in the EU, the main reason for the relative under-performance of domestic demand can be attributed to consumption--more specifically private consumption, which was flat in 1994 (compared to 1.7 percent growth in the EU). 1/

Examining the contributions of the components of demand, it is seen that investment and exports were the main engines of growth in 1994 (Table 2). This pattern, also observed in a number of other EU economies (e.g., Italy and Greece), was different from that observed in the 1984 and 1975 Portuguese recessions:

- Both GDP and investment fell less quickly during the downswing and rebounded less quickly during the upswing than during the earlier recessions.
- Public consumption rose relative to GDP, but not by as much as during the earlier recessions.
- Private consumption was flat during the upswing so far, whereas following the 1984 recession it grew strongly during the upswing.
- Labor productivity was some 10 percent above the level reached at a comparable point in previous recessions, reflecting significant labor shedding by firms.

A number of factors help explain these developments, and they are examined in turn.

The continuing fiscal consolidation under the convergence program has kept growth in public consumption relatively low: in past upswings, public consumption instead grew much faster (in relation to GDP). Monetary policy was also constrained by the need to support the escudo, and thus could not play a countercyclical role. In addition, turbulence in the international bond markets kept interest rate differentials and real interest rates higher than they would otherwise be, which dampened investment somewhat, while the atypical weakness in consumption has restrained income growth and hence muted the usual accelerator effects on investment. 2/ On the other hand,

1/ For many EU countries, including Portugal, public consumption is being constrained by convergence programs designed to satisfy the Maastricht criteria. See Chapter II for further details on fiscal adjustment.

2/ However, investment tends not to be very sensitive to interest rates, since most is self-financed (only 30 percent of investments are bank-financed). Although interest rates did not decline significantly during the recession, it should be noted that banks tended to smooth interest rates charged to businesses, protecting them to some extent from fluctuations in interest rates caused by exchange rate instability. Chapter III provides more details.

investment benefitted from some factors not usually present during a recovery. As in Italy, Portuguese firms took the opportunity to shed labor and boost productivity, and this, together with moderate rates of wage increase, led to a decline in the share of wage income in GDP; this in turn improved investment profitability (Table 5). Finally, rising and positive net project transfers from the EU to Portugal have helped investment rebound, although the end of the first Community Support Framework (CSF) and the beginning of the second CSF resulted in some delays in disbursements, which lowered investment in 1994 and correspondingly increased it in 1995.

The behavior of private consumption, which comprises approximately 60 percent of aggregate demand, is intimately linked to developments in disposable income and in the labor market. Real disposable income has not only not rebounded after falling 1.3 percent in 1993, but has even declined further, by 1.5 percent in 1994 (Table 6). ^{1/} The weakness in wages (which fell 1.3 percent in real terms in 1994), and the rise in direct and social security taxes (which rose 1.4 percent in real terms) contributed to this, as did accelerating reductions in receipts of private external transfers. However, many ostensible private external transfers appear actually to reflect inflows by expatriates, and their decline has been attributed to the increasing availability of alternative investment vehicles abroad. To the extent that these transfers do not truly represent income for residents, their decline may have little influence on domestic consumption.

The decline of the private savings rate bears out the shifting relationship between private consumption and disposable income (Table 7 and Chart 2). As a percent of disposable income and as a percent of GDP, the savings rate fell, also reflecting consumption smoothing behavior in the face of cyclical weakness in income. By contrast, savings by firms remained relatively constant. Since government dissaving has also remained relatively constant over 1993-94, the decline in household saving had as its counterpart an increase in foreign saving, which in turn reflected the increase in EU transfers.

The contribution of net exports to GDP growth was positive in 1993 (due primarily to the drop in imports of goods and nonfactor services), and negative (-0.5 percent) in 1994. Exports of goods and nonfactor services grew by 9.4 percent in volume terms in 1994, because of a 14.3 percent growth in merchandise exports. ^{2/} The drop in exports of services was

^{1/} Excluding external private transfers, the fall in real disposable income was 0.7 percent.

^{2/} The growth in exports of goods and non-factor services in 1994 exceeded the growth of imports for Portuguese partner countries, which was 8.2 percent. Hence, the share of Portuguese exports increased despite the appreciation in the escudo real effective exchange rate--an indication of the continuing structural improvements favorably affecting Portuguese exports. Chapter IV provides more detail on these developments.

accounted for by non-tourist services (especially air transport), as tourist services grew by 1.1 percent. The 8.9 percent growth in the volume of imports of goods and non-factor services in 1994 was due to an 11.2 percent growth in merchandise imports, with imports of services dropping due to lower spending by Portuguese tourists abroad. The growth in merchandise imports reflects high--but not surprising by historical standards--elasticities, and the high investment component of imports. 1/

Further indications of the behavior of GDP and its components can be gleaned from higher frequency and more disaggregated data. Economic activity bottomed out around the third quarter of 1993, when GDP fell by 1.9 percent year-on-year (Chart 1). 2/ GDP growth became positive in the first quarter of 1994, led by exports, whose growth was positive already in the fourth quarter of 1993, and which surged strongly--with growth rates exceeding 10 percent--in the first three quarters of 1994. Investment growth became positive in the third quarter of 1994, while import growth surged in the third and fourth quarters, dampening GDP growth. 3/ Investment in equipment grew much faster than investment in construction, reversing a recent trend (Table 4). Also, the share of private sector investment in total investment continued to fall, reflecting the increasing importance of public investment financed by EU funds. The breakdown of GDP growth by sector of origin is consistent with the investment and export led pattern of growth described earlier. Manufacturing and energy grew faster than GDP, whereas services grew more slowly than GDP.

Since quarterly GDP estimates only extend to end-1994, more timely information has to be sought in other indicators, which are not as reliable and do not always agree on the direction of change. Nevertheless, the statistical integration of such indicators through the construction of coincident indicators is one useful way to synthesize these data (Chart 1 and Table 3). 4/ The picture is clearest for investment, whose strong growth is reflected in most available indicators, such as sales of steel, cement, heavy commercial vehicles, and machinery imports (as of the first

1/ Imports of intermediate goods grew at 13.6 percent, which also reflects the rise in exports.

2/ According to quarterly GDP estimates supplied by the National Statistical Institute (INE).

3/ Investment has a high import content, so the contemporaneous increase in investment and imports is not surprising.

4/ A number of different coincident indicators have become available recently for Portugal. INE produces an indicator utilizing a principal components methodology, the Bank of Portugal uses a methodology developed by Stock and Watson (1993), while the Ministry of Planning produces a diffusion-type indicator. The indicators tend to broadly agree, except in the case of private consumption--a phenomenon that is not unexpected for an indicator that is at a turning point.

- 4a -
CHART 2
PORTUGAL
Savings
(In Percent)

Sources: Bank of Portugal, and IMF.

1/ Private and nonfinancial public enterprises.

2/ General Government: Current balance and official unrequited transfers.

CHART 1
PORTUGAL
Aggregate Demand
(In Percent)

Sources: Data provided by the authorities; and staff estimates.

1/ Staff estimates for series at constant 1987 prices, using growth rates for the demand components provided by the Bank of Portugal.

2/ Assessment of activity by construction entrepreneurs, according to INE's construction survey.

quarter of 1995), as well as the coincident indicator. 1/ When comparing the period January-July 1995 with the same period in the previous year, sales of cement increased by 9.7 percent, while sales of steel increased by 17.5 percent.

The available indicators of private consumption provide mixed signals, suggesting a weak and uneven pattern of recovery. In the first quarter of 1995, retail sales were weak, as were passenger vehicle sales. 2/ Gasoline sales were growing, but at a rate lower than that achieved in the first three quarters of 1994. Some observers also suggested that durable goods purchases may have been delayed because of initial uncertainty regarding the date of general elections. Later data seem to suggest that private consumption may be beginning to pick up. Retail sales grew 1.5 percent year-on-year in the period January-June, while imports of consumption goods grew 5.1 percent year-on-year in nominal terms in the period January-May. Consumer credit grew rapidly, although from a low base. 3/ Finally, the consumer confidence indicator has continued to improve until June 1995, reaching levels last seen in April 1993. In terms of overall output, the coincident indicator constructed by INE reached year-on-year growth of 2.8 percent by the first quarter of 1995, having turned positive in the third quarter of 1994.

3. Prices

CPI inflation continued to decline toward the EU average despite brief interruptions in the process of disinflation caused by special factors (Charts 3 and 4, and Table 9). 4/ From a peak of 13.4 percent in 1990, CPI declined to 5.2 percent in 1994. In the same period, the inflation differential between Portugal and the EU fell from 7.8 percent to 2.2 percent, while the differential between Portugal and its trading partners (a broader basket than the EU) fell from 8.3 percent to 1.2 percent (measured on a year-on-year basis at mid-year). In addition, in 1994 Portuguese inflation fell below the Spanish inflation rate for the first

1/ The sales of light commercial vehicles were affected by the announcement of a higher tax rate effective in 1995. Hence, the growth rate in this series was increased in 1994, and correspondingly lowered in 1995.

2/ The series for automobile sales was affected by liberalization of the importation of used cars, which are not included in this measure--about 10 percent of car imports consist of used cars. Clearly, some substitution would be expected away from new and in favor of used cars.

3/ In the first half of 1995, consumer credit increased by 50 percent, and mortgage credit by 25 percent, with rapid liberalization and heightened competition in the financial sector. Chapter III and Appendix IV provide additional information.

4/ Discussion in this section will focus on the CPI, because there does not currently exist a satisfactory PPI index.

time in many years. By August 1995, CPI inflation had fallen to 4 percent. A number of factors help account for the reduction in inflation, and they are discussed in turn.

The first factor aiding disinflation is the exchange rate policy followed by the Portuguese authorities. After the abandonment of the crawling peg in October 1990, the escudo shadowed a basket of five currencies, formally joining the ERM in April 1992. Despite four downward realignments of the central rate, the real effective exchange rate has appreciated significantly--12.4 percent between October 1990 and June 1995. As a result, tradeable price inflation fell from 9 percent in 1990 to 4.4 percent in 1994, and growth in import prices slowed appreciably. 1/ Because of the relative openness of the Portuguese economy--the estimated weight of tradeable goods in the CPI is 58 percent--tradeable prices have exerted a considerable downward pressure on inflation.

The second factor is the wage flexibility evident in the labor market (Chart 5 and Table 12). 2/ In 1994, ex post real wages implicit in collective agreements were flat, whereas productivity increased by 1.1 percent, and unit labor costs increased by only 3.6 percent. The importance of wage flexibility was evident in the evolution of non-tradeables prices, which fell even more rapidly than tradeables prices--down to 6.4 percent in 1994 from 19.1 percent in 1990. The rapid rise in unemployment in 1994 was a particularly significant factor in this regard. The reduction in inflation was also aided by continuing structural improvements arising out of increasing competition resulting from the opening up of the economy to Europe and the modernization of retail channels.

The final contributing factor was the cyclical weakness of output in 1993 and the continuing weakness of private consumption despite the recovery in 1994 and early 1995. The weakness of private consumption was also instrumental in moderating the effect of a 1 percentage point increase in the VAT rate in January 1995, which directly resulted in a 0.6 percent increase in the CPI (according to estimates provided by the Portuguese authorities). The increase in the VAT rate together with a transitory increase in potato prices caused by factors external to the Portuguese economy, temporarily arrested the downward path of inflation, which had

1/ Import prices contributed much more to disinflation in the 1991-92 period than in the 1993-94 period, however.

2/ This issue is explored more fully in Appendix I.

CHART 3
PORTUGAL
Inflation Rates 1/
(In Percent; Year-on-Year)

Source: IMF, International Financial Statistics.

1/ Consumer Price Index.

- 6a -

CHART 4
PORTUGAL
Price Developments
(in percent)

Source: Bank of Portugal, Monthly Bulletin, various issues.

1/ Excludes food and energy.

CHART 5
PORTUGAL
Labor Market 1/

Source: Data provided by the authorities; WEO; and Staff estimates.

1/ In percent, unless otherwise indicated.

2/ Series redefined after 1991.

3/ Share of long-term unemployed (one-year or more) in total.

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fallen to 4 percent on a year-on-year basis by end-1994, only to rise to 4.8 percent by March 1995. ^{1/} But by June 1995, these transitory factors appeared to have run their course.

Among the components of CPI, growth in clothing and footwear--a volatile subgroup which is excluded from the underlying CPI index--increased to 4.8 percent in 1994 from 2.8 percent in 1993, whereas all other components exhibited declines. Administered prices, which in previous years had grown at a rate similar to that of non-administered prices, grew by only 3.9 percent in 1994 (compared to 5.4 percent for non-administered prices). Underlying inflation, which in recent years had been growing significantly faster than total CPI (excluding rents), fell to 5.7 percent in 1994, reflecting the more "average" behavior of the food and beverages subgroup.

4. The labor market

Following the recession, unemployment continued increasing, reaching 6.8 percent in 1994 (Chart 5 and Table 10). In the first quarter of 1995 unemployment increased further, to 7.4 percent, although by the third quarter of 1995 it fell back somewhat, to 6.9 percent. Despite the rapid rise in unemployment, Portugal still enjoys one of the lowest rates of unemployment in the EU, well below the EU average (11.6 percent in 1994).

The rise in unemployment does not, in the first instance, appear to be out of line with Portuguese historical experience. After the 1984 recession, for example, unemployment was higher, peaking at 8.5 percent. ^{2/} Other indicators that are often thought of as signifying labor market rigidity also worsened considerably, however: youth unemployment rose from about 10 percent at the beginning of 1992 to more than 16 percent in the first quarter of 1995, while long-term unemployment rose from about 22 percent to 37 percent over the same period. Expenditures on unemployment benefits increased faster than unemployment primarily because of an increase in the coverage ratio (the percentage of unemployed receiving unemployment benefits). In 1985, the previous peak of unemployment, 21 percent of registered unemployed were receiving benefits; in 1993, this ratio had risen to 48 percent. ^{3/} This occurred because of

^{1/} The rise in the price of potatoes was caused by floods in Central Europe. The Bank of Portugal estimates that they accounted for an additional 0.5 percent increase, given the sizeable weight of potatoes in the Portuguese CPI. The rise in the CPI was less than the combined effect of the rises in the VAT rate and potato prices, however, implying that the passthrough was less than perfect.

^{2/} Such comparisons should be regarded with caution, however, because the employment, labor force and unemployment series began to be compiled on the basis of different labor force survey definitions after 1991.

^{3/} The coverage ratio as a percent of those unemployed according to the labor force survey definition rose from 19 percent to 71 percent in the same period.

an easing of unemployment benefit eligibility requirements in 1989, raising the question of whether the flexibility that had characterized the Portuguese labor market had been adversely affected. This question is addressed in more detail in Appendix I.

The rise in unemployment is accounted for primarily by a drop in employment of 2 percent between 1992-93 and an increase in the labor force of 1.3 percent between 1993-94. Although dependent employment declined by 2 percent between 1993-94, self-employment increased, so that total employment declined by only 0.1 percent in the same period. To the extent that self-employment is not a perfect substitute for dependent employment (70 percent of total employment in agriculture, for example, is represented by self-employment), under-employment may have increased. The 1993 fall in the labor force was primarily cyclical, as was the 1994 increase in the labor force; the increase in the number of first employment seekers was relatively small. The participation rate, especially for females, mostly recovered its pre-1993 levels.

The sectoral distribution of employment mainly reflected output developments, with increases in agriculture, and declines in manufacturing and construction in the period 1993-94 (Table 11). However, there was a noteworthy decline in services in the period 1992-94. As is shown by the experience of some other EU countries (e.g., Italy), employment in services has in the past been relatively immune to recessions. This state of affairs was overturned in the 1993 recession, probably as a result of technological and structural changes in the service industries.

Economy-wide wages grew by only 4.7 percent in 1994, while wages specified in wage agreements increased by 5.2 percent--exactly equal to CPI inflation (implying a fall of 0.2 percent in real terms if deflated by the private consumption deflator). ^{1/} Wages in Portugal have tended to react quickly and flexibly to labor market conditions, and the 1993 recession was no exception (Chart 5 and Table 12). Another factor explaining the weakness of wages is the continuing decline in the number of workers covered by collective agreements. A social pact also failed to be concluded during 1993-94. Economy-wide productivity increased by 1.1 percent in 1994 (or 1.4 percent if changes in working hours are included in the calculation).

^{1/} The same rate of increase in wages implicit in collective agreements was observed in the first four months of 1995.

II. Fiscal Policy

1. Overview

Portugal has made substantial progress with fiscal consolidation since the mid-1980s. There was a serious setback in 1993 when the general government deficit doubled to 7 percent of GDP and the primary balance-- which had been in surplus for a decade--turned into deficit. The debt-to-GDP ratio had been declining, reaching around 60 percent in 1992, but in 1993 it reversed its trend. The setback of 1993 was partly due to the recession, which reduced revenues and increased unemployment benefits. However, there were also structural factors that contributed importantly to the fiscal deterioration. Specifically, revenues fell due to the weakening of tax collection after the abolition of customs within the EU, and social security and capital expenditures increased. The next two budgets reduced the deficit modestly, by about 1½ percent of GDP in 1994-95, while the public debt-to-GDP ratio has continued rising.

The 1995 budget seeks to maintain the deficit-to-GDP ratio at 5.8 percent, implying some deterioration in the primary balance. At the time the 1995 budget was being formulated, a worse fiscal outcome was expected for 1994, and thus, the 1995 budget envisaged some adjustment in relation to projections for 1994; since the 1994 outcome was better than expected, the 1995 budget targets are unambitious in comparison. However, the execution of the budget in the first half of 1995 was also better than projected in the budget.

Since the mid-1980s several major structural reforms have shaped the public finances. The VAT was introduced in 1986 and has gradually been harmonized with the EU; the income tax was introduced in 1989. Most recently, in 1994 the government initiated a program to improve tax administration. The government began a large scale privatization program in 1989, and devoted a substantial part of the receipts to reducing debt. Finally, changes in debt management policy have resulted in a shift from central bank borrowing to market-based domestic borrowing and the introduction of long-term fixed-rate instruments.

2. Fiscal policy in 1994

The 1994 budget targeted a general government deficit of 6.6 percent of GDP, 0.4 percent better than in 1993, and a deterioration of the primary balance of 0.3 percent of GDP to -0.7 percent. The projected improvement in the fiscal balance was entirely due to lower projected interest payments, as a result of lower interest rates and a once-and-for-all effect of a change in interest payments on government bonds from twice to once a year. The main policy measures of the 1994 budget were an increase in contributions of public sector employees by 2 percent, several measures aimed at improving the finances of social security (see Appendix II) and a wage increase of

2.5 percent, below the range of projected inflation of 4 to 5½ percent. The budget also included efforts to strengthen tax administration. Revenue projections were made cautiously, however.

General Government Revenues and Expenditures

(In percent of GDP)

	1993	1994		1995
		Budget	Outturn	Budget
Revenues	40.5	40.3	40.6	40.9
Current	37.2	36.7	37.8	37.6
Expenditure	47.5	46.9	46.4	46.7
Current	40.0	39.5	39.8	39.4
Of which: interest	6.6	5.9	5.8	5.5
Capital	7.4	7.4	6.6	7.3
Overall balance	-7.0	-6.6	-5.8	-5.8
Of which: primary	-0.4	-0.7	--	-0.4
Overall balance including net lending	-7.0	-6.9	-5.9	-6.1

The fiscal outturn in 1994 was dominated by a stronger-than-projected revenue performance that more than compensated for some expenditure overrun. The general government deficit fell by 1.2 percent of GDP to 5.8 percent and the primary deficit was eliminated (Tables 14 and 15, and Chart 6). Looking at the different levels of the general government, the central administration improved its balance significantly, while the balance of the social security system worsened (Tables 16-18). The borrowing requirement of the general government also fell, by ½ percent of GDP to 6.7 percent.

General government revenues maintained their share in GDP of 40½ percent, as higher tax revenues offset declining non-tax and capital revenues. Tax revenues increased by 1½ percent of GDP to 34 percent, which fully offset the revenue fall of 1993. In particular, VAT revenues climbed to 7.1 percent of GDP, the highest yield since the VAT was imposed, while general income taxes merely maintained their share in GDP due to the weak recovery. Social security revenues increased marginally due to the increase in contributions of public sector employees. The good VAT performance reflected two main factors: (i) there was a full year to collect taxes in 1994, whereas the elimination of custom borders in 1993 had in effect reduced VAT collections to 10 months; and (ii) the authorities implemented measures to reduce tax evasion, such as the condition that tax payers pay in full their 1994 taxes before they could benefit from a program to regularize tax arrears. Non-tax revenues continued their downward trend due to lower

CHART 6
PORTUGAL

General Government Main Indicators (In percent of GDP)

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interest income earned by the Treasury on government deposits. Capital revenues fell substantially, by $\frac{1}{2}$ percent of GDP, due to delayed transfers from the EU.

Expenditures of the general government fell by 1 percent of GDP to 46½ percent, reflecting a fall in interest payments and capital expenditures that more than compensated for an increase in current primary expenditures. Interest payments fell by 0.8 percent of GDP, benefitting from the 6½ percent reduction in implicit interest rates on public debt in 1993-94. This, in turn, was due to interest rate trends (see Chapter III) together with debt management policies designed to minimize borrowing costs. In contrast, primary current expenditures increased by 0.6 percent of GDP due to higher transfers by the social security system and to the EU. Social security expenditures rose due to cyclical factors such as higher unemployment benefits and structural factors such as the impact of population ageing on pensions. Transfers to the EU were recalculated in light of the upward revision to national accounts data. Additional payments were made retroactive to 1986, the date of Portugal's accession to EU membership. Finally, expenditures on personnel did not fall as much as originally intended because in October the government granted an additional 1 percent pay rise to civil servants.

Capital expenditures were below budget in 1994 and fell by 0.8 percent of GDP with respect to the previous year due to delays in initiating the execution of the Second Community Support Framework. This interrupted the sustained increase in capital expenditures since 1989, when the EU program of structural support funds was initiated. Despite the delays in disbursements, structural funds financed 10 percent of investment in Portugal, helping increase the general government share in total gross fixed investment from 13 percent in 1988 to 18 percent in 1994 (Table 19).

The public sector borrowing requirement (PSBR) declined in 1994 to 6.7 percent of GDP (Table 20). It fell by less than the general government deficit because the government assumed public enterprise debts of 1½ percent of GDP, significantly more than in previous years. Close to half of the debts assumed were from TAP, the national airline, and *Siderurgia Nacional*, the steel company. Moreover, privatization receipts used for debt reduction were only 0.2 percent of GDP in 1994, half the amount of a year earlier and substantially less than in 1992, when they reached 1½ percent of GDP.

The financing of the PSBR changed considerably in 1994 compared to the recent past. The dominant role of non-bank credit receded while domestic bank and foreign credits financed 90 percent of the PSBR. 1/ Net financing from the Bank of Portugal, which since the adoption of the new

1/ The increase in the bank credit component was due, in large part, to the purchase of government bonds by one bank from its affiliated mutual fund. See Chapter III and Appendix III.

Organic Law of the Bank of Portugal in 1991 could only occur through drawing down Treasury deposits, still amounted to 2½ percent of GDP in 1992 but declined to zero in 1994.

The financial position of the wider public sector was positively influenced by a shrinking deficit in the public enterprise sector which--at 0.4 percent of GDP--was less than a third of its recent peak in 1991. This favorable performance is the result of several factors. First, the restructuring of some of the most important public enterprises, including the national airline, TAP, had a positive financial impact. In particular, contained wage increases (of 1.3 percent on average) yielded a very moderate rise in operational costs, while sales volumes rose and export market shares increased in the paper and fuel markets. Second, declining interest rates and the state assumption of some of the public enterprises' debts reduced their interest bill. Third, capital expenditures fell in some of the companies, notably the electricity company, EDP, Portugal Telecom, and Portucel, the pulp and paper producer.

3. The 1995 budget and fiscal policy in the first half of 1995

The 1995 budget envisages stabilizing the general government deficit at 5.8 percent of GDP, with the primary balance worsening by 0.4 percent of GDP (Table 21). Public debt is projected to edge up to 71 percent of GDP, due in part to the continued assumption of public enterprise debt by the government. When originally drawn, the budget envisaged some fiscal consolidation because the 1994 deficit was expected to be higher than currently estimated. The 1995 budget modifies slightly the structure of taxation, and foresees a sharp increase in capital expenditures that is made possible by higher transfers from the EU and lower interest expenditures. Underlying the budget are projections of real GDP growth of 2½ to 3½ percent, and inflation of 3½ to 4½ percent.

Tax receipts are projected to remain at almost 34 percent of GDP, with a reduction in direct taxation and an increase in indirect taxation (Table 22). Direct taxation is projected to decline by 0.3 percent of GDP due to a number of changes to the personal income (IRS) and corporate income (IRC) taxes, including: (i) the introduction of tax benefits and exemptions on saving instruments and pension funds; (ii) the reduction of the withholding tax on bonds from 25 to 20 percent to equalize it with the withholding tax on deposits; (iii) the adjustment of brackets of the IRS by 4 percent and exemptions by 6 percent; (iv) the introduction of fiscal credits for investment, in the form of a grace period for the payment of IRC when enterprises undertake new investments; and (v) elimination of the double taxation of dividends. Social security contributions for employers were reduced by ¾ of 1 percent, also contributing to the decline in direct taxation. Indirect taxation is projected to increase by 0.2 percent of GDP. The main policy changes underlying this projection are: (i) a 1 percent increase in the standard VAT rate to 17 percent and the elimination of the higher 30 percent rate, in a continued process of harmonization of VAT rates

with average EU rates; 1/ (ii) a reduction in the stamp tax on loans to enterprises from 9 to 7 percent and the elimination of the stamp tax on consumer credit; and (iii) an increase in the base and specific rates of the automobile tax.

Current spending is budgeted to fall by 0.4 percent of GDP mainly on account of the continued decline in the share of interest payments in GDP. Public sector wages were adjusted by 4 percent, in the middle of the targeted inflation range. However, personnel expenditures will continue to be adversely affected by increases in pension expenditures of the civil service. Thus, continuing with the trend observed throughout the 1990s, transfers, including social security, will continue to grow, reaching a budgeted 15.7 percent of GDP in 1995. The capital budget is projected to recover from the delays suffered in 1994. Capital outlays are projected to increase by almost 20 percent to 7.3 percent of GDP, mainly due to an increase in the disbursement of structural funds from the EU.

The budget outturn in the first semester of 1995 has been favorable, indicating that it may be possible to obtain a general government deficit some ½ percent of GDP lower than in 1994. Tax revenues performed well in the first semester of 1995. Direct taxes surpassed budgetary projections and more than offset delays in collecting VAT revenues. Also the collection of tax arrears, shortening of the IRS collection lag, (see Box), and the economic recovery underway all helped tax revenues. For 1995, it is expected that direct taxes will surpass budgetary projections by some Esc 50-60 billion (0.3 percent of GDP) and that indirect taxes will be as budgeted. In the first semester, though, VAT revenues were weak due to delays associated with increased documentation required to process VAT returns. In turn, primary expenditures, and in particular social security transfers, have been contained within the budgetary projections. The capital budget was affected favorably by a pick-up in disbursements of EU transfers.

4. Public debt management

The financing of the general government was profoundly affected by the liberalization of financial markets, the opening of the capital account, and a new Organic Law of the Bank of Portugal. These changes increasingly exposed the government to market forces to fulfill its financing needs. Based on the New Organic Law, direct financing of the government from the Bank of Portugal ceased in 1991 (except for the draw-down of Treasury deposits). The opening of the capital account in 1992 allowed Portugal to tap foreign bond markets, while domestic borrowing is now mostly done through marketable instruments. The main goals of the government's debt management strategy has been to increase Portugal's presence in foreign

1/ Revenues from the increase in the standard rate (estimated at Esc 45 billion) are earmarked for the social security system.

creditor markets, and to lengthen the maturity and lower the cost of its domestic debt, while enhancing the depth and liquidity of domestic bond markets.

In 1994, total government debt increased by 3 percent of GDP to 69½ percent. This pace is slower than in the previous year due to the stabilization of the primary balance and a reduction in the differential between the interest rate on public debt and the nominal output growth rate (Tables 23 and 24, and Chart 7).

Two-thirds of the increase in debt in 1994 was in the form of foreign borrowing, as the government faced lower interest rates abroad than domestically. External debt stood at 9½ percent of GDP, and the 1995 budget projects a further increase to 12 percent. In 1995, Portugal negotiated a stand-by multicurrency credit facility of up to DM 3 billion. The facility will be used to bridge financing needs and allow quick transitory shifts from domestic to external markets in case the Treasury faces direr conditions in the domestic market. The government also launched a 10-year global French franc bond and a 7-year Euro-yen bond.

To achieve the goals set for domestic debt, the Treasury began issuing 7-and-10 year bonds in 1993. With the sharp rise in world bond yields in early 1994, it proved increasingly difficult to place long-term securities, and the government issued Treasury bills to meet one third of its financing needs in 1994. Consequently, the average maturity of domestic debt fell from 3.4 years in 1993 to 3.1 in 1994. Nevertheless, the share of long-term Treasury bonds in Portugal's domestic debt increased three-fold in the 2½ years to June 1995 (Chart 8). Beginning in 1995, the Treasury announced and began implementing a regular calendar of long-term bond auctions. The debt auctions have already increased the average maturity of the debt and raised the share of long-term marketable bonds in total domestic debt to 50 percent in June 1995, from 46½ percent in December 1994.

5. The privatization program

Portugal's privatization program raised more than Esc 1,200 billion--over 9 percent of GDP--from 1989 through the first half of 1995, making Portugal the third largest privatizer in the OECD, after the United Kingdom and New Zealand. 1/ About 65 percent of the privatization receipts have accrued to the state and the remainder has been used by holding companies to reduce liabilities and augment the capital of their affiliated companies, mostly in preparation for future privatizations. In 1993, the mandatory minimum share of privatization receipts to be used for debt reduction was reduced from 80 percent to 40 percent.

1/ For a review of the privatization program, see SM/94/217, Supplement I, Appendix I.

CHART 7
PORTUGAL

Direct Public Debt Levels and Interest Rates

Sources: Ministry of Finance; and INE.

1/ In accordance with Maastricht definition.

2/ Nominal interest rates adjusted for increase in the GDP deflator.

Chart 8
Portugal
Composition of Domestic Debt
(In Percent)

December 1992

June 1995

Source: Ministry of Finance.

1/ Floating rate notes.

2/ Includes family treasury bonds, which are non-marketable bonds held by individuals.

Tax Administration: Problems and Actions

- The abolition of customs borders within the EU in 1993, which changed the method of collecting VAT on imports, uncovered weaknesses in tax administration. Problems with tax compliance extend to the VAT, where collections are substantially below potential, and to income taxes, where tax compliance varies widely according to the category of income. Moreover, tax arrears are a serious concern; they were estimated at 5 percent of GDP in 1994 including arrears on social security contributions. Although modern and harmonized to EU standards, Portugal's tax system is less efficient and equitable than intended by tax legislation and yields revenues that are below potential.

- A technical assistance mission conducted by the Fund in 1994 examined Portugal's tax system and found that the tax administration effort was heavily concentrated on processing VAT and income tax returns. Little attention was being paid to ascertaining whether businesses were actually paying the appropriate amount of taxes. The mission recommended resetting priorities by (i) establishing a reasonable probability that non-compliance will be detected; (ii) applying appropriate penalties once non-compliance is discovered; and (iii) providing adequate information and service to assist tax payers in fulfilling their tax obligations.

- The main specific recommendations to improve tax administration centered on increasing the probability that non-compliance will be detected by (i) shifting resources toward detection of taxpayers that stop filing and those that become delinquent, with priority for follow-up actions given to large taxpayers; (ii) giving priority to auditing VAT, because of its revenue potential and because improved VAT compliance leads to better compliance with profit taxes; and (iii) improving audit selection systems and increasing audit coverage.

- During 1994-95 the authorities implemented several changes to strengthen tax collection. In January 1994 they adopted a new code of sanctions that made tax evasion a crime punishable by imprisonment. Also in 1994 they passed Decree-Law 225-94 which allows taxpayers in arrears to reschedule their obligations at favorable interest rates and maturities of 3 to 10 years. As of mid-1995, taxpayers responsible for tax arrears of Esc 259 billion, or 1.8 percent of GDP, had agreed to regularize payments. Payments on the debt regularized were Esc 30 billion in 1994 and Esc 20 billion in the first semester of 1995. In January 1995, the authorities shortened the collection lag on the personal income tax from three to one month, with an estimated yield of Esc 12-13 billion in 1995. In July 1995, they initiated a program to automate and unify VAT and income tax payer information, with a view to improve auditing capabilities. Finally, the authorities increased the number of auditors.

- In line with recommendations of the IMF technical assistance report, the authorities need to intensify their tax administration efforts in three areas: (i) improving the system for detecting delinquent taxpayers; (ii) re-directing auditing procedures and staff to VAT payers; and (iii) amending the legal framework to reduce the duration of payments

Privatization Receipts
(In billions of escudos)

	1989	1990	1991	1992	1993	1994 Jan. - June	1995
Total	70.8	148.2	152.8	305.0	67.5	185.0	282.7
State	49.7	138.9	102.9	214.1	51.6	93.8	130.7
Of which: used for debt reduction	44.8	71.7	73.0	199.8	88.3	30.0	112.0 ^{1/}

Source: Ministry of Finance.

^{1/} 1995 budget.

About 60 percent of privatization proceeds stem from sales in the banking and insurance sector, while transport and telecommunication sectors account for most of the rest (Table 25). The state has reduced its presence in the financial and other sectors of the economy significantly, from 20 percent of value added in 1989 to 10 percent in 1994, and from 6½ percent of employment to 3 percent. Most specifically, in the banking sector, public ownership has been reduced to one third from 90 percent in the mid-1980s, while privatization in the insurance sector was completed except for insurance companies belonging to *Caixa Geral de Depositos* and *Banco de Fomento e Exterior*, the two major banks remaining in the public sector. About two thirds of privatizations receipts have resulted from public offers, which have increased the size of the stock exchange. In 1994, privatized companies accounted for 37 percent of market capitalization and 33 percent of value traded.

In 1994 and the first half of 1995 there was an acceleration of the privatization program, after a lull in 1993. The most important privatizations continued to be in the financial, industrial and transport sectors. In particular, privatizations in the financial sector accounted for 40 percent of the 1994 revenues, while privatization of cement companies yielded 55 percent. In 1995, the government began privatizing the communications sector with the sale of the first tranche of Telecom, the largest transaction since the privatization program began. The government approved further privatizations for the remainder of 1995 and drew up a plan to continue privatizing public enterprises in 1996-97.

III. Monetary Developments

In 1994 and 1995, monetary policy continued to use exchange rate stability within the Exchange Rate Mechanism (ERM) of the European Monetary System as an intermediate objective to achieve the final objective of price stability. After the August 1993 widening of the ERM bands to 15 percent, the authorities did not take advantage of the wide bands for the escudo, but successfully sought to maintain the currency within the old 6 percent band vis-à-vis the deutsche mark. Year-on-year inflation declined from 6.4 percent at the end of 1993 to 4.0 percent at the end of 1994. During this period, the central bank defended the parity of the escudo by increasing official interest rates as well as intervening in the foreign exchange markets. This policy continued in 1995 when the authorities did not allow the escudo to depreciate by as much as the 3.5 percent March realignment of the central parity. Meanwhile, year-on-year inflation first accelerated to 4.8 percent in March largely as a result of indirect tax increases and special factors (see Chapter I), then declined back to 4 percent in August.

1. Interest rate and exchange rate developments

In the first two months of 1994, the increased confidence in the escudo brought about an accumulation of international reserves. Official interest rates were also gradually lowered, with rates for both provision and absorption of liquidity 1 percent lower in mid-February than at the end of 1993 (Table 32). In the meantime, interbank rates and long-term bond yields experienced even larger declines with shrinking differentials against deutsche mark interest rates, as non-residents purchased large amounts of fixed-rate government bonds denominated in escudos.

In contrast, the period from March to June 1994 was characterized by intense exchange market pressures, which forced the Bank of Portugal repeatedly to increase official rates and intervene in the foreign exchange market. These tensions, as well as the reversal of expectations in international bond markets, caused an increase of long-term differentials vis-à-vis Germany of more than 2 percentage points between mid-April and mid-June, as non-residents sold a substantial part of their holdings of fixed-term government bonds. In the meantime, domestic residents were selling bonds and increasing bank deposits, especially in foreign currency. Pressures on the exchange rate abated at the end of June.

In the second semester of 1994, in the absence of tensions in the foreign exchange market and in a context of declining inflation, the Bank of Portugal gradually reduced official rates so that at the end of October the absorption and provision of liquidity rates defined an 8.5-11.5 percent intervention band; in the meantime, repo rates were driven to 8.875 percent. Money market rates followed the decline of policy rates with the 3-month differential vis-à-vis Germany returning to its end-1993 level. In contrast, long-term differentials, affected by the increase in international yields, remained broadly unchanged during the second semester and above

their end-1993 level. In this period, non-resident investors continued to sell fixed-term government bonds--although they started to show renewed interest toward the end of the year--while private individuals substantially increased their foreign currency deposits.

Money market rates continued to decline until mid-February 1995 with the 3-month interest differential with Germany falling some 60 basis points from the end-1994 level. Meanwhile, long-term yields diminished somewhat, but long-term differentials with Germany remained unchanged.

In mid-February 1995, the strength of the deutsche mark put the escudo under renewed pressure, together with the peseta and other currencies participating in the ERM. In spite of the increased foreign exchange instability, the escudo was maintained within the previous narrow 6 percent band with limited central bank intervention. On March 6, the authorities agreed to realign the central parity of the escudo by 3.5 percent, as the peseta was realigned by 7 percent. After the realignment, exchange rate pressures intensified. The Bank of Portugal escalated its intervention in the foreign exchange market and let repo rates increase to the upper limit of the intervention band (11.5 percent). As a result, both short-term and long-term interest differentials with Germany increased. At the end of March, when tensions in the foreign exchange market subsided, the escudo turned out somewhat depreciated vis-à-vis the deutsche mark, but not as much as other European currencies like the peseta, the lira, pound sterling or the Swedish krona.

In the period from April to June 1995, the exchange rate of the escudo remained relatively stable, so repo rates were reduced back to 8.875 percent. This decline prompted a reduction in money market rates and differentials with Germany. In the same period, long-term yields diminished, but the differential with Germany hovered around 5 percent.

Most interest rate spreads between loan rates and deposit rates during 1994 and 1995 declined (Table 31). As time deposit rates (181 days to 1 year) fell from 9.1 percent at end-1993 to 8.5 percent in June 1995, the discount rate on commercial bills fell from 18.2 to 15.9 percent in the same period and the average lending rate to non-financial enterprises dropped from 15.7 to 13.5 percent. Price competition increased especially in markets for housing and consumer credit, as indicated also by the smaller variance in the distribution of lending rates. Most indicators of concentration confirm that in 1994 the degree of competition in the banking system increased. ^{1/}

^{1/} However, the available statistics do not take into account 1995 mergers (see Appendix IV).

2. Money and credit

In 1994 and early 1995, money and credit aggregates accelerated sharply (Table 28). The economic recovery accounts only for part of this expansion, mainly due to the consequences of the drop in the demand for government bonds. On the one hand, as both residents and non-residents lost interest in government bonds, the government ran down deposits with the central bank and increased its issues of Treasury bills, causing net credit to the General Government and, in turn, total domestic credit to increase. On the other hand, domestic investors (in particular mutual funds) substituted deposits and Treasury bills in their portfolios in place of medium-term bonds, representing an acceleration of monetary aggregates. ^{1/}

The year-on-year growth of the monetary aggregate L-, which includes Treasury bills, stopped declining in the second quarter of 1994 and then began increasing rapidly to reach 9.5 percent year-on-year in December (6.2 percent at end-1993). This acceleration was entirely due to the less liquid components, as the narrow money aggregate M1- grew by only 7.3 percent (7.2 percent in 1993). However, in early 1995, as L- continued to accelerate (9.8 percent year-on-year in July), also M1- picked up (14.8 percent year-on-year in July).

Total domestic credit accelerated from 8.8 percent in 1993 to 11.9 percent in 1994 entirely as a result of the expansion of net credit to the General Government, which grew by 14.9 percent (compared to 2.4 percent in 1993), while credit to the private sector slowed down to 10.7 percent in 1994 from 11.4 percent in 1993. In early 1995, domestic credit accelerated further (15.9 percent year-on-year in July). In this instance, the most dynamic component was credit to the private sector, which increased at a year-on-year growth rate of 17.6 percent, while net credit to the General Government decelerated to 11.3 percent.

The turnaround in the expansion of credit to the private sector began in the third quarter of 1994 under the stimulus of the economic recovery and declining interest rates. Since then, both components of credit to the private sector (individuals and non-financial firms) accelerated, but credit to individuals (mortgages and consumer credit) remained the most dynamic, as it was boosted by structural changes--for example, the removal of restrictions on consumer credit and increased bank competition in the mortgage market. In this period, credit to non-financial firms was mainly granted to the services and construction sector, while credit to the manufacturing sector--which was still relying mainly on self-financing--was falling.

^{1/} This reflects, in large part, the sale of bonds by one mutual fund to its affiliated bank--a transition that also largely accounts for the increase in a credit to the general government discussed below. See Appendix IV.

3. Monetary policy instruments

On July 12, 1994, the Bank of Portugal changed its intervention procedures in the money market. Until then, the Bank regularly refinanced the banking system by granting credit at a predetermined rate until the end of the reserve requirement period. In July 1994, the Bank substituted this refinancing procedure with regular daily repos at a rate determined through an auction mechanism. This repo rate should fluctuate between an upper and a lower bound set by fixed rates regulating the provision and absorption of liquidity. The new system is expected to be more flexible than the previous one and to signal monetary policy objectives more clearly and rapidly.

On November 1, 1994, the Bank of Portugal reduced reserve requirements from 17 percent (partially remunerated) to 2 percent (totally non-remunerated). To sterilize the excess liquidity created by the reduction of the reserve coefficient, the Bank of Portugal issued partially remunerated certificates of deposit, whose maturity ranged from 2 to 10 years. ^{1/} The goal of the reform was to align the Portuguese system of reserve requirements to those prevailing in Europe and, to the extent that non-remunerated certificates of deposit would expire, to increase the competitiveness of the Portuguese banking system.

On September 12, 1995, the government passed a Decree-Law (no. 231/95) that amended the Organic Law of the Bank of Portugal to adapt it to the provisions of the EC Treaty. The main changes were the following:

(1) Art. 3 was changed to state: "The primary objective of the Bank of Portugal, as the central bank of the Portuguese Republic, shall be to maintain price stability, taking into account the overall economic policy of the Government."

(2) Art. 25 was changed to state:

"1. Overdraft facilities or any other type of credit facility with the Bank in favour of the State or other State-dependent services or bodies, other public-law legal persons and public undertakings, or any other bodies on which the State, the Autonomous Regions or local authorities may, directly or indirectly, have a dominant influence, shall be prohibited"

"2. The Bank shall not guarantee any commitments of the State or any other body mentioned in the foregoing paragraph, and shall not directly purchase debt instruments issued by the State or by the same bodies."

^{1/} When the Deposit Guarantee Fund was established at the beginning of 1995, most banks used these certificates of deposit to make the initial contribution. See Appendix IV.

- (3) In Art. 18, the reference to the Government's guidelines was abolished and it was changed to state that "... besides the conduct of monetary policy, under the terms of Article 3, it shall be particularly incumbent on the Bank to cooperate in the formulation and to implement the foreign exchange policy".
- (4) Art. 35.1 (b) was reworded as a result of the prohibition of direct purchase of debt instruments from the State".

4. Financial markets

Portugal's financial markets continue to develop apace in the wake of liberalization measures taken in recent years. ^{1/} As a result of the creation of a block trading market in June 1994, bonds and equities are now traded on four markets: (a) the Lisbon Stock Exchange regular sessions (accounting for 32.8 percent of total transactions in the first half of 1995); (b) special stock exchange sessions, used in the case of privatization issues (11.2 percent); (c) the block trading market (47.8 percent); and (d) the over-the-counter market (8.3 percent of total trading).

The large share of transactions taken up by the block trading market--characterized by lower costs and greater ease of transactions--was viewed with concern by some observers because its introduction drained liquidity from the stock exchange and because of its lesser transparency, with prices sometimes as much as 10 percent different from those quoted on the stock exchange. This market was limited to transactions in bonds whose outstanding amount exceeded Esc 10 billion and which had been accepted for trading on the stock exchange; in practice, this limited the market mainly to government bonds. In addition, the minimum size of transaction--Esc 75 million--was small compared with the average transaction in government bonds so that the latter were mostly traded in this market.

In March 1994, the decision was taken to specialize the two Portuguese Stock Exchanges: spot transactions would take place on the Lisbon Stock Exchange, while futures and derivatives contracts would be traded on the Oporto Stock Exchange. The first contract quoted on the latter would be a stock index future, to be followed by long-term fixed rate bond futures.

^{1/} See SM/94/217 Supplement 1, Appendix III.

IV. The Balance of Payments

1. Current account

Portugal's international trade expanded again in 1994, with both export and import volumes resuming double-digit volume growth which had been interrupted by the 1992-93 recession. The expansion of trade was related both to economic growth in partner countries and to the ongoing process of economic integration of Portugal into the EU. The merchandise trade deficit was US\$6.7 billion in 1994 (7.6 percent of GDP), slightly smaller than in 1993 and the smallest as a percent of GDP since 1986 (Table 33). This continued the typical pattern of the past decade, with merchandise trade deficits financed mainly by surpluses on services and transfers.

The trade performance occurred against the background of relatively stable real exchange rates, after the large real appreciation of the escudo during the late 1980s and early 1990s. The latter appreciation now appears to be fading into history, without having resulted in any dramatic deterioration of Portugal's trade position; this tends to corroborate the view that this real appreciation had coincided with an increase in the equilibrium exchange rate, associated with structural changes in the Portuguese economy. 1/ The real appreciation of the escudo had caused problems for specific industries; however, many Portuguese firms had adjusted successfully by cutting costs and by undertaking investments in more efficient production facilities.

In 1994, the escudo weakened in nominal effective terms by some 5 percent (Table 34). This reflected the depreciation of the escudo within the ERM after the widening of the bands in August 1993. The currency was realigned downward by 3.5 percent in March 1995. Nonetheless, the escudo strengthened in nominal effective terms by some 2 percent in the first four months of 1995, mainly as a result of the weakening of the U.S. dollar. There was relatively little change in indicators of competitiveness during 1994 and early 1995 (Chart 9). The real exchange rate based on consumer prices depreciated by some 1.7 percent in 1994, then appreciated 3 percent in the first four months of 1995. Real effective exchange rates based on unit labor costs in manufacturing were approximately unchanged in 1994. 2/ The relative price of non-tradeables to tradeables rose 1.8 percent in 1994. The profit margin index for the export sector, reflecting export prices relative to costs of wage and materials, also changed little in 1994. Behind these changes in effective exchange rates and overall competitiveness

1/ See SM/94/217, Supplement I, Appendix II.

2/ There have been long-standing problems with the relative unit labor cost measure. In particular, data on productivity are believed to reflect an underestimate of industrial production, derived from a survey sample that systematically excludes newer (and generally more dynamic) enterprises. Moreover, ULC is based on contract rather than actual wages, and the coverage of wage agreements declined significantly in 1993.

Indicators of Competitiveness
(1990 = 100)

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indicators were, however, some issues concerning particular bilateral exchange rates; in particular, with the depreciation of the Italian lira in 1992-95, some difficulties were being experienced by industries (such as footwear, and large household appliances) in which Italy was an important competitor.

Portugal's export volume increased by 14.3 percent in 1994 (Table 35), and 10.6 percent in the first quarter of 1995 over the same period a year earlier. This was a result of increases in both partner country demand and market share. Exports to the United States, Italy, and to a lesser extent the United Kingdom grew particularly rapidly; there was slower, but still double-digit, growth in exports to Germany, France, and Spain, which retained their ranking as Portugal's three largest export markets. Exports to Italy grew faster than total exports during this period, despite the weakness of the lira. Export volume growth in 1994 was strongest for energy products, chemicals, and most importantly machinery (which accounted for 15 percent of total 1994 exports). In the first quarter of 1995, exports of machinery were again important, and automobile exports also grew very strongly--exports of transport material were 43.6 percent above their level in the same period of 1994. ^{1/}

Meanwhile, Portugal's economic recovery brought an increase in imports, particularly of inputs. Total imports rose by 11.2 percent in 1994; they decelerated slightly in the first quarter of 1995, increasing by 10.7 compared with the same period of 1994. Imports from Spain, already Portugal's largest supplier, rose especially rapidly; there was also strong growth in imports from the United States. Despite Portuguese concerns of a loss of competitiveness vis-à-vis Italy as a result of the depreciation of the lira during 1994 and 1995, Portuguese imports from Italy increased much less rapidly than from the EU as a whole (although some loss of competitiveness may have been evident in third-country export markets). Imports of metals and minerals, chemicals, and transport equipment--in short, materials used for production and investment--grew particularly strongly. At the same time, the weakness of domestic consumption was reflected in the relative weakness of other categories of imports--although this pattern began to change with the revival of domestic demand in early 1995.

Portugal's terms of trade resumed their upward trend in 1994, contributing to the improvement in the trade balance. In the first quarter of 1995, Portugal's terms of trade improved by a further 3.3 percent, compared with the first quarter of 1994. In particular, the pulp and paper industry, accounting for some 5 1/2 percent of exports, benefited from large

^{1/} One major development that is expected to have an important impact on trade in the future is the Autoeuropa (Ford-Volkswagen) plant, whose production came onstream beginning in mid-1995 and was expected to reach normal levels by 1997--after which it is projected to account for some 10 percent of Portuguese exports.

price increases in 1994 and through the first quarter of 1995: pulp prices were 67 percent higher in the first quarter of 1995 than a year earlier, and paper prices 34 percent higher.

The services balance, which had been in surplus for many years, weakened somewhat in 1994. Tourism receipts, the most important item, stagnated in dollar terms, despite a 6 percent increase in total arrivals (Table 40)--possibly reflecting increasing competition among tourist destinations. Payments for transport and insurance rose with the increased export volume, although receipts fell. The balance on investment income shifted from a small surplus to a small deficit, reflecting a decline in receipts and rise in payments, associated with the decline in Portugal's net international reserves.

The most important changes in the current account in 1994 were associated with unilateral transfers. Receipts of private transfers continued their downward trend; this partly reflects Portuguese expatriates' weakening ties to their home country, and the convergence of income levels in Portugal toward levels in countries to which Portuguese emigrated. In addition, a significant part of private transfers as measured in the balance of payments is believed actually to constitute investment by the expatriates; to a certain extent, the decline in private transfers constitutes a portfolio reallocation away from Portuguese assets toward assets in other countries. Public transfers also declined sharply in 1994: transfers received from the EU were postponed due to delays in project implementation. Moreover, Portugal's contributions to the EU were adjusted based on revised estimates of Portugal's GDP; retroactive payments were made in 1994. As a result, net public and private transfers received fell from 7.8 percent of GDP in 1993 to 6.1 percent of GDP in 1994. The current account swung from a surplus of 1.0 percent of GDP in 1993 to a deficit of 1.2 percent of GDP in 1994.

2. Capital account

The capital account also ran a small deficit in 1994, although much reduced from the previous year. Private nondebt capital swung from a net inflow of US\$0.9 billion in 1993 to an outflow of US\$1 billion in 1994, mainly reflecting a near-doubling of the outflow of short-term capital to US\$3.1 billion. The worldwide dampening of investors' interest in emerging markets in 1994--and then again in the wake of the Mexican crisis at the beginning of 1995--may also have played a role. In addition, the inflow of medium- and long-term debt capital in 1993 was reversed in 1994. At the same time, short-term bank capital swung from an outflow of US\$4.8 billion in 1993 to an inflow of over US\$1 billion in 1994. This conjunction of an outflow of private non-bank capital with an inflow of bank capital appears to reflect mainly the transfer of funds to offshore financial centers: funds previously invested in Portugal were invested in offshore centers, mainly in escudo-denominated certificates of deposits, with the correspondents of Portuguese banks and the funds were on-lent from these

centers to Portuguese banks. 1/ There was a seasonal pattern to the flows to the offshore centers: institutional investors transferred funds back to Portugal at end-year for window-dressing purposes (for tax and regulatory reasons), then moved the funds abroad again early in the year. The selloff of Portuguese public debt by non-residents continued in 1994, with a net outflow of US\$1 billion divided equally between short-term and medium and long-term debt; this may reflect, in part, the change in perceived global interest rate trends, which dampened international investors' interest in the debt of high-yield countries.

Foreign direct investment in Portugal shrank by over a quarter in dollar terms in 1994, the third year of decline in a row. This was due, in part, to the weakening of the escudo against the dollar by a cumulative 22 percent in 1993 and 1994, although the slow recovery of the Portuguese economy may also have played a role. Investment from a wide range of countries declined--with Germany a notable exception, whose investment in Portugal more than doubled (partly in connection with the construction of the Autoeuropa plant whose production came onstream in 1995). The largest decline in FDI was in the financial sector, whose share in the total fell by a third as the privatization of banks was completed.

Total international reserves (excluding gold) declined by US\$289 million during 1994 to reach US\$15.5 billion at year-end. They fell by a further US\$344 million during the first quarter of 1995, due in part to foreign exchange market intervention to quell market pressures--but they had risen again to some US\$16.0 billion by August 1995. In addition, reserves bear the brunt of temporary variations in receipts and payments, including those involving foreign borrowing and debt servicing, as well as the receipt of official transfers.

3. Commercial policy

Portugal's commercial policy is mainly determined by its membership in the EU under the single market program completed in 1992. Portugal has no remaining trade restrictions, such as tariffs and quantitative restrictions, different from other EU countries. Some remaining trade barriers, such as technical specifications, are gradually being reduced. For example, with regard to imports of used cars, Portugal had a tax regime that discouraged their sale, but in compliance with the EU requirements the authorities recently eliminated the tax discrepancy and introduced a new law on inspections.

1/ Some 96 percent of these funds went to the non-OECD area. The greater part of the movement in the accounts is attributable to one or two Portuguese institutional investors that transferred large amounts of funds to the Cayman Islands.

Portugal ratified the Uruguay Round agreement in December 1994. In implementing the agreement, one key area was textiles and footwear, with the phasing out of the Multifibre Agreement; in this context, bilateral accords have been reached with some exporting countries (such as Brazil), and, as of mid-1995, others (such as with China) were in the process of negotiation. In the area of agriculture, Portugal had been allowed several years to liberalize production in some areas consistent with the new Common Agricultural Policy, but had chosen to accelerate this transition process in exchange for more favorable EU financial support in the context of the new Community Support Framework. This accelerated transition has not been without costs--as seen, for instance, in a concentration of non-performing loans in the agricultural sector.

Table 1. Portugal: Aggregate Demand

	1989	1990	1991	1992	1993	1994
<u>(In billions of escudos, at current prices)</u>						
Private consumption	5,140.4	6,141.8	7,244.5	8,346.9	8,887.7	9,367.7
Public consumption	1,242.8	1,533.3	1,955.7	2,241.1	2,415.8	2,570.6
Investment	2,354.7	2,728.8	3,087.7	3,543.9	3,408.8	3,678.1
Gross fixed investment	2,237.0	2,612.4	2,987.7	3,426.5	3,321.3	3,557.9
Change in stocks	117.7	116.4	100.0	117.4	87.5	120.2
Total domestic demand	8,737.9	10,403.9	12,287.9	14,131.9	14,712.4	15,616.4
Exports (goods and nonfactor services)	3,008.7	3,527.2	3,609.0	3,684.8	3,746.9	4,270.3
Aggregate demand	11,746.5	13,931.1	15,896.9	17,816.7	18,459.2	19,886.7
Imports (goods and nonfactor services)	3,527.7	4,273.5	4,567.0	4,784.8	4,699.2	5,281.2
GDP	8,218.9	9,657.6	11,329.8	13,031.9	13,760.0	14,605.5
<u>(Percentage change at constant prices)</u>						
Private consumption	3.3	5.0	5.2	4.6	-0.3	0.0
Public consumption	4.6	1.9	3.2	1.5	-1.5	1.4
Investment	3.5	7.5	1.8	6.1	-8.3	4.9
Gross fixed investment	4.5	8.1	2.5	5.6	-7.6	4.2
Total domestic demand	3.5	5.2	4.0	4.5	-2.5	1.4
Exports (goods and nonfactor services)	13.1	12.3	2.1	4.9	-0.8	9.4
Aggregate demand	5.8	7.0	3.5	4.6	-2.2	3.0
Imports (goods and nonfactor services)	6.1	13.9	6.4	11.6	-4.8	8.9
GDP	5.7	4.1	2.3	1.7	-1.2	1.0
<u>(Percentage change, implicit deflators)</u>						
Private consumption	12.2	13.8	12.1	10.2	6.8	5.4
Public consumption	16.4	21.1	23.6	12.9	9.5	4.9
Investment	8.2	7.8	11.2	8.2	4.9	2.8
Gross fixed investment	9.8	8.0	11.6	8.7	5.0	2.8
Total domestic demand	11.7	13.1	13.6	10.1	6.8	4.7
Exports (goods and nonfactor services)	11.4	4.4	0.2	-2.7	2.5	4.2
Aggregate demand	11.6	10.8	10.2	7.2	5.9	4.6
Imports (goods and nonfactor services)	10.7	6.3	0.4	-6.1	3.2	3.2
GDP	12.0	12.9	14.7	13.1	6.8	5.1

Source: Banco de Portugal estimates.

Table 2. Portugal: Contributions of Demand Components
to Real GDP Growth ^{1/}

(In percentage)

	1989	1990	1991	1992	1993	1994
Private consumption	2.1	3.1	3.3	2.9	-0.2	0.0
Public consumption	0.7	0.3	0.5	0.3	-0.3	0.2
Investment	1.1	2.1	0.5	1.7	-2.3	1.2
Gross fixed investment	1.3	2.2	0.7	1.5	-2.0	1.0
Change in stocks	-0.2	-0.1	-0.2	0.2	-0.2	0.2
Domestic demand	3.8	5.5	4.3	4.9	-2.7	1.5
Exports (goods and nonfactor services)	4.5	4.5	0.8	1.6	-0.2	2.6
Aggregate demand	8.3	10.0	5.0	6.5	-3.0	4.0
Imports (goods and nonfactor services)	-2.6	-6.0	-2.8	-4.7	1.8	-3.0
Foreign balance (net exports)	1.9	-1.5	-2.1	-3.1	1.5	-0.5
GDP	5.7	4.1	2.3	1.7	-1.2	1.0

Source: Banco de Portugal estimates.

^{1/} Based on the structure of the previous year (at current prices).

Table 3. Portugal: Consumption and investment indicators

(Year-on-year real percentage change)

	Consumption			Investment				
	Current consumption Total 1/	Auto sales 2/	Gasoline sales	Machinery imports 3/	Sales of Commercial vehicles		Cement 6/	Steel 7/
					Light 4/	Heavy 5/		
1988	7.1	70.1	10.9	28.5	45.0	18.0	10.7	16.4
1989	7.8	-9.7	9.1	8.7	0.6	-2.4	2.8	8.4
1990	6.2	9.4	7.8	11.3	1.4	-12.2	7.0	0.7
1991	7.6	7.9	10.0	4.2	-1.2	-9.2	4.1	-1.9
1992	3.0	22.1	13.1	5.2	21.1	-5.0	2.2	15.9
1993	1.0	-12.7	6.0	n.a.	-1.6	-28.1	-0.9	-3.6
1994	-1.2	-3.7	3.0	0.7	22.4	-21.8	0.6	6.7
1989								
I	12.8	23.5	11.8	3.0	22.0	24.6	10.5	23.6
II	7.8	-15.8	11.7	8.5	1.2	-7.4	9.7	19.0
III	7.3	-18.7	7.5	15.8	-7.9	-15.9	0.5	4.5
IV	5.0	-21.6	6.1	.3	-8.2	-5.5	-8.5	-10.6
1990								
I	6.5	-12.4	5.8	28.0	-2.1	-15.9	2.1	-15.1
II	6.6	17.8	9.2	12.6	10.4	3.1	4.6	-4.2
III	6.4	17.2	6.1	1.4	0.8	-14.3	8.2	6.8
IV	5.5	20.1	10.5	6.5	-2.7	-21.3	13.9	18.4
1991								
I	10.4	8.5	4.0	4.3	-2.5	-14.7	0.7	1.1
II	7.9	10.2	9.5	7.1	-11.0	-21.9	3.7	-4.0
III	5.7	11.5	12.5	9.0	6.2	3.4	7.2	-4.3
IV	7.1	2.1	13.0	-2.5	3.6	1.4	4.7	0.2
1992								
I	2.1	28.5	18.7	5.2	24.9	6.3	11.0	29.0
II	5.4	25.6	12.7	-1.8	23.0	-7.1	-1.5	4.8
III	3.8	12.2	11.0	10.8	17.6	-6.0	-0.2	14.7
IV	1.0	21.6	11.4	6.8	19.2	-11.8	0.4	17.0
1993								
I	2.1	-7.0	8.0	n.a.	6.2	-28.3	1.1	7.8
II	0.4	-16.9	7.4	n.a.	2.6	-18.9	2.8	18.6
III	0.5	-9.0	4.9	n.a.	-4.9	-31.5	-2.2	-21.5
IV	1.2	-16.9	4.3	n.a.	-9.8	-33.8	-5.6	-16.0
1994								
I	-1.8	-8.2	5.4	-9.5	5.0	-28.7	-8.8	-19.7
II	-1.4	2.8	4.6	-3.1	10.3	-25.7	-3.3	-17.6
III	-2.2	-8.2	2.2	6.0	14.1	-22.5	5.6	43.7
IV	0.3	-1.6	0.4	10.1	59.7	-9.0	10.1	33.2
1995								
I	-1.1	-11.1	1.1	n.a.	-24.5	1.1	10.6	39.9

1/ Based on sales by main supermarkets.

2/ Passenger vehicles, excluding 4x4

3/ Imports of capital goods, excluding transport equipment

4/ Light commercial vehicles, excluding 4x4

5/ Heavy commercial vehicles, excluding 4x4

6/ Sold to construction industry

7/ From 1988 to 1992 includes steel imports

Table 4. Portugal: Composition and Structure
of Gross Fixed Investment ^{1/}

	1989	1990	1991	1992	1993	1994
<u>(Real growth, in percent)</u>						
Gross fixed investment	4.5	8.1	2.5	5.6	-7.6	4.2
Construction	4.3	5.3	4.5	2.5	-0.6	1.1
Equipment	4.6	10.2	0.9	8.2	-13.7	7.2
<u>(In percent of total)</u>						
Composition by sector						
Public sector	31.4	26.0	28.6	28.9	30.6	31.0
General Government						
(SPA)	12.7	12.6	13.8	14.9	17.2	18.2
Public enterprises ^{2/}	18.7	13.4	14.8	14.0	13.4	12.8
Private sector	68.6	74.0	71.4	71.1	69.4	69.0
Total	100.0	100.0	100.0	100.0	100.0	100.0
Structure						
Construction	42.4	43.0	45.8	46.2	49.1	47.5
Equipment	57.6	57.0	54.2	53.8	50.9	52.5

Sources: Figures for 1989:INE; since 1990: Bank of Portugal, Ministry of Finance-GAFEEP.

^{1/} Figures for public enterprises are based on estimates provided by the GAFEEP. Investment by the private sector (including nationalized banks) were calculated as a residual.

^{2/} Nonfinancial public enterprises.

Table 5. Portugal: Distribution of National Income

	1989	1990	1991	1992	1993	1994
(In billions of escudos)						
1. Wage income	3,566.3	4,319.6	5,002.1	5737.4	6,015.1	6172.1
Wages	2894.4	3518.7	4,048.2	4,606.1	4,780.8	4825.5
Social security	671.9	800.9	953.9	1,131.3	1,234.3	1346.6
2. Gross operating surplus	3,634.3	4,151.6	4,963.7	5,641.6	6151.2	6601.1
3. GDP at factor cost (3=1+2)	7,200.6	8,471.2	9,965.8	11,379.0	12,166.3	12,773.2
4. Indirect taxes net of subsidies	1,018.0	1,186.0	1,363.6	1,652.9	1,593.7	1832.3
5. GDP at market price (5=3+4)	8,218.6	9,657.2	11,329.4	13031.9	13,760.0	14,605.5
6. Net factor payment from abroad	-113.1	-34.1	10.8	90.0	13.2	-52.2
7. GNP at factor cost (7=3+6)	7,087.4	8,437.1	9,976.6	11,469.0	12,179.5	12721.0
8. GNP at market price (8=5+6)	8,105.4	9,623.1	11,340.2	13,121.9	13,773.2	14553.3
9. Net unrequited transfers	604.7	649.6	658.9	690.5	713.3	610.7
10. National disposable income (10=8+9)	8,710.1	10,272.7	11,999.2	13,812.4	14,486.5	15164.0
Households	6,155.7	7,485.9	8,698.7	9,790.4	10319.3	10715.7
Firms	1,198.3	1,415.6	1,646.4	1768.7	2,137.0	2166.3
General government	1,356.1	1,371.2	1,654.1	2,253.3	2,030.2	2282.0
(Percentage change)						
1. Wage income	18.0	21.1	15.8	14.7	4.8	2.6
Wages	18.6	21.6	15.0	13.8	3.8	0.9
Social security	15.4	19.2	19.1	18.6	9.1	9.1
2. Gross operating surplus	18.5	14.2	19.6	13.7	9.0	7.3
3. GDP at factor cost (3=1+2)	18.3	17.6	17.6	14.2	6.9	5.0
4. Indirect taxes net of subsidies	13.2	16.5	15.0	21.2	-3.6	15.0
5. GDP at market prices (5=3+4)	17.8	17.5	17.3	15.0	5.6	6.1
Memorandum item:						
Share of wage income in GDP						
factor cost	54.3	54.8	54.1	50.4	49.4	48.3

Source: Figures for 1989: INE; since 1990: estimates of Bank of Portugal.

Table 6. Portugal: Disposable Income

	1989	1990	1991	1992	1993	1994
(In billions of escudos)						
Disposable household income	6,155.7	7,485.9	8,696.7	9,790.4	10,319.3	10,715.7
Private consumption	5,140.4	6,141.8	7,244.5	8,346.9	8,887.7	9,367.7
Households saving	1,015.3	1,344.1	1,454.1	1,448.6	1,431.6	1,348.0
Saving rate (in percent) ^{1/}	16.5	18.0	16.7	14.7	13.9	12.6
Direct taxes	491.4	546.2	695.2	929.6	950.4	1,014.1
Social security taxes	930.9	1,109.8	1,327.7	1,567.1	1,723.3	1,838.1
Personal income	7,578.1	9,152.2	10,721.6	12,281.2	12,993.0	13,568.0
Wage bill	3,566.3	4,319.5	5,002.1	5,737.4	6,015.1	6,172.1
Other earned income	2,426.5	2,960.2	3,507.3	4,050.5	4,203.4	4,424.4
Domestic currency transfer	997.4	1,234.1	1,546.0	1,850.3	2,148.8	2,404.1
Transfers from abroad	587.9	638.3	666.2	648.0	625.7	567.4
(Percentage change)						
Disposable income	14.0	21.6	16.2	12.6	5.4	3.8
Real disposable income ^{2/}	1.1	6.0	3.7	2.1	-1.3	-1.5
Personal income	15.7	20.8	17.1	14.5	5.8	4.4
Wage bill	18.0	21.1	15.8	14.7	4.8	2.6
Other earnings income	13.2	22.0	18.5	15.5	3.8	5.3
Domestic currency transfer	15.4	23.7	25.3	19.7	16.1	11.9
Private external transfers	12.9	8.6	4.4	-3.5	-2.7	-9.3
Memorandum items:						
Factor income (GDP at factor costs)						
In billions of escudos	7,200.6	8,471.2	9,965.8	11,379.0	12,166.9	12,778.2
Percentage change	18.3	17.6	17.6	14.2	6.9	5.0

Source: Bank of Portugal.

^{1/} These figures are not comparable with those published in the previous year due to the change in the basis year of National Accounts statistics.

^{2/} Deflated by the CPI.

Table 7. Portugal: Savings and Investment

	1989	1990	1991	1992	1993	1994
<u>(In billions of escudos)</u>						
Domestic saving	2,326.9	2,597.6	2,799.0	3,224.4	3,182.9	3,225.7
Private (including public enterprises)	2,213.6	2,759.7	3,100.6	3,212.2	3,568.5	3,514.3
Households	1,015.3	1,344.1	1,454.1	1,443.6	1,431.6	1,348.0
Firms	1,198.3	1,415.6	1,646.4	1,768.7	2,137.0	2,166.3
Public (general government)	113.3	-162.1	-301.6	12.2	-385.6	-288.6
Foreign saving	27.7	131.2	288.7	319.5	225.9	452.4
Gross saving = gross investment	2,354.7	2,728.8	3,087.7	3,543.9	3,408.8	3,678.1
Gross fixed capital formation	2,237.0	2,612.4	2,987.7	3,426.5	3,321.3	3,557.9
Change in stocks	117.7	116.4	100.0	117.4	87.5	120.2
<u>(In percent of GDP)</u>						
Domestic saving	28.3	26.9	24.7	24.7	23.1	22.1
Private (including public enterprises)	26.9	28.6	27.4	24.6	25.9	24.1
Households	12.4	13.9	12.8	11.1	10.4	9.2
Firms	14.6	14.7	14.5	13.6	15.5	14.8
Public (general government)	1.4	-1.7	-2.7	0.1	-2.8	-2.0
Foreign saving	0.3	1.4	2.5	2.5	1.6	3.1
Gross saving = gross investment	28.6	28.3	27.3	27.2	24.8	25.2
Gross fixed capital formation	27.2	27.1	26.4	26.3	24.1	24.4
Change in stocks	1.4	1.2	0.9	0.9	0.7	0.8

Source: Bank of Portugal, Annual Report.

Table 8. Portugal: Origins of Gross Domestic Product
(Real percentage change, except when otherwise indicated)

	1987 <u>1/</u>	1988	1989	1990	1991	1992	1993	1994
Agriculture, forestry and fishing	431.7	-21.8	12.7	-1.0	-1.4	-1.0	-6.6	1.9
Manufacturing	1,616.5	9.1	8.0	5.3	0.9	-2.0	-4.4	1.6
Energy	227.0	12.5	-4.9	10.0	3.0	2.0	3.5	2.5
Construction	318.8	12.5	-1.5	5.0	4.5	2.5	-0.5	1.0
Services	3,214.4	5.5	6.2	5.6	4.8	4.4	-0.7	0.7
GDP at market prices	5,891.7	8.4	5.7	4.1	2.3	1.7	-1.2	1.0

Source: Bank of Portugal.

1/ In billions of escudos.

Table 9. Portugal: Consumer Prices 1/

(Annual average percent change)

	1988 <u>2/</u>	1989	1990	1991 <u>3/</u>	1992	1993	1994
Total <u>4/</u>	9.7	12.6	13.4	11.4	8.9	6.5	5.2
Food and beverages	9.2	14.4	13.6	9.9	7.1	2.8	4.8
Clothing and footwear	13.2	10.5	9.5	11.9	11.9	7.0	4.1
Housing	10.1	11.8	11.9	12.1	9.6	7.0	3.5
Other <u>5/</u>	9.1	11.6	11.3	10.9	8.6	13.2	6.7
Administered prices	5.0	9.0	12.2	13.8	8.6	6.8	3.9
Nonadministered prices	11.0	13.4	13.2	10.6	9.0	6.5	5.4
Memorandum items:							
12-month inflation rate	11.6	11.6	13.7	9.6	8.4	6.4	4.0
Underlying inflation <u>6/</u>	9.7	12.6	13.2	12.3	11.8	8.9	5.7
NEER <u>7/</u>	-5.2	-3.1	-2.7	0.7	3.2	-6.0	-4.1
Import prices	7.1	7.8	3.4	-0.9	-5.4	2.8	3.0
Inflation in EU <u>8/</u>	3.6	5.0	5.7	5.0	4.2	3.4	3.1
Inflation differential vis-à-vis EU <u>8/</u>	6.1	7.6	7.8	6.5	4.7	3.3	2.2

Source: Bank of Portugal.

1/ Annual averages.

2/ New CPI series starting January 1988.

3/ New CPI series starting January 1991.

4/ Excluding rents.

5/ Excluding health, transport and communications, education, entertainment, and tobacco.

6/ Excluding food and beverages, and energy.

7/ Rate of change of nominal effective exchange rate of the escudo.

8/ EU excluding Portugal.

Table 10. Portugal: Population, Labor Force, Employment, Unemployment, and Labor Market

	1989	1990	1991	1992 ^{1/}	1993	1994
(In thousands)						
Total resident population	9,800	9,808	9,815	9,345	9,350	9,350
Civilian labor force	4,672	4,716	4,829	4,528	4,504	4,564
Total employment	4,400	4,496	4,631	4,341	4,255	4,252
Dependent employment	3,076	3,166	3,211	3,223	3,132	3,070
Fixed term contracts ^{2/}	19.1	18.0	16.1	12.1	10.9	10.6
Unemployment	272	220	199	187	248	312
First employment seekers	77	57	41	40	39	52
New employment seekers	196	163	158	147	209	260
Labor market						
Application for employment by unemployed	309.2	304.3	296.6	339.3	365.1	410.2
Unfilled vacancies	9.7	7.7	8.4	7.0	5.0	5.1
Placements	31.6	30.6	27.5	27.9	28.6	35.1
(In percent)						
Participation rate	47.7	48.1	49.2	48.5	48.2	48.8
Male	56.4	57.7	57.5	56.3	55.4	55.8
Female	39.7	42.6	42.8	41.3	41.5	42.3
Unemployment rate	5.0	4.7	4.1	4.1	5.5	6.8
Male	3.4	3.2	2.8	3.5	4.7	6.0
Female	7.2	6.6	5.8	4.9	6.5	7.8
Duration of unemployment						
Less than 3 months	24.7	29.3	31.4	35.7	29.4	27.3
Between 3 and 12 months	37.4	36.8	38.5	38.4	41.3	38.5
Over 12 months	38.2	33.9	30.1	25.9	29.3	34.2
Memorandum item:						
Unemployment rate in EU-12	8.5	7.8	8.4	9.8	11.1	11.6

Sources: National Institute of Statistics, Inquerito ao Emprego; Bank of Portugal, Monthly Bulletin; and WEO.

^{1/} As a result of methodological changes in the construction of the series, data for 1992 is not strictly comparable to previous years.

^{2/} In percent of dependent employment.

Table 11. Portugal: Employment by Sector ^{1/}

(In thousands)

	1989	1990	1991	1992 ^{2/}	1993	1994
Agriculture, forestry, and fishing	829.0	795.3	799.1	490.1	482.3	490.2
Manufacturing and mining industries	1,141.5	1,158.1	1,154.2	1,061.0	1,029.9	1,025.8
Electricity, water and gas	38.5	40.2	45.9	31.1	29.3	36.7
Construction	365.4	361.1	363.6	346.2	340.2	330.8
Services	2,020.2	2,141.4	2,268.1	2,412.2	2,373.4	2,367.9
Total	4,395.0	4,495.9	4,630.8	4,340.7	4,255.2	4,251.5
Memorandum items:						
Public sector	806.6	808.7	828.2	940.4	902.4	925.6
General government ^{3/}	640.7	655.3	691.4	810.8	786.9	793.4
Public enterprises ^{4/}	165.9	153.4	136.8	129.6	115.5	132.2
Public sector (percent of total)	18.3	18.0	17.9	21.7	21.2	21.8

Source: National Institute of Statistics, Inquerito ao Emprego.

^{1/} Period average.

^{2/} As a result of methodological changes in the construction of the series, data for 1992 is not strictly comparable to previous years.

^{3/} Including education and health services, public and private.

^{4/} Nonfinancial public enterprises covered by GAFEEP.

Table 12. Portugal: Wage Developments

(Annual nominal percentage change, except where otherwise indicated)

	1989	1990	1991	1992	1993	1994
Wages ^{1/}	14.0	17.7	14.2	13.7	7.9	4.7
Contractual wages						
Agriculture	11.4	14.9	14.9	11.7	7.6	5.2
Industry	10.6	13.8	14.4	10.7	7.8	5.2
Construction	9.6	13.9	13.5	10.8	6.6	-
General government	8.0	...	13.5	8.0	5.2	2.8
Services	10.6	13.6	14.5	11.9	7.8	5.1
Total	10.5	13.7	14.2	10.6	7.1	4.7
Of which: total excluding						
General government	10.5	13.7	14.4	11.2	7.6	5.2
Public enterprises	11.6	14.4	14.5	11.9	6.3	4.2
Private sector	10.4	13.8	14.4	11.1	7.7	5.2
Memorandum item:						
Inflation rate (CPI)	12.6	13.4	11.4	8.9	6.5	5.2

Source: Bank of Portugal, Monthly Bulletin.

^{1/} Including employers' social security contributions.

Table 13. Portugal: Labor Costs in Manufacturing

(1990 = 100)

	IPI (1)	Employment (2)	Productivity (3)	Wages (4)	Unit Labor Costs in escudos (5)	Percent Change in ULC	Unit Labor Costs- Exterior in escudos (6)	Relative Unit Labor Costs (7)	Percent Change in RULC
1986	83.2	88.7	93.8	59.7	63.6	...	74.1	85.9	...
1987	87.5	92.7	94.4	67.9	71.9	13.0	82.9	86.8	1.0
1988	89.9	95.7	93.9	75.9	80.8	12.3	87.5	92.3	6.4
1989	92.4	98.7	93.6	86.0	91.9	13.7	93.4	98.4	6.5
1990	100.0	100.0	100.0	100.0	100.0	8.9	100.0	100.0	1.7
1991	100.4	100.1	100.3	116.4	116.1	16.1	103.8	111.8	11.8
1992	97.8	98.8	99.0	129.9	131.2	13.1	104.0	126.2	12.9
1993 (P)	93.6	96.1	97.4	137.2	140.9	7.3	112.4	125.3	-0.7
1994 (P)	95.1	96.0	99.1	144.3	145.7	3.4	114.9	126.8	1.2

Source: Bank of Portugal based on the following data:

- (1) INE, Industrial Production Index (manufacturing); adjusted for working days.
 - (2) INE
 - (3) (1)/(2)
 - (4) Ministry of Employment and Social Security. Wages in manufacturing.
 - (5) ULC = (4)/(3)
 - (6) ULC of main partner countries weighted by manufacturing trade.
 - (7) (5)/(6)
- P = Provisional

Table 14. Portugal: General Government Expenditures and Revenues

(In billions of escudos; national accounts basis)

	1988	1989	1990	1991	1992	1993	1994	1995 Budget
Current receipts	2,470.1	2,933.7	3,486.2	4,194.3	5,124.3	5,124.3	5,520.0	5,941.0
Taxes	2,146.0	2,571.2	3,080.9	3,673.3	4,435.9	4,471.7	4,958.4	5,339.1
Direct taxes	1,129.0	1,443.1	1,757.8	2,162.1	2,622.4	2,695.4	2,913.4	3,100.1
Income and property	477.1	678.3	805.7	1,026.7	1,291.3	1,243.8	1,329.7	1,365.2
Social security	651.9	764.8	952.1	1,135.4	1,331.1	1,451.6	1,583.7	1,734.9
Indirect taxes	1,017.0	1,128.1	1,323.1	1,511.2	1,813.5	1,776.3	2,045.0	2,239.0
Other current receipts	324.1	362.5	405.3	521.0	688.4	652.6	561.6	601.9
Current expenditure	2,465.1	2,828.0	3,643.7	4,510.4	5,112.0	5,509.9	5,808.5	6,236.3
Goods and services	1,025.3	1,226.7	1,495.6	1,909.7	2,241.1	2,415.7	2,570.6	2,753.7
Subsidies	128.1	122.0	147.1	153.3	130.6	135.9	117.4	134.8
Interest payments	491.4	519.7	832.4	946.3	991.3	908.9	847.8	868.4
Transfers	820.3	959.6	1,168.6	1,501.1	1,749.0	2,049.4	2,272.7	2,479.4
Current balance	5.0	105.7	-157.5	-316.1	12.3	-385.6	-288.5	-295.3
Capital receipts	118.7	176.7	227.1	301.0	426.6	447.2	415.3	523.1
Capital expenditure	373.8	470.7	593.6	700.5	864.9	1,023.3	968.5	1,152.6
Investment	250.9	283.2	329.1	392.1	523.3	571.1	646.4	745.7
Transfers	122.9	187.5	264.5	308.4	341.6	452.2	322.1	406.9
Capital balance	-255.1	-294	-366.5	-399.5	-438.3	-576.1	-553.2	-629.5
Balance excl. net lending	-250.1	-188.3	-524.0	-715.6	-426.0	-961.7	-841.7	-924.8
Of which: Primary	241.3	331.4	308.4	230.7	565.3	-52.8	6.1	-56.4
Net lending	40.1	83.5	98.0	-12.9	24.5	6.8	17.8	38.2
Overall balance	-290.2	-271.8	-622.0	-702.7	-450.5	-968.5	-859.5	-963.0
Memorandum items:								
Total expenditure (exc. net lending)	2,838.9	3,298.7	4,237.3	5,210.9	5,976.9	6,533.2	6,777.0	7,388.9
Of which:								
Military expenditures	136.5	153.9	176.1	271.6	227.8	238.1	259.9	266.0
Total primary exp.	2,347.5	2,779.0	3,404.9	4,264.6	4,985.6	5,624.3	5,929.2	6,520.5
Current primary exp.	1,973.7	2,308.3	2,811.3	3,564.1	4,120.7	4,601.0	4,960.7	5,367.9
Total receipts	2,588.8	3,110.4	3,713.3	4,495.3	5,550.9	5,571.5	5,935.3	6,464.1
Borrowing requirement of non-financial public enterprises	49.6	72.2	76.1	154.6	164.4	68.7	51.6	...

Sources: Ministry of Finance.

Table 15. Portugal: General Government Expenditures and Revenues

(In percent of GDP)

	1988	1989	1990	1991	1992	1993	1994	1995 Budget
Current receipts	35.6	35.7	36.1	37.0	39.3	37.2	37.8	37.6
Taxes	30.9	31.3	31.9	32.4	34.0	32.5	33.9	33.8
Direct taxes	16.3	17.6	18.2	19.1	20.1	19.6	19.9	19.6
Income and property	6.9	8.3	8.3	9.1	9.9	9.0	9.1	8.6
Social security	9.4	9.3	9.9	10.0	10.2	10.5	10.8	11.0
Indirect taxes	14.6	13.7	13.7	13.3	13.9	12.9	14.0	14.2
Other current receipts	4.7	4.4	4.2	4.6	5.3	4.7	3.8	3.8
Current expenditure	35.5	34.4	37.7	39.8	39.2	40.0	39.8	39.4
Goods and services	14.8	14.9	15.5	16.9	17.2	17.6	17.6	17.4
Subsidies	1.8	1.5	1.5	1.4	1.0	1.0	0.8	0.9
Interest payments	7.1	6.3	8.6	8.4	7.6	6.6	5.8	5.5
Transfers	11.8	11.7	12.1	13.2	13.4	14.9	15.6	15.7
Current balance	0.1	1.3	-1.6	-2.8	0.1	-2.8	-2.0	-1.9
Capital receipts	1.7	2.1	2.4	2.7	3.3	3.3	2.8	3.3
Capital expenditure	5.4	5.7	6.1	6.2	6.6	7.4	6.6	7.3
Investment	3.6	3.4	3.4	3.5	4.0	4.2	4.4	4.7
Transfers	1.8	2.3	2.7	2.7	2.6	3.3	2.2	2.6
Capital balance	-3.7	-3.6	-3.8	-3.5	-3.4	-4.2	-3.8	-4.0
Balance excl. net lending	-3.6	-2.3	-5.4	-6.3	-3.3	-7.0	-5.8	-5.8
Of which: Primary	3.5	4.0	3.2	2.0	4.3	-0.4	0.0	-0.4
Net lending	0.6	1.0	1.0	-0.1	0.2	0.0	0.1	0.2
Overall balance	-4.2	-3.3	-6.4	-6.2	-3.5	-7.0	-5.9	-6.1
Memorandum items:								
Total expenditure (exc. net lending)	40.9	40.1	43.9	46.0	45.9	47.5	46.4	46.7
Of which:								
Military expenditures	2.0	1.9	1.8	2.4	1.7	1.7	1.8	1.7
Total primary expenditures	33.8	33.8	35.3	37.6	38.3	40.9	40.6	41.2
Current primary expenditures	28.4	28.1	29.1	31.5	31.6	33.4	34.0	33.9
Total receipts	37.3	37.8	38.4	39.7	42.6	40.5	40.6	40.9
Borrowing requirement of non-financial public enterprises	0.7	0.9	0.8	1.4	1.3	0.5	0.4	...

Sources: Ministry of Finance and INE.

Table 16. Portugal : General Government Accounts, 1992

(In billions of escudos, national accounts basis)

	Central Government				
	State	Autonomous Services and Funds	Local Administration	Social Security	Total Consolidated
Current revenue	3,141.7	927.2	468.5	1,463.5	5,124.1
Taxes on income and property	1,186.0	0.8	104.5	--	1,291.3
Social security contributions	--	--	--	1,331.1	1,331.1
Taxes on goods and services	1,594.5	68.0	140.4	10.6	1,813.5
Nontax revenue	361.2	858.4	223.6	121.8	688.2
Of which: From other general government sectors	3.2	669.5	120.5	83.6	--
Current expenditures	3,230.1	888.4	434.1	1,436.3	5,112.3
Goods and services	1,185.4	626.0	361.1	68.8	2,241.3
Of which: Salaries	1,049.1	459.3	227.2	42.3	1,777.9
Subsidies	92.2	30.3	8.0	--	130.5
Interest payments	947.0	8.4	35.9	--	991.3
Other current transfers	1,005.5	223.7	29.1	1,367.5	1,749.2
Of which: From other general government sectors	817.7	22.9	0.8	35.2	--
Current balance	-88.4	38.8	34.4	27.2	12.0
Capital revenue	58.9	372.0	204.4	126.2	426.5
Of which: From other general government sectors	--	228.4	103.2	3.4	--
Capital expenditure	424.4	398.9	254.8	121.6	864.8
Fixed investment	92.3	197.4	223.8	9.8	523.3
Capital transfers	332.1	201.5	31.0	111.8	341.5
Of which: To other general government sectors	279.9	7.0	--	48.0	--
Capital balance	-365.5	-26.9	-50.4	4.6	-438.2
Overall balance	-453.9	11.9	-16.0	31.8	-426.2
Primary balance	493.1	20.3	19.9	31.8	565.1
Net lending	5.6	21.2	3.5	-5.8	24.5
Overall balance including net lending	-459.5	-9.3	-19.5	37.6	-450.7
In percent of GDP	-3.5	-0.1	-0.1	0.3	-3.5

Source: Ministry of Finance.

Table 17. Portugal : General Government Accounts, 1993

(In billions of escudos, national accounts basis)

	Central Government		Local Administration	Social Security	Total Consolidated
	State	Autonomous Services and Funds			
Current revenue	2,980.7	965.2	497.1	1,720.2	5,124.3
Taxes on income and property	1,133.4	--	110.4	--	1,243.8
Social security contributions	--	--	--	1,451.6	1,451.6
Taxes on goods and services	1,565.8	53.3	145.4	11.8	1,776.3
Nontax revenue	281.5	911.9	241.3	256.8	652.6
Of which: From other general government sectors	6.3	705.6	125.7	201.3	--
Current expenditures	3,512.5	916.4	480.4	1,639.4	5,509.8
Goods and services	1,307.8	635.4	404.6	67.9	2,415.7
Of which: Salaries	1,149.2	468.9	244.2	42.2	1,904.5
Subsidies	103.7	24.8	7.4	--	135.9
Interest payments	866.9	7.8	34.1	--	908.8
Other current transfers	1,234.1	248.4	34.3	1,571.5	2,049.4
Of which: From other general government sectors	994.6	15.1	1.1	28.1	--
Current balance	-531.8	48.8	16.7	80.8	-385.5
Capital revenue	62.3	377.8	210.1	161.6	447.0
Of which: From other general government sectors	8.4	241.2	111.7	3.5	--
Capital expenditure	476.4	415.1	289.6	207.0	1,023.4
Fixed investment	108.2	189.4	263.8	9.8	571.2
Capital transfers	368.2	225.7	25.8	197.2	452.2
Of which: To other general government sectors	294.2	4.4	--	66.1	--
Capital balance	-414.1	-37.3	-79.5	-45.4	-576.3
Overall balance	-945.9	11.5	-62.8	35.4	-961.8
Primary balance	-79.0	19.3	-28.7	35.4	-53.0
Net lending	-14.6	18.5	1.9	1.1	6.9
Overall balance including net lending	-931.3	-7.0	-64.7	34.3	-968.7
In percent of GDP	-6.8	-0.1	-0.5	0.2	-7.0

Source: Ministry of Finance.

Table 18. Portugal : General Government Accounts, 1994

(In billions of escudos, national accounts basis)

	<u>Central Government</u>		Local Administration	Social Security	Total Consolidated
	State	Autonomous Services and Funds			
Current revenue	3,262.8	1,014.9	535.1	1,840.8	5,520.0
Taxes on income and property	1,207.0	--	122.7	--	1,329.7
Social security contributions	--	--	--	1,583.7	1,583.7
Taxes on goods and services	1,826.9	47.0	159.2	11.9	2,045.0
Nontax revenue	228.9	967.9	253.2	245.2	561.6
Of which: From other general government sectors	6.4	783.2	127.8	216.2	--
Current expenditures	3,599.5	963.8	522.7	1,856.1	5,808.4
Goods and services	1,375.2	686.4	439.2	69.8	2,570.6
Of which: Salaries	1,191.8	494.4	255.7	44.0	1,985.9
Subsidies	102.0	5.8	9.6	--	117.4
Interest payments	803.1	5.8	38.9	--	847.8
Other current transfers	1,319.2	265.8	35.0	1,786.3	2,272.6
Of which: From other general government sectors	1,069.5	20.9	1.5	41.8	--
Current balance	-336.7	51.1	12.4	-15.3	-288.5
Capital revenue	34.6	424.2	231.1	114.0	415.3
Of which: From other general government sectors	4.0	256.4	124.2	4.0	--
Capital expenditure	478.0	430.0	305.4	143.9	968.7
Fixed investment	117.2	239.0	278.9	11.4	646.5
Capital transfers	360.8	191.0	26.5	132.5	322.2
Of which: To other general government sectors	309.1	12.2	0.1	67.2	--
Capital balance	-443.4	-5.8	-74.3	-29.9	-553.4
Overall balance	-780.1	45.3	-61.9	-45.2	-841.9
Primary balance	23.0	51.1	-23.0	-45.2	5.9
Net lending	-1.3	17.6	1.4	--	17.7
Overall balance including net lending	-778.8	27.7	-63.3	-45.2	-859.6
In percent of GDP	-5.3	0.2	-0.4	-0.3	-5.9

Source: Ministry of Finance.

Table 19. Portugal: Public Transfers Between Portugal and the EU 1/
(In billions of escudos)

	1989	1990	1991	1992	1993	1994	1995 Proj.
A. From the EU to Portugal	198.8	215.5	385.1	461.3	619.7	544.5	683.0
(In percent of GDP)	2.4	2.2	3.4	3.5	4.5	3.7	4.3
Structural funds	124.0	144.4	300.1	359.6	500.9	363.6	472.0
(In percent of GDP)	1.5	1.5	2.6	2.8	3.6	2.5	3.0
(In percent of total investment)	5.5	5.5	10.0	10.5	15.1	10.2	12.0
ERDF	63.0	74.1	185.2	222.5	286.0	234.4	273.0
ESF	35.4	29.7	54.9	87.2	152.8	71.9	118.0
EAGGF-Guidance 2/	25.6	40.6	60.0	49.9	62.1	53.3	81.0
FEDIP	10.1	17.6	20.3	21.2	10.8	5.4	...
Cohesion Fund	...	...	...	...	15.7	42.0	70.0
EAGGF-Guarantee 3/	30.0	38.3	56.6	74.4	86.4	127.0	135.0
Other 4/	34.6	15.2	8.1	6.2	5.9	6.5	6.0
B. From Portugal to the EU	82.8	94.8	130.2	145.4	176.6	244.4	219.9
(In percent of GDP)	1.0	1.0	1.1	1.1	1.3	1.7	1.4
Customs and agricultural duties	26.2	27.7	37.7	36.7	35.4	39.6	46.6
Other own resources	52.9	63.3	88.7	108.7	141.2	204.8	173.3
Other	3.7	3.8	3.8	--	--	--	--
C. Net transfers (A-B)	115.9	120.7	254.9	315.9	443.1	300.1	463.1
(In percent of GDP)	1.4	1.2	2.2	2.4	3.2	2.1	2.9

Sources: Ministry of Finance; and INE.

1/ On a cash basis.

2/ Mostly under FEDAP, Specific Program for Portuguese Agriculture.

3/ Mostly price subsidies.

4/ Includes reimbursements and adjustments.

Acronyms:

EAGGF: European Guidance and Guarantee Fund

ERF: European Regional Fund

ESR: European Social Fund

FEDIP: Specific Program for the Development of Portuguese Industry

Table 20. Portugal: General Government Financing 1/

	1992	1993	1994 2/
<u>(In billions of escudos)</u>			
General government deficit	426.1	961.9	841.9
Privatization receipts used for debt reductio	-199.9	-51.3	-30.0
Adjustment for complementary period	0.4	-35.8	-81.2
Other adjustments 3/	186.3	121.0	252.2
Public sector borrowing requirement	412.9	995.8	982.9
Domestic credit	313.3	65.4	488.6
Bank credit, net	397.8	168.7	490.2
Bank of Portugal	306.6	10.9	6.0
Deposit money banks	91.2	157.8	484.2
TB and CLIP held by the public	-84.5	-103.3	-1.6
Non-bank credit	489.3	405.0	176.5
Of which: saving certificates 4/	251.8	199.0	95.0
Non-securitized credit	31.3	72.5	33.4
Foreign credit, net	-2.5	316.5	394.2
Foreign holdings of securitized debt	-413.9	163.2	-164.7
Net foreign assets of the Treasury 5/	1.7	-5.7	36.8
Errors and omissions	-6.3	-21.1	18.1
<u>(In percent of GDP)</u>			
General government deficit	3.3	7.0	5.8
Privatization receipts used for debt reductio	-1.5	-0.4	-0.2
Adjustment for complementary period	0.0	-0.3	-0.6
Other adjustments 3/	1.4	0.9	1.7
Public sector borrowing requirement	3.2	7.2	6.7
Domestic credit	2.4	0.5	3.3
Bank credit, net	3.1	1.2	3.4
Bank of Portugal	2.4	0.1	0.0
Deposit money banks	0.7	1.1	3.3
TB and CLIP held by the public	-0.6	-0.8	-0.0
Non-bank credit	3.8	2.9	1.2
Of which: saving certificates 4/	1.9	1.4	0.7
Non-securitized credit	0.2	0.5	0.2
Foreign credit, net	-0.0	2.3	2.7
Foreign holdings of securitized debt	-3.2	1.2	-1.1
Net foreign assets of the Treasury 5/	0.0	-0.0	0.3
Errors and omissions	-0.0	-0.2	0.1

Source: Bank of Portugal, Annual Report, 1994.

- 1/ The definition of general government in the monetary statistics is broader than that of the budget. The former includes some autonomous entities that are considered public enterprises in the budget.
- 2/ Provisional data.
- 3/ Includes take over of debt of public entities.
- 4/ Credit net of amortization and interest paid. Interest paid on these certificates is not included in the above-the-line item of interest payments of the general government.
- 5/ Increase (-), decrease (+).

Table 21. Portugal : General Government Accounts, 1995 (Budget)

(In billions of escudos, national accounts basis)

	Central Government		Local Administration	Social Security	Total Consolidated
	State	Autonomous Services and Funds			
Current revenue	3,424.2	1,098.8	576.3	1,972.1	5,940.9
Taxes on income and property	1,237.5	--	127.7	--	1,365.2
Social security contributions	--	--	--	1,734.9	1,734.9
Taxes on goods and services	1,951.9	50.2	170.8	66.0	2,238.9
Nontax revenue	234.8	1,048.6	277.8	171.2	601.9
Of which: From other general government sectors	6.0	835.2	136.4	152.9	--
Current expenditures	3,737.0	1,042.4	524.7	2,062.6	6,236.2
Goods and services	1,525.0	708.5	444.1	76.1	2,753.7
Of which: Salaries	1311.7	535.7	266.8	47.7	2,161.9
Subsidies	123.3	1.5	9.9	--	134.7
Interest payments	811.6	12.7	44.1	--	868.4
Other current transfers	1,277.1	319.7	26.6	1,986.5	2,479.4
Of which: From other general government sectors	1055.6	21.5	1.0	52.4	--
Current balance	-312.8	56.4	51.6	-90.5	-295.3
Capital revenue	56.4	495.1	241.0	128.7	523.0
Of which: From other general government sectors	7.2	251.8	134.8	4.4	--
Capital expenditure	555.6	534.7	301.9	158.7	1,152.7
Fixed investment	180.2	275.9	275.8	13.9	745.8
Capital transfers	375.4	258.8	26.1	144.8	406.9
Of which: To other general government sectors	321.7	6.6	2.2	67.7	--
Capital balance	-499.2	-39.6	-60.9	-30.0	-629.7
Overall balance	-812.0	16.8	-9.3	-120.5	-925.0
Primary balance	-0.4	29.5	34.8	-120.5	-56.6
Net lending	180.4	36.2	1.5	-180.0	38.1
Overall balance including net lending	-992.4	-19.4	-10.8	59.5	-963.1
In percent of GDP	-6.3	-0.1	-0.1	0.4	-6.1

Source: Ministry of Finance.

Table 22. Portugal: State Tax Revenue

	1989	1990	1991	1992	1993	1994		1995
						Budget	Outturn	Budget
<u>(In billions of escudos)</u>								
Direct taxes	603.6	723.9	941.0	1,174.8	1,123.3	1,158.0	1,191.5	1,222.0
General income tax	432.3	669.2	898.1	1,160.0	1,105.6	1,145.0	1,176.4	1,206.0
Personal	337.3	455.4	607.0	811.6	826.4	860.0	865.8	895.0
Corporate	95.0	213.8	291.1	348.4	279.2	285.0	310.6	311.0
Other	171.3	54.7	42.9	14.8	17.7	13.0	15.1	16.0
Indirect taxes	1,017.5	1,167.1	1,354.9	1,670.7	1,671.5	1,837.0	1,965.7	2,063.0
Value-added tax 1/	479.1	550.8	636.6	832.0	798.6	945.0	1,030.7	1,124.0
Tax on petroleum products	212.0	250.1	309.4	362.5	369.6	386.0	401.1	433.0
Stamp tax	133.9	161.4	186.5	213.9	224.7	225.0	205.8	170.0
Tobacco tax	60.8	70.4	86.5	108.7	132.3	140.0	141.5	150.0
Motor vehicle tax	53.6	60.6	67.0	100.3	99.5	109.0	122.6	140.0
Alcohol and beer tax	12.2	15.1	18.6	24.2	24.6	27.0	28.0	...
Other taxes	65.9	58.7	50.3	29.1	22.2	5.0	36.0	46.0
Total	1,621.1	1,891.0	2,295.9	2,845.5	2,794.8	2,995.0	3,157.2	3,285.0
<u>(In percent of GDP)</u>								
Direct taxes	7.3	7.5	8.3	9.0	8.0	7.9	8.1	7.6
General income tax	5.3	6.9	7.9	8.9	8.0	7.9	8.1	7.6
Personal	4.1	4.7	5.4	6.2	6.0	5.9	5.9	5.7
Corporate	1.2	2.2	2.6	2.7	2.0	2.0	2.1	2.0
Other	2.1	0.8	0.4	0.1	--	--	--	--
Indirect taxes	12.4	12.1	12.0	12.8	12.1	12.7	13.5	13.0
Value-added tax 1/	5.8	5.7	5.6	6.4	5.8	6.5	7.1	7.1
Tax on petroleum products	2.6	2.6	2.7	2.8	2.7	2.7	2.7	2.7
Stamp tax	1.6	1.7	1.6	1.6	1.6	1.6	1.4	1.1
Tobacco tax	0.7	0.7	0.8	0.8	1.0	1.0	1.0	0.9
Motor vehicle tax	0.7	0.6	0.6	0.8	0.7	0.8	0.8	0.9
Alcohol and beer tax	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.0
Other taxes	0.8	0.6	0.4	0.2	0.2	0.0	0.2	0.3
Total	19.7	19.6	20.3	21.8	20.2	20.6	21.5	20.7

Source: Ministry of Finance and INE.

1/ In 1995 it excludes Esc. 45 billion of VAT revenues that accrue to social security.

Table 23. Portugal: Direct Public Debt

	1989	1990	1991	1992	1993	1994	1995 Projected
<u>(In billions of escudos)</u>							
Direct public debt 1/	5,109.5	5,663.3	6,689.3	7,226.0	8,478.8	9,477.0	10,479.3
Domestic debt	4,186.7	4,989.9	6,154.3	6,682.9	7,486.4	8,105.3	8,597.5
External debt	922.8	673.4	535.0	543.1	992.4	1,371.7	1,881.8
Total government debt 2/	...	6,574.8	7,846.2	8,001.7	9,162.7	10,166.5	11,273.6
<u>(In percent of GDP)</u>							
Direct public debt	62.2	58.6	59.0	55.4	61.6	64.9	66.2
Domestic debt	50.9	51.7	54.3	51.3	54.4	55.5	54.3
External debt	11.2	7.0	4.7	4.2	7.2	9.4	11.9
Total government debt 1/	...	68.1	69.3	61.4	66.6	69.6	71.3
<u>(In percent of direct public debt)</u>							
Direct public debt	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Domestic debt	81.9	88.1	92.0	92.5	88.3	85.5	82.0
External debt	18.1	11.9	8.0	7.5	11.7	14.5	18.0

Source: Ministry of Finance and INE

1/ Gross securitized debt of the State.

2/ Government debt in accordance with Maastricht Treaty criteria.

Table 24. Portugal: Interest Rates on Direct Public Debt

	1989	1990	1991	1992	1993	1994	1995 Projected
<u>(In billions of escudos; national accounts basis)</u>							
Interest payments	501.8	681.6	816.3	998.6	884.9	760.1	773.0
Domestic debt	430.4	620.2	754.9	963.3	845.1	699.8	679.9
External debt	71.4	61.4	61.4	35.3	39.8	60.3	93.1
<u>(In percent of GDP)</u>							
Interest payments	6.1	7.1	7.2	7.7	6.4	5.2	5.0
Domestic debt	5.2	6.4	6.7	7.4	6.1	4.8	4.4
External debt	0.9	0.6	0.5	0.3	0.3	0.4	0.6
<u>(In percent, unless indicated otherwise)</u>							
Implicit nominal interest rate	11.0	13.7	14.9	16.8	13.6	10.3	9.5
Domestic debt	11.8	14.9	15.4	17.8	14.8	11.3	10.4
External debt	7.7	9.1	11.5	6.5	4.0	4.4	4.9
Implicit real interest rate 1/	-0.9	0.7	0.2	3.3	6.3	4.9	4.9
Domestic debt	-0.2	1.8	0.6	4.2	7.4	5.9	5.7
External debt	-3.8	-3.4	-2.8	-5.8	-2.7	-0.7	0.5
Memorandum items:							
Inflation rates							
CPI	12.6	13.4	11.4	8.9	6.5	5.2	4.3
GDP	12.0	12.9	14.7	13.1	6.9	5.1	4.4
Nominal GDP growth	18.4	17.5	17.3	15.0	5.6	6.1	6.3
Interest/growth differential on direct public debt 2/	-7.4	-3.8	-2.4	1.8	8.0	4.2	3.2
Direct public debt (in billions of escudos)	5,110	5,663	6,689	7,226	8,479	9,477	10,479
Domestic debt	4,187	4,990	6,154	6,683	7,486	8,105	8,598
External debt	923	673	535	543	992	1,372	1,882

Source: Ministry of Finance and INE.

1/ Implicit nominal interest rate deflated by the GDP deflator.

2/ Nominal interest rate minus growth rate of nominal GDP.

Table 25. Portugal: Privatizations, 1989-95

Date	Enterprise	Sector	Percent Privatized	Procedure	Total Receipts (billion Esc)	Receipts of the State (billion Esc)
3/22/89	Unicer, tranche 1	Brewery	49	Public Offer	9.4	9.4
7/10/89	Banco Totta e Acores, tranche 1	Banking	49	Public Offer	28.6	12.2
10/2/89	Alianca Seguradora, tranche 1	Insurance	49	Public Offer	7.1	2.3
12/4/89	Tranquilidade, tranche 1	Insurance	49	Public Offer	25.8	25.8
5/11/90	Jornal de Noticias	Newspaper	86.26	Public Offer	7.5	--
6/28/90	Unicer, tranche 2	Brewery	51	Public Offer	13.3	13.3
7/31/90	Banco Totta e Acores, tranche 2	Banking	31	Public Offer	22.4	22.4
8/6/90	Transinsular	Sea Transport	51.1	Public Offer	1.8	--
10/9/90	Tranquilidade, tranche 2	Insurance	51	Public Offer	18.9	18.9
11/12/90	Central de Cerveja	Brewery	100	Public Offer	34.6	34.6
12/11/90	Banco Portugues do Atlantico, tranche 1	Banking	33	Public Offer	49.8	49.8
5/6/91	Sociedade Financeira Portuguesa	Banking	100	Public Offer	16.1	--
5/15/91	Diario de Noticias	Newspaper	100	Public Offer	8.4	8.4
5/29/91	Alianca Seguradora, tranche 2	Insurance	51	Public Offer	6.8	6.8
6/21/91	Portline	Sea Transport	80	Public Tender	5.8	--
6/25/91	Companhia de Seguros Bonanca, tranche 1	Insurance	60	Public Offer	18.8	18.8
7/9/91	Banco Espirito Santo & C.L., tranche 1	Banking	40	Public Offer	60.9	60.9
8/27/91	Banco Fonseca & Burnay, tranche 1	Banking	80	Public Tender	36.1	7.9
2/25/92	Banco Espirito Santo & C.L., tranche 2	Banking	60	Public Offer	89.0	89.0
3/10/92	Rodoviaria do Algarve	Road Transport	100	Public Offer	2.9	--
4/14/92	Companhia de Seguros Mundial Conf.	Insurance	100	Public Offer	33.4	33.4
4/22/92	Rodoviaria Douro e Minho	Road Transport	100	Public Offer	0.5	--
5/25/92	Banco Portugues do Atlantico, tranche 2	Banking	17.64	Public Offer	50.6	--
5/12/92	Transporta	Transport	100	Public Offer	0.6	--
5/19/92	Rodocargo	Transport	100	Public Offer	0.5	--
6/4/92	Petroleos de Portugal	Oil	25	Public Tender	40.8	8.5
7/20/92	Banco Fonseca & Burnay, tranche 2	Banking	20	Public Offer	9.0	9.0
11/17/92	Companhia de Seguros Imperio	Insurance	100	Public Offer	25.5	22.1
11/23/92	Banif	Banking	16.01	Public Offer	5.3	5.3
11/25/92	Companhia de Seguros de Credito, tranche 1	Insurance	3.33	Public Offer	0.1	0.1
12/2/92	Companhia de Seguros de Credito, tranche 2	Insurance	45.67	Direct Sale	1.5	1.5
12/2/92	Credito Predial Portugues	Banking	100	Public Offer	40.8	40.8
12/9/92	Companhia de Seguros Bonanca, tranche 2	Insurance	15	Public Offer	4.3	4.3
2/3/93	Uniao de Bancos Portugueses, tranche 1	Banking	61.11	Public Offer	24.4	24.4
3/15/93	Socarmar	Banking	51	Public Tender	1.8	1.8
4/12/93	Radio Comercial	Radio Communication	100	Public Offer	1.2	1.2
7/7/93	Banco Portugues do Atlantico, tranche 3	Banking	17.5	Public Offer	32.4	32.4
7/27/93	Rodoviaria Beira Litoral	Road Transport	100	Public Offer	1.8	--
11/16/93	Rodoviaria do Tejo	Road Transport	100	Public Offer	2.0	--
12/20/93	Rodoviaria do Alentejo	Road Transport	100	Public Offer	3.4	--

Table 25 (Concluded). Portugal: Privatizations, 1989-95

Date	Enterprise	Sector	Percent Privatized	Procedure	Total Receipts (billion Esc)	Receipts of the State (billion Esc)
2/10/94	AGA	Cement	100	Public Tender	0.3	0.3
3/25/94	Banco Portugues do Atlantico, tranche 3	Banking	7.5	Direct Sale	15.4	15.4
5/31/94	Secil	Cement	51	Public Tender	31.2	--
5/31/94	CMP	Cement	80	Public Tender	31.8	--
7/4/94	CIMFOR	Cement	20	Public Offer	39.6	39.6
8/8/94	Rodoviaria Estramadura	Transport	100	Public Offer	3.4	--
11/16/94	Banco Pinto e Soto Maior, tranche 1	Banking	80	Public Tender	37.3	37.3
12/12/94	Companhia de Seguros Bonanca	Insurance	25	Public Offer	6.6	--
12/27/94	Banco Fomento Exterior	Banking	19.5	Public Offer	19.4	--
1/10/95	Rodoviaria Sul do Tejo	Road Transport	100	Public Offer	4.0	--
3/24/95	Banco Portugues Atlantico, tranche 5	Banking	24.4	Direct Sale	75.1	75.1
3/28/95	Banco Pinto e Soto Maior, tranche 2	Banking	20	Public Offer	6.8	6.8
5/15/95	Rodoviaria Lisboa	Road Transport	100	Public Offer	6.0	--
5/29/95	Secil	Cement	7.9	Public Offer	4.8	--
5/29/95	CMP	Cement	20	Public Offer	7.8	--
6/1/95	Portugal Telecom	Telecommunications	27.3	Public Offer and Direct Sale	142.6	48.8
6/27/95	Portucel Industrial	Pulp and Paper	40	Public Offer and Direct Sale	35.6	--

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Source: Ministry of Finance.

Table 26. Portugal: Monetary Survey 1/
(In billions of escudos; end-of-period)

	1986	1987	1988	1989	1990	1991	1992	1993	1994
I. Net foreign assets	1,090.0	1,240.3	1,716.0	2,305.7	2,623.2	3,173.6	3,529.1	4,454.3	3,866.0
Bank of Portugal	953.5	1,096.2	1,514.5	2,277.8	2,617.0	3,445.8	3,563.0	3,700.7	3,273.8
Other monetary institutions	136.5	144.1	201.5	27.9	6.2	-272.2	-33.9	753.6	592.2
II. Total domestic credit	5,095.1	5,786.5	6,529.7	6,882.5	7,812.5	9,262.1	10,767.1	11,710.1	13,100.3
Net credit to general government	1,845.9	2,312.8	2,604.2	2,520.1	2,800.1	2,914.0	3,122.2	3,195.5	3,672.7
Credit to the private sector 2/	3,249.2	3,473.7	3,925.5	4,362.4	5,012.4	6,348.1	7,644.9	8,514.6	9,427.6
Credit to non-financial firms and individuals	3,162.0	3,376.3	3,815.7	4,221.4	4,724.0	5,848.2	6,852.5	7,641.7	8,345.7
Non-financial public firms	789.7	716.1	645.3	614.6	693.2	787.3	703.8	696.9	718.3
Other non-financial firms and individuals	2,372.3	2,660.2	3,170.4	3,606.8	4,030.8	5,060.9	6,148.7	6,944.8	7,627.4
Credit to non-monetary financial institutions 3/	87.2	97.4	109.8	141.0	286.4	499.9	792.4	872.9	1,081.9
III. Other items net	-910.4	-916.2	-1,113.5	-1,189.1	-1,550.1	-1,792.5	-1,941.7	-2,665.9	-2,279.3
Capital and reserves	-889.1	-830.3	-1,134.5	-1,312.6	-1,553.0	-1,836.1	-2,129.7	-2,745.5	-2,877.5
Sundry items net	-83.5	-8.6	182.8	295.6	108.6	192.4	440.1	631.0	881.7
Counterpart to forex fluctuations	-119.7	-32.3	-122.2	-132.0	-25.7	14.9	-65.6	-260.5	0.0
Non-monetary assets	-18.1	-45.0	-39.8	-40.1	-80.0	-163.7	-186.5	-290.9	-283.5
Liquid assets held by the public (L) = I+II+III	5,274.8	6,110.6	7,132.2	7,999.2	8,885.7	10,643.4	12,354.4	13,498.5	14,686.8
Liquid assets held by non-financial residents (L-)	3,969.8	4,772.6	5,625.8	6,226.2	6,905.9	8,184.3	9,279.4	9,852.5	10,783.7
Broad money (M2-)	3,657.1	4,280.2	5,059.1	5,717.2	6,229.9	7,801.5	9,106.5	9,759.0	10,654.5
Narrow money (M1-)	1,334.2	1,611.6	1,951.2	2,242.5	2,352.2	2,704.7	3,163.7	3,392.6	3,641.4
Currency in circulation	398.3	457.7	509.5	577.3	623.9	683.1	706.2	752.9	795.8
Demand deposits	934.9	1,153.9	1,441.7	1,665.2	1,728.3	2,021.6	2,455.5	2,639.7	2,845.6
Quasi-money	2,322.9	2,668.6	3,107.9	3,474.7	3,877.7	5,096.6	5,942.8	6,366.4	7,013.1
Time-deposits	2,237.2	2,531.5	2,853.8	3,173.7	3,510.1	4,506.7	5,699.1	6,232.3	6,897.9
Certificates of deposits	0.0	6.6	47.5	135.3	218.1	270.6	119.7	65.1	31.8
Cash certificates	28.8	15.4	26.9	31.4	41.2	48.3	41.2	44.0	12.4
Repurchase agreements of securities	56.9	115.1	179.7	134.3	108.3	271.2	82.8	25.0	71.0
Contingent liabilities	.	.	.	.	.	.	.	.	.
Treasury-bills and CLIPs	332.7	492.4	566.7	509	676	382.8	172.9	93.5	129.2
Liquid assets held by non-monetary financial institutions	37.0	43.2	85.8	185.3	226.1	516.3	823	1,077.7	1,226.3
Deposits and other liquid assets held by emigrants	1,248.0	1,294.8	1,420.6	1,587.7	1,753.7	1,942.8	2,252	2,568.3	2,676.8
Memorandum item:									
Broad money (M3H) 4/	3,657.1	4,280.2	5,059.1	5,717.2	6,229.9	7,801.5	9,106.5	9,759.0	10,654.5

Source: Bank of Portugal, Monthly Bulletin, various issues.

1/ Figures adjusted for the abnormal component of checks in process of collection in 1986-1991.

2/ Includes non-financial public firms.

3/ Includes credit to small savings banks and agricultural credit cooperatives.

4/ M3H is defined as M2-.

Table 27. Portugal: Sources and Uses of Base Money

	1986	1987	1988	1989	1990	1991	1992	1993	1994
(Stocks in billions of escudos; end-of-period)									
Sources									
Net foreign assets, Bank of Portugal	953.5	1,096.2	1,514.5	2,277.8	2,617.0	3,445.8	3,563.0	3,700.7	3,273.8
Net credit to general government	1,180.1	1,094.9	954.0	844.4	637.0	-544.4	-237.8	-226.8	-220.7
Credit to financial institutions	106.7	67.1	25.6	116.7	16.7	160.1	18.5	274.8	576.1
Total A	2,240.3	2,258.2	2,494.1	3,238.9	3,270.7	3,061.5	3,343.7	3,748.7	3,629.2
Other compulsory deposits				5.5	7.0	191.3	0.4	0	0
Operations absorbing liquidity 1/	990.5	964.0	920.6	781.3	837.1	125.4	381.4	23.8	1854.5
Capital and reserves, counterpart to foreign exchange fluctuations, sundry items (net)	563.6	418.8	583.2	559.1	374.0	229.9	180.4	693.9	525
Total B	1,554.2	1,382.7	1,503.8	1,345.9	1,218.1	546.6	562.2	717.7	2379.5
Monetary base (= Total A - Total B)	686.3	875.5	990.2	1,893.0	2,052.6	2,515.0	2,781.7	3031.1	1249.7
Uses									
Currency (notes and coins)	443.5	507.9	560.5	628.4	693.7	765.3	797.8	846.2	881.1
Reserves and other non-compulsory deposits 2/	242.8	367.6	429.7	1,264.6	1,358.9	1,749.7	1,983.9	2184.9	368.6
(In percent of monetary base)									
Sources									
Net foreign assets, Bank of Portugal	138.9	125.2	152.9	120.3	127.5	137.0	128.1	122.1	262.0
Net credit to general government	172.0	125.1	96.3	44.6	31.0	-21.6	-8.5	-7.5	-17.7
Credit to financial institutions	15.5	7.7	2.6	6.2	0.8	6.4	0.7	9.1	46.1
Total A	326.4	257.9	251.9	171.1	159.3	121.7	120.2	123.7	290.4
Other compulsory deposits	0.0	0.0	0.0	0.3	0.3	7.6	0.0	0.0	0.0
Operations absorbing liquidity 1/	144.3	110.1	93.0	41.3	40.8	5.0	13.7	0.8	148.4
Capital and reserves, counterpart to foreign exchange fluctuations, sundry items (net)	82.1	47.8	58.9	29.5	18.2	9.1	6.5	22.9	42.0
Total B	226.5	157.9	151.9	71.1	59.3	21.7	20.2	23.7	190.4
Monetary base (= Total A - Total B)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Uses									
Currency (notes and coins)	64.6	58.0	56.6	33.2	33.8	30.4	28.7	27.9	70.5
Reserves and other non-compulsory deposits 2/	35.4	42.0	43.4	66.8	66.2	69.6	71.3	72.1	29.5

Sources: Bank of Portugal, Monthly Bulletin, and Annual Report, various issues.

1/ Securities repurchase agreements, central bank monetary certificates, central bank intervention bills, time-deposits and central bank deposits.

2/ Prior to 1989, includes penalty reserves due to noncompliance with credit ceilings.

Table 28. Portugal: Credit and Monetary Aggregates 1/

(Percent change over previous year; end-of-period)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995 5/
Credit aggregates										
Total domestic credit		13.6	12.8	5.4	13.5	18.6	16.2	8.8	11.9	15.9 6/
Net credit to general government		25.3	12.8	-3.2	11.1	4.1	7.1	2.3	14.9	11.3 6/
Credit to the private sector 2/		6.9	13.0	11.1	14.9	26.6	20.4	11.4	10.7	17.6 6/
Credit to non-financial firms and individuals		6.8	13.0	10.6	11.9	23.8	17.2	11.5	9.2	14.1
Non-financial public firms		-7.0	-9.9	-4.8	12.8	13.6	-10.6	-1.0	3.1	-0.9
Other non-financial firms and individuals		11.2	19.2	13.8	11.8	25.6	21.5	12.9	9.8	15.5
Credit to non-monetary financial institutions 3/		11.7	12.7	28.4	104.5	73.3	58.5	10.2	23.9	44.0
Monetary aggregates										
Liquid assets held by the public (L)		15.8	16.7	12.2	11.1	19.8	16.1	9.3	8.8	
Liquid assets held by non-financial residents (L-)		19.8	17.9	10.7	10.9	18.5	13.4	6.2	9.5	9.8 6/
Broad money (M2-)		17.0	18.2	13.0	9.0	25.2	16.7	7.2	9.2	10.9
Narrow money (M1-)		20.8	21.1	14.9	4.9	15.0	17.0	7.2	7.3	14.8 6/
Currency in circulation		14.6	11.3	13.3	8.1	9.5	3.7	6.3	5.7	6.6
Demand deposits		23.4	24.9	15.5	3.8	17.0	21.5	7.5	7.8	14.3
Quasi-money		14.9	16.5	11.8	11.6	31.4	16.6	7.1	10.2	10.1
Time-deposits		13.2	12.7	11.2	10.6	28.4	26.5	9.4	10.7	
Certificates of deposits			619.7	184.8	61.2	24.1	-55.8	-45.6	-51.2	
Cash certificates		-46.5	74.7	16.7	31.2	17.2	-14.7	6.8	-71.8	
Repurchase agreements of securities		102.3	56.1	-25.3	-19.4	150.4	-69.5	-69.8	184.0	
Contingent liabilities		.	.	.	.	.	.	.	.	
Treasury-bills and CLIP		48.0	15.1	-10.2	32.8	-43.4	-54.8	-45.9	38.2	
Liquid assets held by non-monetary fin. institutions 3/		16.8	98.6	116.0	22.0	128.4	59.4	30.9	13.8	
Deposits and other liquid assets held by emigrants		3.7	9.7	11.8	10.5	10.8	15.9	14.0	4.2	
Memorandum items:										
Broad Money (M3H) 4/		17.0	18.2	13.0	9.0	25.2	16.7	7.2	9.2	10.9
Inflation (CPI)	11.7	9.4	9.6	12.6	13.4	11.4	8.9	6.5	5.2	3.8
GDP deflator	20.5	11.3	11.3	11.7	14.5	14.0	13.0	6.5	5.1	

Source: Bank of Portugal.

1/ Figures adjusted for the abnormal component of cheques in process of collection.

2/ Private sector is defined to include non-financial public firms.

3/ Includes credit to small savings banks and agricultural credit cooperatives.

4/ M3H is defined as M2-.

5/ June.

6/ July.

Table 29. Portugal: Structure of Monetary Aggregates 1/

	1986	1987	1988	1989	1990	1991	1992	1993	1994
	(In percent)								
Currency in circulation / Narrow money (M1-)	29.9	28.4	26.1	25.7	26.5	25.3	22.4	22.2	21.9
Demand deposits / Narrow money (M1-)	70.1	71.6	73.9	74.3	73.5	74.7	77.6	77.8	78.1
Narrow money (M1-) / Broad money (M2-)	36.5	37.7	38.6	39.2	37.8	34.7	34.7	34.8	34.2
Quasi-money / Broad money (M2-)	63.5	62.3	61.4	60.8	62.2	65.3	65.3	65.2	65.8
Narrow money (M1-) / Liquid assets held by non-financial residents (L-)	33.4	33.8	34.7	36.0	34.1	33.0	34.1	34.4	33.8
Quasi-money / L-	58.2	55.9	55.2	55.8	56.2	62.3	64.0	64.6	65.0
Broad money (M2-) / L-	91.7	89.7	89.9	91.8	90.2	95.3	98.1	99.1	98.8
Short-term Treasury bills and CLIP / L-	8.3	10.3	10.1	8.2	9.8	4.7	1.9	0.9	1.2
L- / Liquid assets held by the public (L)	75.6	78.1	78.9	77.8	77.7	76.9	75.1	73.0	73.4
Emigrants deposits and other liquid assets / L	23.7	21.2	19.9	19.8	19.7	18.3	18.2	19.0	18.2
Nominal GDP / M2- (Percent change)	1.39	1.39	1.37	1.44	1.55	1.45	1.43	1.41	1.37
		-0.1%	-1.0%	4.7%	7.8%	-6.3%	-1.5%	-1.5%	-2.8%
Nominal GDP / L- (Percent change)	1.27	1.24	1.23	1.32	1.40	1.38	1.40	1.40	1.35
		-2.2%	-0.8%	6.9%	5.9%	-1.0%	1.4%	-0.6%	-3.0%
Nominal GDP / L (Percent change)	0.96	0.97	0.97	1.03	1.09	1.06	1.05	1.02	0.99
		0.9%	0.2%	5.5%	5.8%	-2.1%	-0.9%	-3.4%	-2.4%
Memorandum items:									
Inflation (CPI)	11.7	9.4	9.6	12.6	13.4	11.4	8.9	6.5	5.2
Inflation (GDP deflator)	20.5	10.6	11.4	12	12.9	14.7	13.1	6.8	5.1

Source: Bank of Portugal.

1/ Figures adjusted for the abnormal component of cheques in process of collection.

The monetary aggregates are defined as follows:

Narrow money (M1-) = Currency in circulation + Demand deposits.

Quasi-money = Time deposits + Certificates of deposits + Cash deposits + Repurchase agreements.

Broad money (M2-) = Narrow money (M1-) + Quasi-money.

Liquid assets held by non-financial residents (L-) = Broad Money (M2-) + Short-term Treasury bills and CLIP

Liquid assets held by the public (L) = Liquid assets held by non-financial residents (L-) + Liquid assets held by non-monetary financial institutions + Emigrants deposits and other liquid assets.

Table 30. Portugal: Selected Interest Rates

	Overnight Rate	3-Month Interbank Deposit Rate <u>1/</u>	3-Month Treasury Bill <u>2/</u>	6-Month Treasury Bill <u>2/</u>	1-Year Treasury Bill <u>2/</u>	Year-on-year CPI Inflation
1991						
Jun	19.3	19.1	17.9	18.3	18.0	12.6
Jul	12.7	18.4	17.9	18.4	18.9	12.1
Aug	14.1	18.3	17.9	18.4	18.9	11.4
Sep	17.8	18.4	17.9	18.3	18.9	10.2
Oct	15.6	18.2	17.8	18.3	18.8	9.8
Nov	17.9	18.4	17.7	18.1	18.3	9.9
Dec	18.6	18.7	17.8	18.2	18.5	9.6
1992						
Jan	17.4	18.3	17.6	18.1	17.9	8.6
Feb	16.5	17.8	17.3	17.4	17.4	8.0
Mar	17.5	17.5	16.9	17.0	16.9	8.5
Apr	17.1	17.1	16.4	16.5	16.0	9.5
May	17.4	17.0	16.5	16.5	16.0	9.8
Jun	16.8	17.1	16.8	16.5	16.0	9.5
Jul	16.5	16.8	16.7	16.4	16.0	9.9
Aug	14.9	15.5	15.0	15.2	15.3	9.2
Sep	26.1	15.0	13.9	14.3	13.2	9.1
Oct	18.2	15.8	15.0	14.8	14.4	8.7
Nov	17.9	16.1	15.3	15.1	...	8.6
Dec	14.2	16.5	16.0	15.6	14.7	8.4
1993						
Jan	13.4	14.5	14.6	14.7	13.6	8.5
Feb	13.2	13.7	13.6	13.5	13.0	8.0
Mar	18.0	15.7	...	13.5	13.3	7.3
Apr	19.3	17.1	...	15.5	...	6.2
May	15.6	15.3	15.5	15.2	13.4	5.7
Jun	11.9	12.6	13.0	12.3	12.4	5.6
Jul	11.5	13.1	11.0	11.0	10.8	5.8
Aug	11.2	11.4	10.9	10.8	10.5	5.8
Sep	11.1	11.0	10.6	10.5	10.0	6.0
Oct	11.5	11.3	10.6	10.3	10.0	6.3
Nov	11.1	11.5	10.9	10.5	10.0	6.6
Dec	11.2	11.7	11.0	10.6	10.0	6.4
1994						
Jan	10.6	11.1	10.7	10.5	10.0	6.3
Feb	9.9	10.0	9.8	9.7	9.7	6.1
Mar	10.7	9.6	9.6	9.3	9.2	6.0
Apr	15.0	11.9	...	...	...	6.0
May	11.5	11.1	10.8	10.8	...	5.7
Jun	14.4	13.7	11.9	12.2	11.5	5.6
Jul	11.8	12.7	12.5	12.3	12.0	5.1
Aug	10.3	11.9	11.7	11.5	11.5	4.8
Sep	9.4	10.6	11.0	10.8	10.8	4.7
Oct	9.1	10.0	10.1	10.4	10.5	4.5
Nov	8.8	9.9	9.9	10.2	10.4	4.0
Dec	8.9	10.5	10.4	10.7	10.7	4.0
1995						
Jan	8.8	10.6	10.5	10.9	11.3	4.5
Feb	8.8	9.9	9.9	10.4	10.9	4.6
Mar	9.9	10.8	10.7	10.9	11.5	4.8
Apr	9.2	10.8	10.7	11.1	11.5	4.6
May	9.0	10.0	10.0	10.4	11.0	4.3
Jun	9.0	9.8	9.8	10.3	10.8	3.8
Jul	8.9	9.5	9.3	9.7	10.1	3.7

Source: Bank of Portugal

1/ Prior to June 1992, figures are weighted averages for interbank deposits with maturity between 31-90 days.

2/ Primary market rates.

Table 31. Portugal: Lending and Deposit Rates 1/

(In percent)

	1991	1992				1993				1994				1995 2/	
	Dec.	Mar.	Jun.	Sept.	Dec.	Mar.	Jun.	Sept.	Dec.	Mar.	Jun.	Sept.	Dec.	Mar.	Jun.
Lending Rates															
Over 90 days and up to 180 days	21.2	21.5	19.8	19.5	18.9	17.1	16.6	15.8	15.7	15.0	15.4	15.2	14.7	13.8	13.5
Discount of commercial bills	23.9	23.8	22.5	21.3	20.8	20.6	20.4	19.3	18.2	17.9	17.4	17.3	16.3	16.2	15.9
Over 180 days and up to 1 year	22.1	22.3	21.9	19.5	18.6	18.4	18.0	16.2	16.2	14.8	15.1	15.4	14.9	14.5	13.4
Over 1 year and up to 2 years 4/															
Over 2 years and up to 5 years	18.7	22.6	20.9	20.1	18.9	18.7	18.2	17.3	16.4	16.5	16.3	15.2	15.0	15.3	15.7
Over 5 years	20.7	20.6	19.3	18.7	17.0	16.5	16.7	15.5	13.6	15.7	14.7	14.6	12.8	13.1	14.0
Deposit rates (time deposits)															
Over 31 days and up to 90 days	15.5	15.8	16.0	14.5	14.3	13.1	12.1	9.8	10.0	9.0	9.8	9.1	8.7	9.1	8.7
Over 90 days and up to 180 days	18.2	17.0	16.3	14.5	14.0	12.7	12.6	10.6	10.2	9.2	9.3	9.5	9.3	8.9	8.9
Over 180 days and up to 1 year	15.1	15.4	14.9	13.4	13.4	12.3	11.5	9.6	9.1	8.1	8.2	8.3	8.2	8.5	8.5
Over 1 year	15.7	15.6	15.2	12.5	12.7	11.8	11.3	9.2	9.1	8.3	8.2	8.3	8.2	8.3	8.3
Memorandum items:															
Indicative lending rate, Portuguese Banking Association															
90 days	22.4	22.3	21.7	20.8	20.5	19.9	19.4	18.4	18.1	17.2	16.7	16.7	16.3	16.3	
180 days	22.9	22.7	22.2	21.1	20.8	20.1	19.4	18.5	18.2	17.4	16.8	16.8	16.4	16.4	
Maximum rate on demand deposits	4.7	4.7	3/	...	...	...	...	...	...	...	...	...	...	...	
Minimum rate on time deposits over 80 days and up to 1 year	14.0	14.0	3/	...	...	...	...	...	...	...	...	...	...	...	
Inflation (CPI), year-on-year	9.6	8.5	9.5	9.1	8.4	7.3	5.6	6.0	6.4	6.0	5.6	4.7	4.0	4.8	3.8

Source: Bank of Portugal, Monthly Bulletin, various issues.

1/ Weighted averages; loans and advances to non-financial enterprises excluding public enterprises.

2/ Provisional data.

3/ Since May 12, 1992 limits on these rates were lifted.

4/ This series is not considered as representative on lending operations.

Table 32. Portugal: Official Interest Rates on Regular Operations of Provision and Absorption of Liquidity by the Bank of Portugal and Remuneration of Minimum Reserve Requirements

(In percent)

	Provision of Liquidity		Absorption of Liquidity	Remuneration of Minimum Reserve Requirements 1/
	Regular Operations 2/	Standing Facility		
1994				
January 4	10.8750		9.8750	9.6250
January 12	10.7500		9.7500	
January 19		11.5000		
January 26	10.5000		9.5000	
February 4	10.2500		9.2500	
February 14	10.1250		9.1250	
February 21	10.0000		9.0000	
March 4		11.0000		
March 31		13.0000		
April 5	Suspended		Suspended	
April 19	11.0000	12.0000		
May 4			10.0000	
May 12	10.7500	11.7500	9.7500	
May 19	10.3750	11.3750	9.3750	
May 26	Suspended		Suspended	
July 12		13.5000	11.0000	
July IV	10.8150			
August I	10.8320	12.5000	9.7500	
August II	11.0760	12.0000	9.2500	
August III	10.5960			
August IV	10.0040			
September I	9.7980			
September II	9.7220			
September III	9.2530	11.5000	8.7500	
September IV	9.2500			
October I	9.2410			8.7500
October II	9.1250			
October III	9.1030			
October IV	8.8970		8.5000	
November I	8.8750			
November II	8.8750			
November III	8.8750			
November IV	8.8750			0.0000
December I	8.8750			
December II	8.8750			
December III	8.8750			
December IV	8.8750			
1995				
January I	8.8750			
January II	8.8750			
January III	8.8750			
January IV	8.8750			
February I	8.8750			
February II	8.8750			
February III	8.8750			
February IV	8.8770			
March I	8.8770			
March II	11.5630			
March III	11.2780			
March IV	10.1120			
April I	9.2900			
April II	9.0000			
April III	9.0340			
April IV	9.0080			
May I	9.0040			
May II	9.0210			
May III	9.0190			
May IV	8.9960			
June I	8.8340			
June II	8.9010			
June III	8.8960			
June IV	8.8120			
July I	8.9140			
July II	8.8960			
July III	8.8750			
July IV	8.8830			

Source: Bank of Portugal, Monthly Bulletin.

1/ Marginal rate of remuneration.

2/ Since July 14th 1994 this rate corresponds to the weighted average repo rate.

Table 33 Portugal: Balance of Payments

(In millions of U.S. dollars)

	1986	1987	1988	1989	1990	1991	1992	1993	1994
Trade balance, f.o.b.	-1,680	-3,581	-5,518	-4,878	-6,828	-7,855	-9,400	-6,741	-6,701
Exports	7,202	9,268	10,875	12,716	16,301	16,223	18,275	15,905	18,429
Imports	8,882	12,849	16,393	17,594	23,129	24,078	27,675	22,646	25,130
Services	-85	250	137	478	1,147	1,151	1,583	900	295
Of which:									
Tourism receipts	1,531	2,145	2,402	2,885	3,555	3,710	3,721	4,061	4,071
Investment income (net)	-1,014	-932	-877	-718	-233	82	666	137	-207
Transfers	2,915	3,775	4,317	4,539	5,500	5,962	7,797	6,667	5,361
Of which:									
Remittances	2,580	3,256	3,380	3,563	4,262	4,516	4,650	4,168	3,626
Public	264	374	719	810	994	1,372	3,007	2,856	1,942
Current account	1,150	444	-1,064	139	-181	-742	-20	826	-1,045
(In percent of GDP)	3.4	1.1	-2.2	0.3	-0.3	-0.9	-0.0	1.0	-1.2
Private capital	377	1,314	2,247	4,786	4,868	7,831	-775	-2,761	176
Public debt 1/	-1,550	52	-249	-362	-1,180	-1,299	596	-727	-995
Capital account	-1,173	1,366	1,998	4,424	3,688	6,532	-179	-3,488	-820
Overall balance	-23	1,810	934	4,563	3,507	5,790	-199	-2,663	-1,865
Memorandum items:									
Esc/US\$ (period average)	150	141	144.00	157.50	142.60	144.50	135.00	160.80	165.92
Nominal GDP (in billions of escudos)	5,077	5,937	6,945	8,219	9,658	11,330	13,032	13,760	14,606
Nominal GDP (in billions of US dollars)	33.9	42.1	48.2	52.2	67.7	78.4	96.5	85.6	88.0
Total reserves (end of period)	1,456	3,327	5,127	9,952	14,526	20,597	19,129	15,801	15,512

Sources: Bank of Portugal, Monthly Bulletin and Quarterly Bulletin, various issues.

1/ Includes general government, nonfinancial public enterprises, and some state-guaranteed debt.

Table 34. Portugal: Exchange Rate Developments

(Percentage changes over previous years) 1/

	1989	1990	1991	1992	1993	1994	1995 July
Rate of Portuguese escudo against:							
U.S. dollar, period average	-8.6	10.5	-1.3	6.6	-19.1	-3.2	9.5
U.S. dollar, end of period	-2.3	12.2	-0.4	-9.4	-20.5	10.0	11.0
ECU, period average	-2.4	-4.5	1.4	2.5	-7.7	-4.7	0.4
ECU, end of period	-3.5	-2.9	2.1	1.1	-11.2	0.6	-0.2
DM, period average	-2.1	-5.1	1.2	0.8	-12.4	-5.3	-2.3
DM, end of period	-6.8	-1.3	1.3	-2.9	-12.0	-0.8	-2.7
Nominal effective exchange rate							
Bank of Portugal index 2/	-3.1	-2.7	0.7	3.2	-6.0	-4.1	1.9
IMF	-3.1	-1.2	0.3	3.6	-7.3	-4.8	3.3 3/
Real effective exchange rate							
Relative unit labor costs	6.7	1.6	11.8	12.9	-0.7	1.1	...
Bank of Portugal index 2/	4.1	4.7	6.1	8.8	-2.7	-1.7	...
IMF (consumer prices)	4.5	6.6	6.8	9.1	-4.2	-2.1	4.5 3/
Memorandum items:							
Escudo per U.S. dollar, end of period	149.8	133.6	134.2	146.8	176.8	159.1	144.4
Escudo per U.S. dollar, period average	157.5	142.6	144.5	135.0	160.8	166.0	146.0
Escudo per DM, end of period	88.3	89.4	88.3	90.9	101.9	102.7	104.5
Escudo per DM, period average	83.3	88.2	87.1	86.5	97.2	102.3	105.1

Sources: Bank of Portugal; IMF, International Financial Statistics; and staff estimates.

1/ A negative sign indicates a depreciation.

2/ Trade weighted vis-à-vis 13 competitor countries (weights adjusted periodically).

3/ June.

Table 35. Portugal: Merchandise Trade and Terms of Trade

(Customs basis)

	1989	1990	1991	1992	1993 1/	1994 1/
Exports, f.o.b. (in billions of escudos)	2,015.7	2,335.8	2,354.1	2,475.2	2,557.2	3,057.6
Percentage change in unit value	6.3	3.5	-0.3	-2.1	2.3	4.6
Percentage change in volume	19.9	12.0	1.1	7.4	0.7	14.3
Imports, c.i.f. (in billions of escudos)	3,003.2	3,589.6	3,811.1	4,087.6	4,012.3	4,595.2
Percentage change in unit value	7.8	3.4	-0.9	-5.4	2.8	3.0
Percentage change in volume	8.3	15.6	7.1	13.4	-5.1	11.2
Trade balance (in billions of escudos)	-987.5	-1,253.8	-1,457.0	-1,612.4	-1,455.1	-1,537.6
In percent of GDP	-12.0	-13.0	-12.9	-12.4	-10.6	-10.5
Terms of trade (percentage change)	-1.4	0.1	0.6	3.5	-0.5	1.6
Memorandum items:						
Market growth	9.9	6.4	3.6	2.6	-6.0	8.7
Change in competitor countries' prices (in US\$, export weighted)	0.3	13.0	-2.4	2.6	-8.1	...
Change in Portugal's export prices (in US\$)	-3.1	13.8	-1.2	4.8	...	...
Rate of nominal effective depreciation of the escudo 2/	-3.1	-2.7	0.7	3.2	-6.0	-4.1

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Sources: Ministry of Commerce and Tourism, Evolucao do Comercio Externo; Bank of Portugal; IMF Research Department and IFS.

1/ National accounts estimates- Bank of Portugal.

2/ A negative sign indicates a depreciation of the escudo.

Table 36 Portugal: Geographical Distribution of Trade

	1988	1989	1990	1991	1992	1993 1/	1994 1/
(In percent of total imports)							
Imports	93.3	82.5	82.6	84.1	86.6	85.6	84.4
Industrial countries							
Of which:							
EU-12	66.3	67.3	68.9	70.2	73.6	71.8	70.9
Of which:							
France	11.8	11.5	11.4	11.6	12.9	12.7	12.8
Germany	13.8	14.3	14.4	14.6	14.7	15.0	13.8
Italy	9.3	9.0	9.9	10.0	10.3	8.7	8.5
Netherlands	4.7	5.4	5.7	6.0	6.9	4.9	4.3
Spain	13.5	14.5	14.5	15.5	16.7	17.8	19.8
United Kingdom	8.2	7.4	7.5	7.4	7.2	7.4	6.6
United States	4.3	4.4	3.9	3.3	3.0	3.2	3.6
Japan	3.6	3.1	2.6	2.8	3.1	3.2	2.8
Oil exporting countries	5.0	6.4	7.1	5.5	3.7	5.0	5.8
Other	11.8	11.1	10.2	10.4	9.7		
(In percent of total exports)							
Exports	90.3	90.4	91	88.6	89.1	90.2	90.3
Industrial countries							
Of which:							
EU-12	71.7	71.4	73.4	72.7	75.1	75.2	75.0
Of which:							
France	15.3	15.1	15.4	13.9	14.2	15.1	14.7
Germany	14.6	15.7	16.8	18.9	19.2	19.6	18.7
Italy	4.1	4.2	4	3.8	3.9	3.0	3.4
Netherlands	6.0	5.7	5.7	5.5	5.4	5.2	5.1
Spain	11.7	12.8	13.7	14.6	14.9	14.4	14.4
United Kingdom	14.1	12.3	12.1	10.4	11.2	11.4	11.7
United States	5.9	6.0	4.8	3.6	3.5	4.4	5.2
Japan	0.8	1.1	1	0.8	0.8	0.8	0.8
Oil exporting countries	1.0	0.7	0.7	0.6	0.6	0.9	5.8
Other	8.7	8.9	8.4	10.8	10.3		
(In percent of total trade deficit)							
Trade balance	100.0	100.0	100	100.0	100.0	100 2/	100 2/
Industrial countries	71.4	66.5	67	76.3	82.5	77.6	73.1
Of which:							
EU-12	57.2	59.3	60.2	65.8	71.6	65.8	63.2
Of which:							
France	5.8	4.4	3.8	7.8	10.8	8.5	9.1
Germany	12.3	11.4	9.8	7.1	7.8	7.1	4.4
Italy	17.9	18.6	21	20.5	20.3	18.7	18.5
Netherlands	2.6	4.9	5.8	6.7	9.2	4.4	2.9
Spain	16.4	18.1	16.1	17.0	19.5	23.9	30.1
United Kingdom	(1.8)	(2.5)	-1.1	2.2	0.9	0.5	-3.2
United States	1.7	1.3	2.1	2.7	2.3	1.1	0.6
Japan	8.4	7.0	5.7	6.2	6.7	7.5	6.8
Oil exporting countries	11.8	18.0	19.3	13.8	8.5	12.1	15.5
Other	16.9	15.6	13.8	9.9	9.0		

Source: IMF, Direction of Trade Statistics.

1/ Source: Ministry of Commerce and Tourism.

2/ FOB/CIF

Table 37 Portugal: Composition of Exports

(Custom basis; in percent)

	1991	1992	1993	1994	1991	1992	1993	1994	1991	1992	1993	1994
	<u>Share of total exports</u>				<u>Volume Percent changes</u>				<u>Prices</u>			
Agricultural products	8.1	7.7	7.3	7.3	8.7	5.9	...	14.9	2.5	-5.5	...	1.7
Energy products	2.6	2.9	3.4	4.1	-21.4	42.6	...	48.2	-3.7	-17.7	...	-4.2
Products of chemical industry	5.8	5.3	5.6	6.4	-4.7	8.7	...	27.9	-3.5	-10.7	...	4.5
Leather, wood, cork, paper, and pulp products	11.4	10.6	10.5	11.0	4.7	0.4	...	4.7	-10.4	-2.4	...	17.0
Hides, skins and textile products	8.8	8.6	8.7	8.4	-0.1	5.0	...	9.7	1.3	-2.4	...	3.6
Clothing and footwear	30.3	30.4	29.9	27.9	1.6	4.5	...	4.4	3.4	0.7	...	4.6
Metal and mineral products	6.2	5.7	6.0	6.1	2.9	2.8	...	9.2	-7.0	-4.7	...	10.1
Machinery	13.3	14.1	14.7	15.2	4.0	12.0	...	20.4	-0.4	-0.8	...	0.4
Transport equipment	6.5	7.6	6.5	6.1	-7.9	20.5	...	6.3	3.4	2.8	...	2.6
Other	7.0	7.0	7.4	7.5	5.5	4.1	...	15.8	4.4	0.9	...	3.5
Total	100.0	100.0	100.0	100.0	1.1	7.4	...	12.2	-0.3	-2.1	...	4.5

Sources: Ministry of Commerce and Tourism, Evolucao do Comercio Externo.

Table 38 Portugal: Composition of Imports

(Custom basis; in percent)

	1991	1992	1993	1994	1991	1992	1993	1994	1991	1992	1993	1994
	<u>Share of total imports</u>				<u>Volume Percent changes</u>				<u>Prices</u>			
Agricultural products	13.2	12.5	14.0	14.5	9.9	10.0	...	13.4	-1.6	8.5	...	4.0
Energy products	9.1	8.0	8.8	8.7	-2.8	11.6	...	11.0	14.4	-8.6	...	0.7
Products of chemical industry	11.2	11.3	11.9	12.3	9.2	14.2	...	14.8	-0.5	-1.9	...	2.0
Leather, wood, cork, paper, and pulp products	5.4	5.6	5.7	6.0	11.9	15.3	...	13.2	4.0	-6.3	...	5.4
Textiles, clothing and footwear	11.0	11.0	10.7	10.8	10.3	15.6	...	10.2	5.5	-1.7	...	3.6
Metal and mineral products	7.9	7.5	7.2	8.0	14.7	9.7	...	16.7	-4.6	-7.8	...	7.3
Machinery	22.9	22.0	20.9	19.2	4.9	6.8	...	1.7	3.9	-1.4	...	2.8
Transport equipment	13.5	16.1	14.8	15.1	1.5	25.5	...	14.2	6.4	4.9	...	1.5
Other	5.8	6.0	6.0	5.3	21.0	18.6	...	-1.8	1.5	-1.3	...	1.2
Total	100.0	100.0	100.0	100.0	7.1	13.4	...	10.1	3.4	-0.9	...	3.0

Sources: Ministry of Commerce and Tourism, Evolucao do Comercio Externo.

Table 39 Portugal: Invisible Transactions

	1989	1990	1991	1992	1993	1994
(In millions of U.S. dollars)						
Invisible balance	5,017	6,647	7,113	9,380	7,566	5,656
Receipts	9,855	13,034	14,161	17,040	17,477	16,082
Payments	4,838	6,387	7,048	7,660	9,911	10,426
Services	478	1,147	1,151	1,583	900	295
Receipts	4,630	6,605	6,936	7,717	9,129	8,723
Payments	4,152	5,458	5,785	6,134	8,229	8,428
Tourism	2,102	2,688	2,686	2,556	2,168	2,373
Receipts	2,685	3,555	3,710	3,721	4,061	4,071
Payments	583	867	1,024	1,165	1,893	1,697
Transport and insurance	-778	-1,048	-1,189	-1,305	-907	-1,275
Receipts	689	973	955	976	1,250	1,123
Payments	1,467	2,021	2,144	2,281	2,157	2,399
Investment income	-718	-233	82	666	137	-207
Receipts	575	1,145	1,350	1,965	2,314	2,088
Payments	1,293	1,378	1,268	1,299	2,177	2,295
Official transactions	-135	-162	-182	-189	-171	-180
Receipts	38	42	42	47	51	50
Payments	173	204	224	236	222	230
Other	7	-98	-246	-145	-327	-416
Receipts	643	890	879	1,008	1,453	1,391
Payments	636	988	1,125	1,153	1,780	1,807
Transfers	4,539	5,500	5,962	7,797	6,666	5,361
Receipts	5,225	6,429	7,225	9,323	8,349	7,359
Payments	686	929	1,263	1,526	1,682	1,997
Private	3,729	4,506	4,590	4,790	3,811	3,420
Receipts	3,901	4,767	4,954	5,206	4,310	3,835
Payments	172	261	364	416	499	415
Public	810	994	1,372	3,007	2,855	1,942
Receipts	1,324	1,662	2,271	4,117	4,038	3,524
Payments	514	668	899	1,110	1,183	1,583
(In percent of GDP)						
Invisible balance	9.6	9.8	9.1	9.7	8.8	6.4
Services balance	0.9	1.7	1.5	1.6	1.1	0.3
Of which:						
Tourism receipts, gross	5.1	5.2	4.7	3.9	4.7	4.6
Investment income, net	-1.4	-0.3	0.1	0.7	0.2	-0.2
Transfer balance	8.7	8.1	7.6	8.1	7.8	6.1
Private	7.1	6.7	5.9	5.0	4.5	3.9
Public	1.6	1.5	1.7	3.1	3.3	2.2

Sources: Bank of Portugal, 1992 Annual Report and Quarterly Bulletin, various issues.

Table 40. Portugal: Indicators of Tourism

	1989	1990	1991	1992	1993	1994
Tourist arrivals (in thousands)	16,471	18,422	19,641	20,742	20,579	21,728
(Annual percentage change)	2.5	11.8	6.6	5.6	-0.8	6
Of which:						
Spain	12,186	13,806	14,583	15,553	15,776	16,628
United Kingdom	1,137	1,203	1,307	1,435	1,368	1,442
Germany	611	681	852	877	795	874
France	646	658	711	686	591	639
United States	235	252	178	220	208	219
Tourist receipts (in millions of U.S. dollars) 1/	2685	3555	3710	3721	4061	4048
(Annual percentage change)	11.8	32.4	4.4	0.3	9.1	-0.3
Memorandum items:						
Escudos per Spanish peseta	1.33	1.40	1.39	1.32	1.26	1.24
(percentage change) 2/	-7.3	-5.3	0.7	5.0	4.5	1.6
Nominal effective exchange rate						
(percentage change) 2/	-3.1	-2.7	0.7	3.2	-6.0	-4.1

Sources: Bank of Portugal, Direcção Geral do Turismo and IFS.

1/ New series since 1993. Bank of Portugal estimates for 1993 and 1994.

2/ A positive change indicates an appreciation of the Portuguese escudo.

Table 41. Portugal: Capital Account

(In millions of U.S. dollars)

	1989	1990	1991	1992	1993	1994
Private capital	4,786	4,868	7,831	-775	-2,761	176
Non-debt capital	2,863	5,135	6,341	-1,467	904	-956
Short-term	520	1,155	1,898	511	-1,631	-3109
Medium- and long-term	2,343	3,980	4,443	-1,978	2,535	2153
Of which: Foreign direct investment	1,504	2,264	2,285	1,904	1,439	1158
Debt capital	1,290	179	719	1,242	1,157	71
Short-term	656	-311	15	204	508	402
Medium- and long-term	634	490	704	1,038	649	-331
Bank capital (short-term)	633	-446	771	-550	-4,822	1061
Public debt 1/	-362	-1,181	-1,299	596	-727	-995
Short-term	-183	-289	-152	268	-179	-502
Medium- and long-term	-179	-892	-1,147	328	-548	-493
Capital account	4,424	3,687	6,532	-179	-3,488	-819

Sources: Bank of Portugal, Monthly Bulletin, Quarterly Bulletin; and data provided by the Portuguese authorities.

1/ Includes general government, nonfinancial public enterprises, and some state-guaranteed debt.

Table 42. Portugal: Foreign Direct Investment

	1989	1990	1991	1992	1993	1994
(In millions of U.S. dollars)						
Total	1,577	2,594	3,167	3,006	2,924	2,076
Country of origin						
OECD European countries	1,303	2,115	2,371	2,479	2,441	1,706
France	270	435	367	525	300	184
Germany	115	148	106	170	158	371
Spain	184	365	383	238	541	265
Switzerland	94	95	175	91	209	168
United Kingdom	364	515	637	876	643	250
Other	276	557	703	579	590	468
Japan	12	69	34	13	4	16
United States	71	83	277	124	330	91
Other	191	327	485	390	149	263
(In percent of total)						
Country of origin						
OECD European countries	82.6	81.5	74.9	82.5	83.5	82.2
France	17.1	16.8	11.6	17.5	10.3	8.9
Germany	7.3	5.7	3.3	5.7	5.4	17.9
Spain	11.7	14.1	12.1	7.9	18.5	12.8
Switzerland	6.0	3.7	5.5	3.0	7.1	8.1
United Kingdom	23.1	19.9	20.1	29.1	22.0	12.0
Other	17.5	21.5	22.2	19.3	20.2	22.5
Japan	0.8	2.7	1.1	0.4	0.1	0.8
United States	4.5	3.2	8.7	4.1	11.3	4.4
Other	12.1	12.6	15.3	13.0	5.1	12.7
Sectoral destination						
Manufacturing	21.8	18.9	21.7	17.6	22.3	34.4
Construction and public works	7.2	8.7	5.2	7.2	2.4	1.4
Banks and other financial institutions	47.0	60.7	59.9	60.4	59.3	38.8
Retail and wholesale trade, restaurants and hotels	17.7	8.5	7.0	9.4	7.6	16.6
Other	6.4	3.2	7.1	5.4	8.4	8.7
Memorandum items:						
Total foreign direct investment						
Growth rate, in percent	127.9	64.5	22.1	-5.1	-2.7	-2.9
In percent of GDP	3.5	4.3	4.6	3.6	2.9	4.2

Source: Bank of Portugal.

Table 43 Portugal: Official Reserves

(In Millions of U.S. Dollars: end of period)

	1989	1990	1991	1992	1993	1994	1995		
							Mar.	Jun.	Aug.
Gold 1/ 2/	5,184	5,113	5,125	5,188	5,189	5,185	5,189	5,189	5,189
SDRs	2	57	98	46	58	71	78	82	81
Reserve position in the Fund	125.0	176	270	314	302	337	366	422	437
Foreign exchange 2/	9,826	14,252	20,261	18,769	15,441	15,106	14,733	15,637	15,482
Total	15,137	19,598	25,754	24,317	20,990	20,699	20,366	21,330	21,189
Memorandum item:									
Official reserves in months of imports 3/	8.4	8.2	10.3	8.6	8.6	7.4	...	...	...

Sources: Bank of Portugal; and IMF, International Financial Statistics.

1/ National valuation.

2/ Gold and foreign exchange holdings exclude the deposits made with the European Monetary Cooperation Fund (EMCF) of a portion of the gold U.S. dollar holdings; the holdings of ECU issued by the EMCF against these deposits are included in foreign exchange holdings in this table.

3/ Imports include goods and services.

Table 44. Portugal: External Debt
(In Millions of U.S. Dollars, end of period)

	1989	1990	1991	1992	1993	1994
Medium and long-term debt	15,087	16,122	15,829	16,287	13,648	13,885
General government	5,796	5,112	4,242	3,995	2,099	1,912
Nonfinancial public enterprises	6,404	7,179	7,011	6,968	6,303	6,596
Monetary institutions	780	884	1,296	1,420	902	846
Bank of Portugal	1	—	—	—	—	—
Other	2,106	2,947	3,280	3,904	4,344	4,531
Short-term debt	2,901	2,546	2,431	2,849	2,539	2,334
Bank of Portugal and other monetary institutions	53	—	17	103	43	49
Nonfinancial public enterprises	1,085	984	837	1,044	843	384
Other	1,763	1,562	1,577	1,702	1,653	1,901
Total	17,988	18,668	18,260	19,136	16,187	16,219
Of which:						
Monetary	54	—	17	103	43	49
Publicly guaranteed	1,893	2,445	2,789	2,815	2,544	2,897
Memorandum items:						
Share of short-term debt in total debt	16.1	13.6	13.3	14.9	15.7	14.4
Share of public and publicly guaranteed debt in total debt	42.8	40.5	38.5	35.6	28.7	29.7
Ratio of debt to GDP	39.5	31.1	26.6	24.8	20.7	17.6
Ratio of debt to foreign exchange reserves	180.7	128.9	88.5	99.5	104.8	107.4

Sources: Bank of Portugal, Quarterly Bulletin and Monthly Bulletin; IFS; and data provided by the Portuguese authorities.

Table 45. Portugal: External Debt Service Payments

	1989	1990	1991	1992	1993	1994
Amortization payments on medium and long-term debt	2,617	3,642	4,926	4,287	3,299	3006
Of which: advance repayments	1,054	1,575	1,094	...	...	...
Interest 1/	1,293	1,378	1,268	1,299	1,268	1156
Total debt service 2/	3,910	5,020	6,194	5,586	4,567	4,162
Debt service	17.3	17.1	20.4	15.8	13.7	12.1
Debt service excluding advance repayments	12.7	11.7	16.8	13.9	13.7	12.1
Interest payments	5.7	4.7	4.2	3.7	3.8	3.4
Amortization	11.6	12.4	16.2	12.1	9.9	8.7
Excluding advance repayments	6.9	7.1	12.6	12.1	9.9	8.7
Memorandum item:						
Current account receipts (in millions of U.S. dollars)	22,571	29,335	30,384	35,315	33,380	34,510

Sources: Bank of Portugal, Quarterly Bulletin; IFS; and data provided by the Portuguese authorities.

1/ Based on the debit for investment income in the balance of payments.

2/ Excluding amortization of short-term debt.

3/ Foreign exchange earnings from current account receipts.

The Persistence of Portuguese Unemployment

1. Introduction

The persistence of high levels of unemployment in Europe has prompted much academic and policy research attempting to explain it. This research has tended to concentrate on policies and labor market institutions of the larger European countries. The experience of Portugal has, by contrast, remained relatively under-researched, despite the potentially valuable lessons that might be forthcoming given Portugal's relatively favorable unemployment experience and the widespread perception that its labor market is one of the most flexible in the EU. In a recent paper, Blanchard and Jimeno (henceforth referred to as BJ) cast an academic spotlight on the Portuguese experience, drawing attention to the fact that Portuguese unemployment is surprisingly low (6.8 percent), especially when compared to Spanish unemployment (24.4 percent). ^{1/} However, BJ noted that there were few institutional differences between the Portuguese and Spanish labor markets that might account for the wide disparity in their unemployment levels.

This Appendix reviews the institutional and legal features of the Portuguese labor market, and concludes that they are characterized by some degree of rigidity. This tends to undermine the conventional wisdom that it is Portugal's superior labor market flexibility that accounts for typically low unemployment rates, as well as historical episodes such as the rapid fall in unemployment rates following the 1985 recession. ^{2/} If, indeed, Portugal's labor market is not as flexible as previously thought, several hypotheses accounting for Portugal's favorable unemployment experience suggest themselves. These include the following: (1) Labor market practices may diverge significantly from what is specified in formal rules and regulations; (2) Some rigidities may have been introduced too recently to have had their full effect on unemployment; and (3) The timing and incidence of external macroeconomic shocks, as well as the timing of the Portuguese disinflation, may have reduced their impact on unemployment independent of labor market institutions. Each of these hypotheses has distinct policy implications. The Appendix presents preliminary econometric evidence to explore them further.

^{1/} Blanchard, O. and J.F. Jimeno, (January 10, 1994) Structural unemployment: Spain versus Portugal, MIT Mimeo. Also see AER Papers and Proceedings, 85:212-18, (May 1995).

^{2/} It is too early to judge the effects of the 1993 recession on unemployment. This issue is discussed further below.

The study uses a methodology applied to a number of European economies to study unemployment persistence. 1/ The main findings, which are based on a 1978-94 sample, are consistent with the first hypothesis, that actual practice is more flexible than the rules would suggest. Evidence is found of flexibility in employment and wage setting over this period, in comparison with other European countries. However, the econometric methods used cannot rule out the possibility of a regime shift in the Portuguese labor market that has not yet been fully felt. Institutional evidence points to a potential lessening of labor market flexibility. The actual unemployment rate in 1994 is about 1 percent higher than the rate produced from estimated econometric equations; this is not surprising, given the speed with which the unemployment rate has increased. This may point to an increase in the persistence of unemployment in Portugal.

2. Institutional evidence

BJ make the case that Portuguese and Spanish labor market institutions are very similar by examining aspects of these institutions that theories of structural unemployment suggest are important. In summary, they report the following:

- Fiscal policy. The "wedge" between the cost of labor to firms and take-home pay for workers can be significantly affected by fiscal policy. However, this wedge is likely to be similar for the two countries. In Portugal, general government receipts as a percent of GDP increased from 29 percent in 1978 to 40.6 percent in 1994. In Spain, they increased from 27 percent to 39 percent in the same period. (Of course, tax structure and administration influence the extent to which the overall government revenues constitute a labor market distortion.)
- Collective bargaining. According to the OECD Jobs Study, Portugal and Spain have similar collective bargaining institutions: predominantly sectoral (rather than central, or plant-level), with limited coordination. 2/ Empirically, this set of institutions appears to be correlated with the "worst unemployment outcomes".
- Employment protection. Portugal is assigned the highest value of an index of employment protection, 16 (as constructed by the OECD Jobs Study), while Spain is given the second highest, 15. By comparison, the index for France is 6 while that of the United Kingdom is 2.

1/ For an overview of the methodology and a summary of country results, see Henry, B. and D.J. Snower, (Mimeo, April 21, 1995) Explaining the Movement of European Unemployment. For a published example of the methodology, see SM/95/198, 8/15/95, Germany - Selected Background Issues, Chapter II.

2/ OECD, (1994) The OECD Jobs Study, Vols. I and II.

- Unemployment benefits. Replacement rates (the average benefit as a percent of the average wage) for Portugal were 65 percent for those unemployed less than 1 year, 37 percent for 2-3 years, and no benefits thereafter. For Spain, the corresponding rates were 70 percent, 30 percent, and no benefits thereafter.

Clearly, the labor market institutions of Portugal and Spain are quite similar. BJ identify only two differences. One, collective bargaining practices seem more flexible in Portugal: national agreements between employers and unions have been concluded intermittently, whereas in Spain such agreements have ceased to be concluded since the mid-1980s, indicating a lack of consensus among the social partners. The result appears to have been more moderate wage agreements in Portugal at the sectoral level. Two, unemployment benefit eligibility criteria have been more stringent in Portugal, which has a coverage ratio (the ratio of registered unemployed receiving unemployment benefits) of 41 percent, in contrast to 59 percent in Spain. Moreover, the time path of unemployment benefits has been different over time, with Portugal increasing unemployment benefit coverage gradually over time.

To the BJ analysis should be added one additional comment, namely that the direction of change in the Portuguese labor market in recent years has been toward convergence with the EU--that is, toward greater rigidity. In 1989, the law on unemployment benefit eligibility criteria was relaxed, and the amount of the benefit increased. 1/ As a result, the coverage ratio rose from 21 percent of registered unemployed in 1985 (when unemployment last peaked), to 48 percent in 1994 (the most recent unemployment peak). Unemployment benefits increased from 0.3 to 0.9 percent of GDP in the same period. A collective bargaining agreement between employers and employees failed to be concluded in 1993-94, indicating a worsening in the relations between the social partners. Finally, the use of fixed term contracts--often a method of circumventing labor regulations--has significantly declined (to 10.6 percent of dependent employment in 1994, in contrast to 19.1 percent in 1989). This development may partly be explained by more rigorous enforcement of laws designed to curb the "inappropriate" use of such contracts. 2/

Therefore, on the surface Portugal has quite rigid and inflexible labor market institutions, because they are quite similar to those of Spain, which

1/ Until 5/31/89, unemployment benefit eligibility required continuous employment (full time or part time) for 36 consecutive months and payment of contributions. After 7/1/89, eligibility only required employment (full time or part time) and paid contributions for 540 days, provided this occurred within 24 months prior to unemployment.

2/ Anecdotal evidence also suggested that some of the increase in self-employment (which has substituted for losses in dependent employment to a considerable extent following the 1993 recession) occurred because of attempts to circumvent labor regulations.

has the highest rate of unemployment in the EU and is widely regarded as having a rigid and inflexible labor market. 1/ However, the lower unemployment rate is prima facie evidence against such a conclusion. Policy inferences therefore depend crucially on what explains the disparity in unemployment rates between Portugal and Spain: the failure to enforce existing, rigid, labor regulations; the fact that rigidities in labor market institutions have been introduced relatively recently, and there are long lags before unemployment converges to its higher, structural rate; or simply a fortunate timing of macroeconomic shocks and the Portuguese disinflation (which continued until much later than it did in Spain and some other high-unemployment EU countries). 2/ The first of these explanations implies that existing labor laws are being circumvented, which may itself have distortionary effects. This would argue for introducing more flexible laws and enforcing them in a more uniform way. The latter two hypotheses imply that over time Portugal's unemployment situation would converge toward the EU, posing the need to undertake reforms to reduce the distortionary impact of policies on the labor market. The next section presents some preliminary econometric evidence that is useful in assessing the relevance of these hypotheses.

3. Econometric evidence

The main vehicle utilized in this section is a small, 4-equation econometric model of the Portuguese labor market, designed to measure some of the more typical labor market rigidities. The general outline of the model is being applied to several EU economies. 3/ The equations describing the specific model developed for Portugal are:

$$\begin{aligned} (1) \quad n_t &= \beta_n + a_{nn}(L)n_{t-1} + a_{nw}(L)w_t + a_{nk}k_t + a_{ny}y_t + a_{nss}ssc_t + \epsilon_{nt} \\ (2) \quad w_t &= \beta_w + a_{ww}(L)w_{t-1} + a_{wn}(L)\Delta u_{t-1} + a_{wp}p_t + a_{wpc}pc_t + \epsilon_{wt} \\ (3) \quad l_t &= \beta_l + a_{ln}(L)n_t + a_{ll}(L)l_{t-1} + a_{lw}pc_t + a_{lanp}np_t + a_{ws}ssc_t + \epsilon_{lt} \\ (4) \quad u_t &= l_t - n_t \end{aligned}$$

where n denotes employment, w the real wage rate, l the labor force, u the unemployment rate, k business sector capital stock, y real GDP, p productivity, pc the consumer price index, np population, ssc the ratio of social security contributions to the wage bill (in index form), β a constant, and ϵ an error term. L denotes the lag operator (for any time series x_t , $Lx_t = x_{t-1}$), Δ the difference operator ($\Delta = 1 - L$), and $a(L)$ a

1/ A review of some of the institutional features and rigidities of the Spanish labor market can be found in SM/95/25, 2/6/95, Spain - Selected Background Issues, Chapter II.

2/ See Chart 1 for a comparison between inflation and unemployment in Portugal.

3/ See Henry and Snower (1995), previously cited.

CHART 1
PORTUGAL
Unemployment vs. Inflation
(in percent)

Sources: Portuguese authorities; OECD; IMF, International Financial Statistics; and staff estimates.

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APPENDIX I

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polynomial in the lag operator. Equation (4) is a log-linear approximation of the labor force identity. All variables except *ssc* and *u* are measured in logarithms. The data are quarterly for 1978-I to 1994-IV.

Equation (1) is meant to capture labor demand by firms, in an imperfectly competitive environment with employment adjustment costs. Equation (2) represents wage-setting behavior by trade unions in a bargaining framework. Equation (3) is a conventional way to model labor supply. In this framework, labor market rigidities influence the length of lags in equations (1) to (3). Thus, employment protection legislation (firing costs) tend to result in slower adjustment of employment; wage indexation should result in longer adjustment lags for wages, while labor force participation costs should result in longer adjustment lags for the labor force. Finally, the discouraged worker effect can have a negative impact on both wages and the labor force, respectively through the change in unemployment and employment.

The estimated equations for Portugal are contained in the tabulation below. Overall, the results seem consistent with the traditional view of the Portuguese labor market as one of the most flexible in the EU, at least for the data sample that is available. Some interesting and surprising results emerge, however. The employment equation exhibits fairly rapid employment adjustment, with a coefficient on lagged employment of 0.5. These results may be compared with similar estimates for Italy and Spain: 1/ the sum of the coefficients on lagged employment for Italy and Spain are closer to 0.7, indicating greater persistence. 2/ By contrast, employment sensitivity to variation in real wages is similar across the three countries: this result is consistent with conventional wisdom, which suggests that firing restrictions result in employment inflexibility in Portugal, which is ameliorated through wage flexibility. The sensitivity of employment to output is greater than in Italy and about the same as in Spain.

1/ In what follows, comparisons will be presented between the econometric results for Portugal, Italy and Spain. Italy is included because preliminary results exist using the same methodology as in the case of Portugal, in Christofides C.A., Italian Unemployment 1975-94: An Analysis of Macroeconomic Shocks and Policies Using Evidence from a Structural Vector Autoregression, Mimeo (April 20, 1995). A drawback of this comparison is that the Italian and Spanish labor markets are considered inflexible, so that a comparison that is favorable to Portugal may not imply that Portuguese labor markets are characterized by significant flexibility.

2/ The Italian and Spanish results are from staff work in progress; they should be regarded as preliminary.

Regression results

Dependent variable	n_t	n_t LR	w_t	w_t LR	l_t	l_t LR
<u>Summary statistics</u>						
R-bar squared	0.958	0.941	0.912	0.730	0.993	0.983
S.E., estimate	0.012	0.014	0.014	0.025	0.004	0.006
Durbin-Watson statistic	1.957	0.772	2.358	0.458	2.036	0.675
d.f.	54	55	55	64	53	55
<u>Coefficients</u> (t-statistics in parentheses, without regard to sign)						
β	-1.620 (2.8)	-3.410 (6.4)	0.003 --	1.023 (3.8)	-0.190 (0.9)	-0.965 (3.4)
n_t	...	...	...	...	0.842 (20.5)	0.640 (17.3)
n_{t-1}	0.505 (4.8)	...	...	...	-0.670 (8.4)	...
w_t	-0.133 (2.6)	-0.164 (2.8)	...	...	...	...
w_{t-1}	...	...	0.734 (11.4)	...	...	...
l_{t-1}	...	...	...	...	0.716 (8.3)	...
k_t	0.128 (1.6)	0.306 (3.6)	...	...	...	...
pc_t	...	...	-0.03 (3.3)	-0.103 (11.1)	0.011 (2.3)	0.033 (5.6)
Δu_{t-1}	...	...	-0.013 (2.4)	0.004 (0.5)	...	...
y_t	0.233 (3.8)	0.370 (5.8)	...	...	...	...
p_t	...	...	0.292 (4.1)	0.884 (13.2)	...	...
np_t	...	...	...	...	0.162 (1.7)	0.681 (5.8)
ssc_t	-15.791 (3.4)	-26.635 (4.8)	...	...	-4.274 (2.7)	-13.452 (7.8)

Notes: LR refers to the long-run relationship. And n denotes employment, w the real wage rate, l the labor force, u the unemployment rate, k business sector capital stock, y real GDP, p productivity, pc the consumer price index, np population, ssc the ratio of social security contributions to the wage bill (in index form), and β a constant. All variables, except ssc and u , are measured in logarithms.

Finally, as in Italy, social security contributions act to depress employment. ^{1/}

The wage setting equation exhibits somewhat greater persistence than the employment equation, with a coefficient on lagged wages of 0.7. This is somewhat less than Italy, but more than Spain. The reason for this is not, however, a higher degree of indexation in Portugal relative to Spain. Rather, the Spanish equations contain lagged minimum wage terms, which probably capture some of the effect of wage staggering (since minimum wages are likely to correlate highly with wages). In addition, the Portuguese wage setting equation contains two further terms which indicate wage flexibility. One seems to be a short-term bargaining term, the change in the unemployment rate, which indicates that increases in the unemployment rate tend to depress real wages (the effect becomes statistically insignificant in the long run). ^{2/} The other term indicates a statistically and economically significant negative effect of CPI on wages, which is direct evidence of imperfect wage indexation. Finally, wages in Portugal seem to grow at a rate lower than productivity (a long run elasticity of 0.9). This result is an artifact of the sample period: after the Portuguese revolution in 1974, there was an explosion in wages that resulted in a very large increase relative to productivity. The differential between wages and productivity has since then been gradually declining. Because the sample starts in 1978, wages appear to grow at a rate lower than productivity. But viewed over a longer period of time, the ratio of wages to productivity has tended to a constant.

The labor force equation indicates an average degree of persistence; there seems little reason why labor force adjustment costs should be higher or lower in Portugal relative to Spain or Italy. As in Italy, there is significant evidence of a discouraged worker effect. As employment falls, so does the labor force. Social security contributions seem to depress the labor force, while the CPI acts to enlarge it--probably because given the incomplete indexation of wages it acts as a real wage proxy.

The degree of persistence of the system of equations as a whole can be best gauged by examining Charts 4 and 5, which contain the impulse responses of each equation when subjected to a temporary and a permanent shock respectively, where labor demand is decreased by 1 percent. A comparison with Italy, for which similar charts were constructed, shows that adjustment is much faster in the Portuguese case, with employment, the labor

^{1/} Data limitations did not permit a disaggregation of social security contributions into employer and employee, so the variable used here should be considered a proxy.

^{2/} Another interpretation of this effect is that it represents insider employment effects: as employment increases, so does the stock of insiders, which can bargain for higher wages. The specific formulation here precludes a long-run effect, however. In the Italian case, by contrast, the effect persisted in the long-run.

force and unemployment adjusting to within a small distance from their equilibrium values within two years; the comparable figures for Italy range from four to eight years. ^{1/} Wages adjust more slowly than unemployment, because of the added lagged effect of the change in the unemployment rate variable. They also overshoot in the case of the temporary shock, because the reversal in the trajectory of the unemployment rate implies that the change in the unemployment rate eventually becomes negative, which reverses the initial decline in real wages. In the case of the permanent shock, real wages fall temporarily, but remain unchanged in the long run--a surprising result, but one that seems to result from the interaction between the sensitivity of employment to wages and the sensitivity of wages to the change in the unemployment rate.

Having examined the persistence properties of the estimated model for Portugal, it will be useful to examine its within- and out-of-sample forecasting properties, and briefly to investigate some issues regarding system identification, estimation, unit root properties of the variables, and the relative contributions of employment, wages and the labor force to the variance of unemployment innovations. The within-sample performance can be seen in Charts 2 and 3. Each of the four equations appears to track its respective series reasonably well, given the simplicity of the estimated equations. A more stringent test of forecasting performance is the ability to forecast out-of-sample. The tabulation below provides root-mean-square (RMS) errors at different out-of-sample forecast intervals, as well as the Theil U statistic--a measure of how well the model performs relative to a "naive" random walk model.

Theil U statistic and RMS error (in parenthesis)

<u>Variable</u>	<u>1-step ahead</u>	<u>4-step ahead</u>	<u>8-step ahead</u>	<u>12-step ahead</u>
n_t	0.80 (0.013)	0.62 (0.016)	0.28 (0.015)	0.12 (0.009)
w_t	0.14 (0.003)	0.16 (0.003)	1.58 (0.020)	0.81 (0.022)
l_t	0.71 (0.011)	0.16 (0.002)	0.10 (0.003)	0.07 (0.003)
u_t	1.70 (0.224)	0.99 (1.352)	0.71 (1.671)	0.35 (1.075)

Notes: n denotes employment, w the real wage rate, l the labor force, and u the unemployment rate. The Theil U statistic computes the ratio of the forecast error of the estimated model to the forecast error obtained by a random walk model in each variable. A ratio lower than one indicates that the estimated model outperforms a random walk model.

^{1/} See SM/95/48, 3/9/95, Italy - Background Economic Developments and Issues, Annex II.

Employment and Unemployment

Sources: Portuguese authorities, OECD, and staff estimates.

Labor Force and Real Wages

Sources: Portuguese authorities, OECD, and staff estimates.

CHART 4
PORTUGAL
Impulse Responses, Labor Demand
(Temporary shock)

Sources: Portuguese authorities, OECD, and staff estimates.

CHART 5
PORTUGAL
Impulse Responses, Labor Demand
(Permanent Shock)

Sources: Portuguese authorities, OECD, and staff estimates.

The estimated model outperforms a random walk model for n , w , and l (except for the 8-step ahead forecast for w). Forecast errors behave less normally for w than they do for n and l , indicating that the estimated model for w may not be using all available sample information optimally. This is not surprising, given that the number of included lags was truncated to preserve model simplicity. 1/ The behavior of unemployment is interesting, indicating that a random walk could be a satisfactory model for forecast horizons of up to one year--although the estimated model performs much better at forecast horizons longer than 8 quarters. Interestingly, the horizon at which the model outperforms a random walk model coincides with the horizon at which disequilibria tend to disappear.

Similar to results obtained for other EU countries, most of the variables included in the regressions are non-stationary (i.e., contain unit roots). Augmented Dickey-Fuller (ADF) tests (excluding time trends, but including constants) reveal that the hypothesis of non-stationarity cannot be rejected, for all variables except y , p , and w . 2/ In these circumstances, it is important to test that the estimated regressions are cointegrating relationships. ADF tests on the residuals of the estimated regressions for Portugal indeed reject the unit root hypothesis, confirming the existence of cointegration. Results quoted in Henry and Snower (1995) then imply that it is permissible to estimate regressions of the type that is reported here.

To address issues of simultaneity, a system estimator was used--the so called seemingly unrelated regressions (SUR) estimator. 3/ The results were very similar to those obtained using an ordinary least squares (OLS) estimator (which underlies the regressions reported in the text). This is explained by the relatively small estimated residual correlation matrix. Denoting the estimated residual correlations between equations i and j by ρ_{ij} , these correlations were: $\rho_{nw} = -0.31$, $\rho_{nl} = 0.23$, and $\rho_{wl} = 0.11$. The small off-diagonal elements of the residual covariance matrix implied by these estimates also help alleviate problems relating to the identification of the estimated system, because correlated disturbances reflect shocks from different sources, making it difficult to make inferences regarding the response of the estimated system to a specific shock.

Finally, a variance decomposition of the innovations was performed to gauge the relative magnitude of various sources of shocks to the system. The tabulation below presents the results in the short-run (1-step ahead) and in the long-run (24-step ahead):

1/ Future research could explore more complicated models.

2/ However, the hypothesis of non-stationarity is rejected for all variables when utilizing ADF tests including both time trends and constants. The low power of such tests to distinguish between a deterministic and a stochastic (unit root) trend is well known.

3/ Future research could also utilize a 3-stage least squares (3SLS) estimator, intended to address issues of endogeneity.

Variance decomposition

(1-step ahead; 24-step ahead in parentheses; in percent)

<u>Explanatory Variable</u>	B_t	W_t	L_t	U_t
n_t	97 (56)	15 (11)	87 (59)	18 (40)
w_t	2 (44)	85 (87)	2 (31)	-- (46)
l_t	-- (--)	-- (2)	11 (9)	82 (14)

Notes: n denotes employment, w the real wage rate, l the labor force, and u the unemployment rate. All variables, except u, are measured in logarithms.

A number of interesting results may be inferred from the variance decomposition of the innovations. First, the effect of labor force innovations on unemployment, although dominant in the short-run, was relatively small in the long run. Instead, the discouraged worker effect, operating through innovations in employment, became much more significant. Second, wages were mainly affected by shocks to the wage determination equation itself in both the short- and the long-run. This suggests that the evolution of collective bargaining to a large extent followed a dynamic of its own, little affected by innovations in employment. ^{1/} Finally, innovations in wages became dominant for unemployment and the labor force, and very important for employment over the longer-run. This finding is consistent with the view that much of the observed flexibility of the Portuguese labor market is connected with wage rate flexibility and a supportive collective bargaining environment.

4. Conclusion

To summarize, the empirical findings reported here seem consistent with the first hypothesis that was advanced to explain the discord between the institutional analysis advanced by BJ and the actual path of unemployment: that existing labor market regulations are so poorly enforced that they have little impact on the determination of wages and employment. The Portuguese labor market operated relatively flexibly during the sample, adjusting to

^{1/} This finding, however, depends sensitively on the specification adopted for the wage-setting equation. Richer specifications that allowed for more interaction between the endogenous variables and endogenized the "exogenous" variables of the model, could well overturn this result. Results for Italy, which were based on a richer specification, were mixed.

shocks with relatively short lags, and exhibiting incomplete wage indexation and significant discouraged worker effects on wages and the labor force. However, the empirical findings reported here cannot dismiss the hypothesis that Portugal is still adjusting to less flexible institutional arrangements, because they primarily depend on historical data that may not be representative of recently introduced rigidities. It is very difficult to detect a change in the policy regime that may have occurred recently and which would only become visible after a considerable lag.

The institutional evidence earlier presented suggested that some perceptible loss in labor market flexibility affecting collective bargaining and wages is not implausible. Examining carefully the model-based simulations for employment and unemployment (Chart 2a), it is seen that given the relatively short duration of the 1993 recession and the resulting output path, unemployment should have been about 1 percentage point lower than it turned out to be. This is a worrying result, that seems consistent with the rapidity with which the unemployment rate has increased. Moreover, the model is predicting the labor force quite accurately, and actual wages are lower than the rate predicted by the model, suggesting that the ability of wage flexibility to deliver lower unemployment may be diminishing. Although not definitive, the model-based results, when combined with the institutional evidence already discussed, provide cause for concern. In the future, Portuguese unemployment may well prove more persistent and structural than its history suggests.

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The Social Security System: Problems and Options for Reform

1. Introduction

This Appendix describes the evolution and current state of Portugal's social security system, diagnoses its problems, compares Portugal's system with other European countries, and projects the financial impact of expected demographic changes. It then suggests policy measures to ameliorate the system's financial problems and eliminate the design flaws that adversely affect its efficiency and equity. While the discussion will cover the entire spectrum of Portugal's extensive social security system, including both public pensions and the wide array of welfare programs and other benefits, it will focus more sharply on the pension system.

Portugal's social security system is in financial trouble. In 1994-95 the government financed annual deficits of over 2 percent of GDP and demographic trends will induce a further deterioration in the system's finances over the medium term. These deficits jeopardize Portugal's convergence to Maastricht deficit requirements. Even beyond these requirements, a reform of the social security system is inescapable to ensure its viability in the medium-term.

There are seven major factors underlying the financial troubles of Portugal's pension system, many of which conform with trends in other countries with mature pay-as-you-go systems.

- The population is ageing.
- The pension system has matured, with the consequence that contribution rates are high and the system relies on assistance from the government.
- Coverage of various categories of workers and protection against various contingencies have been progressively expanded.
- Wage replacement ratios are high by international standards and there is a weak link between benefits and contributions.
- Early retirement, including through disability pensions, have raised dependency rates.
- Pension fund reserves are small and earn low, even negative, returns.
- Productivity growth cannot increase real wages fast enough to avert the adverse financial impact of population ageing.

The following sections investigate these factors and suggest directions of reform to contain their adverse impact on the public finances.

2. The system's characteristics and problems

a. A brief history

Since its inception in 1935, Portugal's social security system has undergone a series of changes to enlarge its scope and raise the level of benefits, gradually making the system universal. The system began with a general regime that covered dependent and self-employed workers in industry and services. Workers contributed in relation to their wages and the social security regime provided defined pension benefits for old-age and invalidity, insurance against work injuries, and death benefits. The social security system was amended in 1962 to separate dependent workers into several special regimes, with expanded protection against contingencies in the general regime. However, important sectors of the population continued to be excluded from the system, and protection differed for different types of workers. 1/ A new change in the system attempted to alleviate some of these disparities in 1969 and, in particular, created several special regimes for agricultural workers, thus progressively increasing the institutional complexity of social protection.

During the 1970s, the social protection regimes were extended to new groups, such as the clergy, and benefits were broadened for workers in some of the special regimes, such as agricultural workers. The most important change of the decade, however, came with the 1974 revolution: welfare benefits were made universal with the creation of the "social pension" for old-age and disability. Social pensions consisted of a flat amount granted to all persons excluded from contributory social security regimes on the condition that the person's income was 30 percent or less of the minimum wage (50 percent if married). In 1980 programs of social protection for this group were extended and formalized into the non-contributory social security regime.

Throughout the 1980s the coverage of benefits was harmonized across the different types of workers in the contributory regimes, and groups of workers were shifted from special regimes that provided a narrower range of benefits to the general--most generous--regime. For instance agricultural workers were shifted to the general regime in 1987. Currently, benefits are equal for all workers under the general regime, and banking and public sector employees remain in special regimes outside the social security system.

The process of harmonizing benefits across regimes was accompanied by periodic increases in contribution rates, but these rates continue to differ across categories of workers. For example, in 1977 contribution rates for employed and self-employed workers were 26.5 and 22.5 percent, respectively. Currently, these rates stand at 34.75 percent for employed workers and 21 to 24 percent for self-employed workers, but higher rates for the last category are being phased in (See Table 1).

1/ For example, professional and specialized workers were entitled to pensions, sickness and maternity benefits, and family allowances, while fishermen only accrued pensions and reduced family allowances.

b. The system today: regimes and benefits

The social security system comprises three main regimes: (i) the general regime, covering workers, self-employed persons and voluntary contributors; (ii) a special regime for agricultural sector activities, which includes a closed pool of agricultural pensioners; and (iii) a non-contributory regime, which protects persons not included in the other regimes with incomes of 30 percent of the minimum wage (50 percent for married persons) or less; this regime also includes a temporary system of agricultural workers.

Social security benefits encompass pensions and welfare payments. All regimes provide pensions for old-age, survival and disability. These pensions take up three-quarter of social security expenditures. Pensions are linked to earnings in the general regime (comprising 68 percent of pension beneficiaries and 75 percent of pension expenditures), and consist of a flat amount in the other two regimes.

Social security benefits other than pensions vary across regimes (see Table 2). 1/ In the general regime, benefits include insurance against contingencies that affect the ability to work, that is, illness, maternity, work injury and unemployment. These payments comprise about 18 percent of social security expenditures and are not provided to participants of the non-contributory regime. Other benefits provided in the general and non-contributory regimes are, for the most part, not incomes-tested and consist of family allowances, subsidies to infants, children with special education needs, the disabled, etc.

c. The system's problems

Portugal's social security system faces two types of problem: design and financing. The design of benefits and contributions adversely affects the economy's efficiency and influences income redistribution in a direction that is often perverse. The financing problems thwart fiscal adjustment.

(1) The problems of design. The main characteristics of the provision of pensions are summarized in Table 3. The salient features of the pension system are its high contribution rate and the specific parameters of the pension formula that result in a weak link between benefits and contributions: pensions are based on income earned over the last 15 years, there is a minimum contribution period of 15 years, and pensions are capped.

On efficiency grounds, the main shortcoming of the pension system is the high level of the tax on labor, which distorts resource allocation. On equity grounds, the pension system has aspects of perverse income redistribution. The system redistributes income:

1/ The special regime for agricultural workers includes pensioners only, and thus work-related and family subsidies are not provided.

- (i) from those with more years of contribution to those with fewer years, due to caps on pensions;
- (ii) from lower to higher income people, due to the latter's longer life expectancy and upward sloping earning profile in the last working years, as in all defined-benefits systems;
- (iii) from those who cannot evade the system easily (dependent workers) to those who can; likewise, from those who contribute as scheduled to those who incur arrears;
- (iv) from contributors and old-age retirees to disability pensioners, due to lax regulations and control on eligibility (disability pensioners are 17 percent of the total in Portugal compared with 10 percent in most countries); and
- (v) from poorer to richer contributors, due to welfare payments that are not means-tested.

In sum, Portugal's social security system grants benefits that make the system highly redistributive; it provides a weak link between benefits and contributions (thus stimulating evasion); and it reduces the economy's efficiency by taxing labor at a high rate. These last two characteristics make Portugal stand apart from other European countries, as explained in Section 3 below.

(2) The financing problem. In 1994, total expenditures of the social security system reached 10 percent of GDP, while contributions stood at 7½ percent (Table 4 and Chart 1, upper panel). The gap between expenditures and contributions has grown over the years. Expenditures have risen because the steady increase of pension expenditures of the 1980s has been coupled with increased unemployment compensation during the 1990s (See Appendix I). Thus, according to the 1995 Budget document, social security deficits financed by the central government climbed by 2 percent age points of GDP in the last five years, posing a threat to the fiscal convergence program. 1/ Regarding old-age pensions, three factors account for the increase in real expenditures during 1987-94: first, population ageing, which increased the number of pension beneficiaries by 2½ percent per year; second, nominal adjustments to pensions above inflation, which have increased real pensions by 1.8 percent per year; and third, growing pension levels accrued by new retirees--reflecting past real wage increases--that replace much lower pensions of those who die (Chart 1, lower panel). This last factor alone raised real old-age pension expenditures by 4 percent per year during 1987-94.

1/ In principle, the central administration should finance the non-contributory social security regime and the special regime for agricultural workers.

Regarding contributions, there have been two positive influences during the last 15 years: an increase in the participation of women in the labor force and the increase in real wages associated with Portugal's rapid convergence to Europe's standards of living. On the negative side, however, problems with collections exacerbated by the most recent cyclical downswing have kept contributions below their potential. Specifically, the stock of contributions in arrears, which had come down to 2 percent of GDP in 1991, increased to 2.6 percent of GDP in 1994 (Chart 2, upper panel). A program of rescheduling of arrears reduced the stock in 1995, but if deficiencies in the collection system are not addressed, the stock of arrears might increase again. Further, the average number of years of contributions of the retired population in 1995 was 14½ years, which, although 2 years above the 1989 average, is still significantly below the average duration of a working life.

Although Portugal's pensions are on a pay-as-you-go basis, a small Reserve Fund was created in 1989. The Fund's reserves are remunerated at a rate that has often been below market rates, and the Fund remains insufficient to buffer the system against current financial problems and projected demographic changes (Chart 2).

The government tried to arrest the deteriorating finances of the social security system by adopting several policy changes. Some of these changes are being phased in, with little positive financial impact in the short run, while other changes have not gone far enough to stop the financing gap from growing. The main policy changes adopted in 1994-95 were as follows: (i) a phased increase in the contribution rate for the self-employed to levels closer to that for employed workers; (ii) a phased increase in the retirement age for women from 62 to 65 years old; (iii) a change in the formula used to compute pensions, lengthening the period on which the base is computed from 10 to 15 years and lowering the accrual rate from 2.2 to 2 percent; ^{1/} (iv) a reduction in the contribution rate paid by employers of 0.75 percentage points, matched by an increase in VAT rates of 1 percent that has been ear-marked for social security; (v) the creation of a program of rescheduling arrears at 1½ to 10 years maturity and reduced interest rates; and (vi) improved control of eligibility for sickness benefits and several measures to strengthen collections, including the incorporation of social security contributions in the law that makes tax evasion a crime punishable by imprisonment.

The system of pensions for public sector employees is also in financial troubles, as described in the box.

^{1/} The accrual rate is a factor that multiplies the number of years worked and pension base to determine the pension level.

Chart 1
PORTUGAL
Social Security and Pension Expenditures

Sources: Ministry of Employment and Social Security, and Bank of Portugal.

Chart 2
PORTUGAL
**Arrears and Reserves of
the Social Security System**

Sources: Ministry of Employment and Social Security, and Ministry of Finance.

1/ The Reserve Fund was created in 1989.

Pensions in the Public Sector

- The pension system of public sector employees is separate from the social security system. Pension benefits for the public sector are higher, while employee contribution rates are similar. The government funds the difference between contributions and pension expenditures.
- The main parameters of the pension formula in the public sector are as follows: (i) the retirement age is 60 years old or 36 years worked (against a retirement age of 65 in the social security system); (ii) the base salary to compute pensions is the annual salary of the last position held (against the average salary of the best 10 of the last 15 years worked in the social security system); (iii) the accrual rate is 2.8 percent (against 2); (iv) the minimum contribution period is 2 years (against 10). Thus, a public employee with 36 years of service earns a pension equal to the yearly salary of the last position held (i.e., a wage replacement ratio of 100 percent). Pensions are adjusted yearly by the nominal wage increases of the public sector.
- The public sector pension formula described above was changed to conform to that of the social security system. However, the new formula applies only to employees that joined the public sector after September 1993.
- During the early- and mid-1980s, contributions and pensions remained stable as a share of GDP. More recently this has changed. During 1987-94, contributions rose due to real wage increases above real output growth and a 2 percent increase in the employee contribution rate in March 1994. But pension expenditures more than doubled to 3.1 percent of GDP during the same period, thus increasing the burden of civil servants' pensions on the public finances.
- The increase in public sector pension expenditures of the last 5 years reflects not only demographic trends and rising real wages, but also the incorporation into the system of retirees of government institutions previously covered by separate pension plans and the impact of early retirement schemes. This was the consequence of a deliberate policy of containing public employment by granting early retirement and limiting new entrants. In effect, pension beneficiaries increased by 25 percent in 1990-94, beneficiaries 60 years old or younger increased by 45 percent, and contributors rose by a mere 4 percent.

Despite recent changes, it is evident that Portugal's social security system's design flaws and financial problems remain; these must be addressed in a coherent way. The system has evolved to provide welfare and pension benefits to increasing segments of the population with steady increases in contribution rates and, during the 1990s, with rising financing from the government. A comparison of Portugal's pension system with that of other industrial countries may indicate areas for reform. In particular, European countries may be an important benchmark for comparison given the increasing integration of goods, capital, and labor markets.

3. An international perspective

Portugal's expenditures on social programs are below those in other European countries but have been growing at a fast pace, from three-fifths of

the European average in 1980 to three-fourths in 1991 (Table 5). 1/ 2/ During 1980-91, the ratio of social protection expenditures to GDP grew three times faster in Portugal than in the European Union as a whole. The social welfare net extends to as many categories of benefits as in the rest of Europe, but the composition of expenditure differs in two main respects: (i) Portugal's expenditures on sickness, invalidity and disability benefits are proportionately higher than in the EU (43 versus 34 percent of total expenditures), with a correspondingly lower proportion of expenditures on old-age and survivors' pensions; and (ii) unemployment benefits as a proportion of total social expenditures are about half of those in the EU (Table 6). The first difference may reflect a relatively lax enforcement of the criteria to qualify for sickness, invalidity and disability pensions, as they may be used in lieu of early retirement. The second difference reflects the lower benefit coverage and unemployment rate of Portugal compared with other EU countries.

There is a striking difference between Portugal and OECD averages in terms of the recent evolution of the pension system. During 1960-85 the ratio of pension expenditures-to-GDP increased by almost 400 percent against 150 percent in OECD countries. 3/ The source of growth of pension expenditures in Portugal was entirely due to the enlarged coverage of the system. In contrast, enlarged coverage explains about half of the increase in pension expenditures in other OECD countries, while demographic factors and increased benefit levels explain the rest. This difference reflects Portugal's more recent expansion of the social protection system, and in particular pensions, compared with richer countries where the systems have been established for some time.

Demographic trends will shape the financial fortunes of pay-as-you-go social security systems. Currently, Portugal's population does not differ significantly from the OECD average, but this may change in the future. In 1990, the population 60 years or older was 18 percent of the total, against an OECD average (weighted by population size) of 18.2 percent. World Bank projections show that Portugal will witness an increase in this proportion below the OECD increase up to the year 2020. Rapid demographic changes thereafter, however, will result in a higher proportion of old-age to total population in Portugal than in the OECD in the year 2050 (33 percent against 31 percent).

1/ This section compares Portugal with the largest set of industrial countries available in different comparative studies of social protection schemes. The largest set is the EU in some cases and the OECD in others.

2/ Portugal's social expenditure-to-GDP ratios in Table 5 are higher than those in Table 4 because the former is based on the old, much lower, GDP series, and it includes social expenditures outside the social security system.

3/ OECD, The Future of Social Protection. 1988.

Increased dependency ratios in trend and already surfacing financial problems in social security systems have prompted reforms across Europe. ^{1/} In the last few years some countries have tried to put back the effective retirement age either by directly increasing the legal retirement age (Germany, Belgium, Italy) or by raising the number of years necessary to qualify for a full pension (France). An alternative used to improve the finances of pension systems in Germany, France and Greece has been to raise contribution rates, while the government increased its transfers to the pension systems in Germany and Luxembourg. Other countries have effectively reduced pensions by changing the pension formula (Spain, Greece, Italy) and by increasing the minimum contribution period (Greece, Spain). Most recently, in 1995 Italy adopted a new system that bases pensions on lifetime contributions.

As regards the design of the pension system, Portugal's system differs from that in other EU countries in several respects. First and foremost, Portugal's contribution rate of 35 percent is significantly higher than the EU average of 19 percent (Table 7). This is partly explained by the fact that Portugal finances not only pensions but also the large net of social welfare programs by taxing labor rather than using general government revenues.

Other differences in the design of pension systems in Portugal vis-à-vis other EU countries concern the provision of pension benefits:

- (i) In the large majority of countries, pension benefits depend on earnings instead of being provided at a flat rate. In Europe, countries are equally split between systems where pensions are assessed over career earnings and systems with pensions based on an average salary of the last 2-15 years. Portugal is in this second group, where the present value of benefits and contributions are less closely tied than in the first group.
- (ii) The pension formula of most EU countries has an accrual factor that is below Portugal's 2 percent. Only Greece has a larger factor for persons that have contributed over 26 years.
- (iii) To qualify for a maximum pension, Portugal requires 36 years of contributions, two years less than the average for the EU. However, the minimum period of contributions necessary to become eligible for pensions is somewhat higher than the average for EU countries.
- (iv) The retirement age for men in Portugal is the same as in other EU countries. The retirement age for women is lower in Portugal than in the rest of the EU, but it is being gradually increased to equal the age for men by the year 2000.

^{1/} See Giarini and Pereira da Silva. *A Reforma, a Poupança e a Integração dos Fundos de Pensões: Caso Português*, 1993.

- (v) In most European countries pensions are formally indexed to inflation or wages, while in Portugal there are no such formal mechanisms; inflation adjustments are ad hoc.

In sum, although Portugal still spends a lower proportion of GDP than other industrial countries on pension and welfare programs, in the last three decades its welfare system has been expanding very rapidly, mainly by incorporating new beneficiaries into the system. Adverse demographic factors are expected to continue straining welfare systems around the world. Some countries have already started reforming their systems to reduce pension benefits and/or increase contributions and Portugal will need to do likewise.

Portugal's pension system also exhibits some unique characteristics that differ from other European countries. It has a substantially higher contribution rate than other EU countries, while the benefit formula is more generous due to the larger accrual factor; the system has looser ties between contributions and pensions; and benefits have a higher degree of policy discretion due to the absence of a formal indexation mechanism.

4. Changing demographics and its impact on the pension system

With rising incomes, entry of women into the labor force, and medical advances, families have fewer children and people live longer. Together, these forces have raised old-age dependency ratios in Portugal, as in many other countries. Between 1950 and 1995, the share of population over 65 years old in the total population more than doubled, to 15 percent. The trend is expected to worsen in the medium term (Chart 3, upper panel). Demographic projections for the period 1995 to 2075 show an increase in the old-age dependency rate from 0.6 to 1.4 (Chart 3, lower panel). The increase is most dramatic from the year 2020 onwards. ^{1/}

To assess the impact of the demographic trend on the system's finances this section presents simulations based on the current characteristics of Portugal's pension system. The simulations use the post-1994 parameters of the pension regime, assuming that the phase-in period has been completed. The main parameters are as follows: (i) workers are assumed to begin working at age 20 and work until age 65, the retirement age; (ii) workers' real wages increase by

^{1/} Demographic projections are from Portugal's National Institute of Statistics for the period 1995-2020, under the zero-migration scenario, and from the World Bank population projections for the period up to 2075. Projections from both sources are very similar for the years 1995-2000, when they overlap.

Chart 3
PORTUGAL
The Demographics Impact

Sources: INE and World Bank.

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1.2 percent per year, the average increase of the last 15 years; ^{1/} (iii) workers contribute to the social security system throughout their working lives; and (iv) the system's base dependency ratio is derived from actual data on contributors and beneficiaries of the social security system in 1994.

The model generates a lifetime income stream that is used to calculate pensions and contributions. The pension benefit is calculated by applying the pension formula to the lifetime income stream. The model generates a contribution ratio that balances the pension system.

For ease of exposition and to avoid making arbitrary assumptions, the model is simulated under the following conditions: (a) contributions finance pension expenditures only, and welfare payments are financed with general government revenue; (b) evasion, build-up of arrears, and unemployment are zero; and (c) workers contribute throughout their working lives, in contrast with an estimated average contribution period for workers in the system of 14½ years.

Under the above assumptions, the simulations produce the following results:

- (i) The contribution rate that produces financial balance in the pension system is 19 percent, using the 1995 dependency ratio.
- (ii) The contribution rate that balances the pension system would need to double to 38 percent by the year 2033 to maintain solvency given the projected demographic changes (Chart 4, upper panel). If measures to separate the provision and financing of pensions and welfare payments are not taken, then actual social security contribution rate would need to increase from the current 35 percent to 54 percent by 2033. This estimate assumes that welfare payments other than pensions would grow in line with the economy's wage bill and would thus be shielded from adverse demographic trends.
- (iii) Pension expenditures would increase continuously in real terms until the year 2050 (Chart 4, lower panel). This means that in the absence of policy reforms the social security system will continue to generate deficits and remain insolvent.

^{1/} This rate is somewhat higher than rates assumed in studies of social security reforms for other countries. It is chosen to conform with the hypothesis that Portugal's real convergence process will continue during the next few decades, but it may prove somewhat on the high side if the speed of convergence slows. In such case, future contribution revenues would be overestimated.

5. Options for policy reform

Previous sections identified many weaknesses in Portugal's social security system. Most recently, financial pressures from social security have imposed a heavy toll on the government's fiscal convergence program, and have brought the social security system to the forefront of the policy debate. One extensive reform option would be to transform the pay-as-you-go public pension system into a privately-run capitalized pension system. In the long run, the government's role would be limited to supervising private pension plans and providing minimum pensions to the poorest segments of the population. In the short run, the government would also have to bear the fiscal cost of honoring social security debts to older generations. Instead of analyzing such an extensive reform option, this section describes the main elements of reform that would preserve the pay-as-you-go system but that would make it more efficient, equitable and financially secure.

a. Recommendations to increase efficiency and equity

There are eight changes that would help increase the efficiency and equity of the social security system.

- (a) Separate the provision of pensions (i.e., old-age, survivors and disability) from that of other welfare programs. This would raise the efficiency of the system by increasing the link between contributions and pensions.
- (b) Fund pensions with contributions and fund other welfare programs--including social pensions--with general government revenues. This would improve the economy's efficiency by reducing the tax on labor and by using less distortionary taxes to finance welfare programs.
- (c) Rationalize welfare programs by eliminating some programs and targeting the remainder to the neediest segments of the population. This would increase equity by fulfilling more effectively the programs' income support role.
- (d) Eliminate maximum pensions and lower replacement ratios. This would reduce incentives for evading contributions at higher income levels, thus increasing efficiency and eliminating a source of inequity.
- (e) Change the pension base from the last 15 years worked to actual lifetime earnings or contributions. This would reduce incentives to under-report income during the early part of workers' careers. The change would increase social security revenues, eliminate another source of inequity and obviate the minimum contribution period.

Pension System: Baseline Scenario

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- (f) Introduce explicit inflation indexation of pensions. This would eliminate the discretionary increases in real pensions of the recent past which are a potential source of inequity. 1/
- (g) Equalize contribution rates for all types of workers in the general regime, while financing subsidies to specific groups through general taxation revenues instead of contributions. This would improve the efficiency and transparency of the system.
- (h) Tighten eligibility controls on disability pensions, to rid the system of loopholes that effectively grant early retirement.

b. Recommendations to improve financial sustainability

To improve the finances of the pension system, Portugal can initiate reforms to raise revenues or cut costs. Raising contributions to increase revenues is an unattractive option. If Portugal is to enhance its ability to compete internationally and avoid the labor market distortions that have resulted from high contribution rates in other countries, contribution rates should be reduced, not raised. The convergence program and the need to reverse the increasing trend of the debt-to-GDP ratio, however, necessitate a reduction in the government's transfers to the social security system. Hence, higher social security revenues should come only from improved collections and an increase in the retirement age. Cost containment should be the primary instrument to improve the pension system's solvency.

By reducing the accrual rate and linking pensions to lifetime earnings, the target wage replacement ratio can be lowered to cut expenditures. Currently, a worker with 40 years of service is entitled to 75 percent of the gross wage of his last year worked, while in many industrial countries pensions are half of the pre-retirement wage. 2/ Another recommendation explored is to increase lifetime contributions through raising the retirement age in line with growing life expectancy. The simulations are performed by modifying some of the parameters of the model described in section 4. 3/

First, if the current 2 percent accrual rate is reduced to 1.5 percent, the simulation model projects that the solvency of the system at current contribution rates would be lost in the near future and only briefly restored around the year 2010. (Chart 5). The accrual rate may thus need to be reduced slightly

1/ An alternative is to index pensions to wage growth. However, Portugal's ongoing process of real convergence has been associated with increasing real wages. Thus, indexing pensions to wages may well result in higher costs than price indexation of pensions.

2/ See World Bank, *Averting the Old-Age Crisis*. 1994.

3/ To simplify the simulations, it is assumed that the system begins in financial equilibrium. An alternative interpretation of this assumption is that the social security system continues receiving transfers from the government at the 1994-95 level.

below 1.5 percent to maintain solvency in the medium-term. In the alternative baseline scenario with no policy changes, the steady rise in old-age population moves the system increasingly deeper into insolvency over time. Second, if pensions are based on lifetime earnings (or contributions) instead of the income of the last 10 years, then the system's solvency would be maintained until the year 2020 at unchanged contribution rates (Chart 6). The simulation does not include, however, a second order revenue effect: evasion would most likely decline if pensions are based on life-time contributions, thus extending the solvency horizon of the system. Either of the alternatives simulated would reduce the wage replacement ratio from the current 75 percent of gross salary of the last year worked to around 60 percent.

Alternatively, if the retirement age is increased from 65 to 68 years the system would maintain solvency until the year 2020 at unchanged contribution and wage replacement ratios (Chart 7). The simulated increase in the retirement age by 3 years illustrates an option considered in many countries as the result of increased life expectancy.

The merits of the alternative policy choices must be considered to choose their appropriate mix. First, linking pensions to lifetime earnings would eliminate perverse redistribution against workers who contribute for longer. It would also increase efficiency by eliminating the current system's built-in incentives to evade contributions. Thus, this is a fundamental measure that should be taken above and beyond the goal of bringing the social security system back to solvency. Second, reducing the accrual rate provides a transparent and efficient way to lower Portugal's high wage replacement ratio. This would immediately cut pension costs and reduce the rising intergenerational transfer to the elderly that Portugal can ill-afford. Furthermore, a solvent social security system with reasonable contribution rates would advance fiscal convergence and enhance labor competitiveness. Third, lengthening the retirement age would have positive financial effects by increasing revenues. However, rising incomes may affect society's choices regarding the labor-leisure trade-off. Thus, even though life expectancy may continue to rise in the future and increase pension expenditures further, raising the retirement age on a continuous basis may not be the instrument of choice to balance the system.

A reform of the social security system could consist of a combination of the three alternatives simulated. The effects on the finances of the system would need to be calibrated carefully due to the interactive effects among the alternatives. For example, a higher accrual rate would affect lifetime earnings instead of earnings of last 10 years. Furthermore, contributions might increase as incentives for evasion are eliminated by basing pensions on lifetime earnings. Thus, a combination of the three policy prescriptions analyzed may allow for a reduction in the contribution rate beyond the cut that would occur if the finances of pensions and welfare payments were separated.

Finally, the pension system of the public sector needs to be reformed as well. At a minimum, the current pension formula should conform to that in the social security for all public employees and not only for those who joined the

Chart 5
PORTUGAL
Pension System: Change in Accrual Rate

- 96a -

Chart 6
PORTUGAL
Pension System: Pension Linked to Lifetime Income

- 96b -

Chart 7
PORTUGAL
Pension System: Increase in Retirement Age

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public sector after 1993. The objective would be two-fold: (i) to strengthen fiscal convergence prospects; and (ii) to eliminate the negative distributional effect of the more favorable public pension scheme.

6. Concluding remarks

Based on the analysis of Portugal's social security system, this Appendix concludes with five main recommendations to improve the financial sustainability, efficiency and equity of the system:

- Separate the provision of pensions from that of other welfare programs, including social pensions granted to the poorest segments of the population.
- Fund pensions with (lower) contributions and welfare payments with taxation from general revenues.
- Rationalize welfare payments by eliminating some and income-testing others.
- Contain projected pension cost increases by reducing the wage replacement ratio. Specifically, reduce accrual rates and base contributions on lifetime earnings.
- Augment revenues from contributions by improving collections, tightening requirements for disability pensions, and increasing the retirement age in line with changes in life expectancy.

Table 1. Contribution Rates in the General Social Security Regime

(In percent)

	Worker	Employer	Combined
Dependent workers			
General rates	11.0	23.75	34.75
Agricultural workers	8.0-9.5	21.0-23.00	29.0-32.50
Domestic services	8.0	21.00	29.00
Clergy	4.0	8.00	12.00
Soccer professionals	11.0	17.50	28.50
Self-employed	21.0-24.0 ^{1/}		
Voluntary contributors	16.0-23.0		

Source: Ministry of Employment and Social Security.

^{1/} These rates are being increased gradually to reach 25.4 to 32.0 percent by the year 2000.

Table 2. Social Security Benefits by Regime

	General Regime	Special Regime for Agriculture	Non-contributory Regime
Pensions			
Old-age	✓	✓	✓
Disability	✓	✓	✓
Survival	✓	✓	✓
Work-related ^{1/}			
Illness	✓		
Work injuries	✓		
Unemployment	✓		
Maternity, adoption	✓		
Pregnancy, breastfeeding	✓		
Family illnesses, disabled	✓		
Welfare benefits			
Family allowances	✓		✓
Birth	✓		
Infancy	✓		✓
Disabled	✓	✓	✓
Special education ^{2/}	✓		✓
Death ^{2/}	✓		
Funeral	✓		

Source: Ministry of Employment and Social Security.

^{1/} Payment contingent on lost income.

^{2/} Incomes-tested.

Table 3: Main Characteristics of the Pension System

Contribution rate	Employees 11% ^{1/} Employers 23.75% ^{1/}
Retirement age	Women 62 years ^{2/} Men 65 years
Pension base	Highest 10-year average income of the last 15 years
Pension formula	Number of years of employment times 2% times pension base
Coverage	Employed and self-employed persons
Minimum pension	30% of pension base
Maximum pension	80% of pension base
Inflation adjustment	Ad hoc
Survivor pension	60% of pension for spouse and 20-40% for orphans after 6 years of contributions ^{3/}
Disability pension	As old-age pension after 6 years of contribution
Minimum contribution period	15 years
Contribution period for full pension	36 years
Type of pension system	Earnings-related
Minimum provisions	Means-tested social pension for anyone not covered under contributory pension programs.
Early retirement	Age 60 for unemployed if unemployment benefits have been exhausted. For heavy or unhealthy work, from age 50-55.

^{1/} Including contributions for unemployment and family allowances.

^{2/} To be increased to 65 years between 1994 and 2000.

^{3/} Death grant 6 times average monthly earnings. Survivor grant if deceased ineligible for pension: lump sum of 6 months' earnings in best two of last 10 years.

Table 4: Social Security Accounts

(In percent of GDP)

	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Current revenues	7.1	7.6	7.4	8.4	8.2	8.6	8.5	8.5	9.1	8.8	9.6	10.0
Contributions	6.3	6.1	6.0	7.3	7.3	7.5	7.3	7.5	7.8	7.5	7.7	7.4
Budget transfers 1/	0.3	0.9	0.7	0.7	0.5	0.6	0.6	0.6	0.6	0.6	1.5	1.5
Other revenues	0.5	0.6	0.7	0.4	0.5	0.4	0.6	0.4	0.7	0.7	0.4	1.1
Current expenditures	7.3	7.3	7.1	7.4	7.6	7.6	7.3	7.8	8.1	8.3	8.8	9.1
Pensions	4.9	4.9	4.8	4.9	5.2	5.2	5.1	5.5	5.6	5.6	5.9	6.0
Unemployment benefits	0.2	0.3	0.3	0.4	0.4	0.3	0.3	0.3	0.4	0.5	0.8	0.9
Sickness benefits	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.5	0.6
Other welfare programs	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5
Other	1.3	1.3	1.1	1.1	1.1	1.1	1.1	1.0	1.1	1.1	1.1	1.0
Current transfers	0.0	0.0	0.0	0.2	0.3	0.4	0.4	0.5	0.4	0.3	0.2	0.3
Capital revenues	0.3	0.2	0.2	0.3	0.5	0.5	0.5	0.3	0.4	0.9	1.1	0.8
Capital expenditures	0.2	0.3	0.4	0.7	0.8	0.9	0.8	0.5	0.6	0.9	1.5	1.0
Overall balance	-0.0	0.3	0.1	0.4	-0.1	0.3	0.6	0.0	0.4	0.3	0.1	0.3
Current balance	-0.2	0.3	0.4	0.8	0.3	0.7	0.8	0.2	0.6	0.3	0.5	0.6
Capital balance	0.1	-0.1	-0.2	-0.3	-0.3	-0.4	-0.3	-0.2	-0.2	0.0	-0.3	-0.3

Sources: Ministry of Employment and Social Security, Ministry of Finance, and INE.

1/ This classification corresponds to that used by the Ministry of Employment and Social Security. The 1995 Budget document provides a fuller picture of transfers and loans from the central government to social security, but it is not available for as many years as presented in this Table. The Budget document estimates that the government's transfers and loans to social security increased from 0.3 percent of GDP in 1989 to 1 percent in 1990–92 and to 2.3 percent in 1994–95.

Table 5: Social protection expenditures, 1980–1991
(In percent of GDP)

	1980	1983	1986	1989	1991	1980–91 increase
Total						
Portugal	14.7	16.1	16.3	16.6	19.4	4.7
European Union	24.4	25.3	26.0	25.2	26.0	1.6
Excluding unemployment compensation						
Portugal	14.3	15.9	15.9	16.3	19.0	4.7
European Union	23.1	24.5	24.3	23.8	24.6	1.5

Source: OECD: Social Protection in Europe

Table 6: Division of social benefits by function, 1991
(in percent)

	Portugal	European Union
Sickness	31.1	25.4
Invalidity & disability	11.8	8.9
Occupational accidents	1.9	2.1
Old-age	30.1	37.4
Survivors	6.6	8.3
Maternity	0.9	1.0
Family	5.4	6.4
Vocational & placement guidance	2.5	1.3
Unemployment	2.3	5.6
Housing & other	7.4	3.6
Total	100.0	100.0

Source: OECD: Social Protection in Europe

Table 7. Stylised Benefit Formula for Old Age Benefits in European Union Countries 1/

				Earnings/Employment related pension				
	Contribution rate employer/employee/combined	Standard retirement age (male/female)	Basic flat-rate pension or flat-rate component	Assessed income	Contribution periods for full pension/minimum for eligibility	Accrual factor/maximum percentage of assessed income	Minimum provisions within/outside pension scheme	Spouse supplement
Austria	12.6/10.3 22.9	65/60	-	Average (partially wage) adjusted pensionable earnings of last 10 years	45 years/15 years	1.9% p.a. below 30 years 1.5 percent p.a. above/79.5%	Guaranteed minimum income/public assistance	-
Belgium	8.9/7.5 16.4	65/60	-	Average (price and wage change) adjusted pensionable career earnings	45 years for men, 40 years for women/10 years	1 1/3% p.a. for single; 1 2/3% p.a. for married; 1 1/2% p.a. for women/ 75% for married; 60% for single	Guaranteed minimum pension/public assistance	Combined rate 1/4 higher
Denmark	--/-- --	67/67	Between ages 67 and 70 income-tested basic amount. From age 70 flat-rate pension with income tested supplements		40 years of residence/3 years	1/40 p.a. of residence between ages 15 and 67/fixed amount	Basic scheme	Combined basic rate approx. 80% higher
Finland	16.6/-- 16.6	65/65	Universal flat-rate pension with pension tested supplements	Average (mixed wage and price) adjusted pensionable career earnings	40 years	1.5% p.a./60%	Basic scheme	Combined basic rate approx. 90% higher
France	9.8/10.0 19.8	60/60	-	Average adjusted pensionable earnings of best 10 years	40 years/10 years	1 1/3% p.a./50%	Guaranteed minimum income	Flat rate supplement
Germany	8.9/8.9 17.8	65/65 2/	-	Average (national wage) adjusted pensionable career earnings	40 years standard (can be higher--as contributions up to the age of 67 are considered)/5 years	1.5% p.a./60% standard (up to 75%)	Public assistance	-
Greece	10.5/5.3 15.8	65/60	-	Average pensionable earnings of last 2 years	35 years/11 years	Basic amount: from 70 % for low earnings to 30 % for high earnings; suppl. amount: 1 % p.a. above 10 years, 1.5 % to 2.5 % above 26 years	Guaranteed minimum pension	Flat rate supplement

Ireland	12.2/5.5 17.7	66/66	Universal flat-rate income-tested pension and supplements	Constant amount, independent of earnings	Yearly average of at least 48 (weekly) contributions since 1953, or age 16, whichever is later/yearly average of at least 20 (weekly) contributions	Corresponding contributions/fixe d amount	Basic scheme	Income- tested and contributory pension: combined rate approximatel y 2/3 higher
Italy	24.0/8.3 32.3	65/60 for persons with more than 15 years of contributions in 1992. 57-65/57-65 for others.	-	Average (partially price) adjusted pensionable earnings of last 10 years for persons with more than 15 years of contributions in 1992, and adjusted career earnings for others.	35 years/15 years for persons with more than 15 years of contributions in 1992. 40 years/5 years for others.	2 % p.a. for persons with more than 15 years contributions in 1992.	Guaranteed minimum income (social pension)	-
Luxembourg	8.0/8.0 16.0	65/65	Flat-rate component	Average adjusted pensionable career earnings	40 years/5 years	1.6% p.a./64%	Guaranteed minimum pension	-
Netherlands	--/15.2 15.2	65/65	-	Constant amount, independent of earnings	50 years (contributions between age 15 and 64)	Reduction for each year without contribution: 2% p.a. for singles, 1% p.a. for married	Guaranteed minimum income	Individual entitlement related to minimum salary
Portugal 3/	23.8/11.0 34.8	65/65	-	Average (price adjusted) earnings of the best 10 years in last 15 years	36 years/15 years	2% p.a./max. 80%, min. 30%	Means-tested social pension/public assistance	20% or minimum flat-rate supplement
Spain	13.9/2.8 16.7	65/65	-	Average (partially price-adjusted) pensionable earnings of last 8 years	35 years/15 years	50% for first 10 years, 2% p.a. above 10 years/100%	Guaranteed minimum pension/public assistance	-
Sweden	13.0/8.0 21.0	65/65	Universal flat-rate pension with income-tested supplements	Average adjusted pensionable earnings of best 15 years	30 years/3 years	2% p.a./60%	Basic scheme	Combined basic rate is 63% higher
United Kingdom 4/	10.5/8.3 18.8	65/60	Basic flat-rate pension, depending on past contributions	Average (wage- adjusted) pensionable earnings	Contributions since 1978, but minimum 20 years	1% p.a./20%	Public assistance	Combined basic rate is 60% higher

Source: OECD, *Reforming Public Pensions*, and World Bank, *Averting the Old Age Crisis*.

- 1/ The pension formula presented applies to the national scheme, the general scheme or the most representative scheme for employees in a country.
2/ To be increased gradually to 67 years by 2017.
3/ According to reforms introduced in 1994, which are being phased in.
4/ After 1986 reform of SERPS, phased in.

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Interest Rates

This Appendix analyzes the determinants of Portuguese long-term interest rate differentials vis-à-vis Germany. Specifically, it considers: (a) the impact of inflation differentials on long-term differentials; (b) the response of Portuguese long-term yields to fluctuations in German yields; and (c) the link between the Portuguese and the Spanish bond markets. The approach taken is to estimate vector autoregressions (VAR) equations relating current and past levels of Portuguese yields (or yield differentials) to current and past levels of the other variables examined. The resulting estimates reveal the patterns of co-movement of the variables, but cannot directly be interpreted as structural equations. The estimated VARs are used, in turn, to derive impulse response functions showing how Portuguese interest rates would respond to unexpected changes in inflation, and German and Spanish yields.

Following this approach, the Appendix presents evidence showing that (a) inflation differentials have a significant and persistent impact on long-term differentials, but with relatively long lags; (b) the effect of German yields on Portuguese yields is significantly larger than one, as is characteristic of other European countries with fiscal problems; and (c) there seems to be a relatively weak link between Spanish and Portuguese bond markets. In addition, the study finds that shocks to short-term differentials--though large in the sample period as a result of the recurrent exchange rate crises--have a very short-lived effect on long-term differentials.

1. The data

Chart 1 presents the monthly data from January 1991 to August 1995 used in the econometric analysis. Long-term, short-term and inflation differentials with Germany have a clear common trend over the sample period (top panel). 1/ However, long-term differentials seem to be affected also by variations in German long-term bond yields (intermediate panel) and in Spanish long-term differentials with Germany (bottom panel).

1/ The series of Portuguese long-term secondary market yields is made of yields on variable rate bonds up to May 1992 and yields on fixed rate bonds with the longest maturity available thereafter (10-year since November 1993). Short-term interest rates are three-month interbank rates. Inflation rates are year-on-year.

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CHART 1

PORTUGAL

Interest Rate Differentials

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2. The econometric methodology

To identify the main determinants of Portuguese long-term differentials with Germany, the study estimates three VAR (vector autoregression) models. 1/ The first model (VAR1), includes only three variables, ordered as follows: short-term differentials, long-term differentials and inflation differentials. 2/ Impulse response functions are calculated to assess the impact of a shock to each variable on the other variables in the system, as well as forecast error variance decompositions to estimate the share of the variance of each variable due to a shock in the other variables.

A shock to one variable can be interpreted as an unexpected change in that variable (i.e., a change not accounted by lagged values or simultaneous innovations to preceding variables in the casual chain). As long as investors determine long-term interest rates on the basis of future expected short-term interest rates and inflation rates, only unexpected changes of the latter should have a significant impact on the former.

In the second model (VAR2), a similar exercise is performed on a larger set of variables including the German long-term yield. 3/ A significant positive effect of the latter on the interest differential would indicate that German long-term yields have a more than one-to-one effect on Portuguese yields. In the third model (VAR3), the Spanish long-term

1/ All models have 2 lags. Cointegration analysis indicates that non-stationarity is not a problem (as confirmed by the well-behaved impulse response functions shown below). Different cointegration tests yield different results, but they always indicate at least one cointegration vector and in some instances as many cointegration vectors as variables (in which case, all variables would be stationary). Given the ambiguity of the tests and the short sample period, we decide not to impose any cointegration restrictions.

2/ As impulse responses are calculated from a standard Cholesky decomposition, the ordering of the variables implies a casual chain of simultaneous relationships among the variables. Under the ordering assumed in VAR1, short-term differentials are not simultaneously affected by any other variable, long-term differentials are simultaneously affected only by short-term differentials and inflation differentials are simultaneously affected by both short-term and long-term differentials. These identification restrictions imply that inflation differentials can affect interest rate differentials only with a lag and are justified by the fact that inflation data are released with a delay, so that they cannot affect same month interest rates.

3/ The German long-term yield is inserted at the beginning of the casual chain, as it is considered exogenous with respect to Portuguese variables.

differential with Germany is added to the variables of model VAR2. ^{1/} A significant effect of the Spanish differential on the Portuguese long-term differential would indicate that the Portuguese bond market is affected by shocks in the Spanish bond market.

3. Inflation differentials and long-term differentials (model VAR1)

Chart 2 shows that the impulse responses (IRs) of Portuguese interest differentials to a shock in the inflation differential are positive, strong and persistent, as they are significantly different from zero for most of the 3-year simulation horizon (top and intermediate panels). The IR of the long-term differential peaks after eight months, while the IR of the short-term differential after six months. It is noteworthy that over the medium- and long-run, the impulse of the long-term differential is at least as large (if not larger) than the one of the inflation differential to its own shock (bottom panel), indicating a one-to-one effect.

The rest of the IRs in model VAR1 is also plausible. Chart 3 shows that the inflation differential reacts negatively to a positive shock to long-term and short-term differentials, though the effect is significantly different from zero only for a few months. Chart 4 (top panel) shows that the long-term differential reacts first positively and then negatively to a positive shock to the short-term differential, as if liquidity effects prevailed in the short-run and inflation expectation effects in the long-run, though only the former are significantly different from zero. Chart 4 (bottom panel) shows that long-term rates seem to anticipate by a few months future movements of short-term rates, consistently with the expectations theory of the term structure.

The top panel of Chart 5 shows that the share of the forecast error variance (FEV) of the long-term differential accounted by a shock to the inflation differential increases constantly over the simulation period up to almost 50 percent after three years, while the bottom panel confirms that this share is significantly different from zero. Chart 6 presents similar statistics for the short-term interest differential. The top panel shows that the share of the variance accounted by a shock to the inflation differential is just below 25 percent in the long-run, while the bottom panel indicates that this share is significantly different from zero.

^{1/} In model VAR3, the Spanish differential is inserted between the German long-term yield and the Portuguese differentials. As a result, the ordering of the variables in model VAR3 is: German long-term yield, Spanish long-term differential with Germany, Portuguese short-term differential with Germany, Portuguese long-term differential with Germany and Portuguese inflation differential with Germany. Under this ordering, a shock to the Spanish differential is the component of its innovation which is orthogonal to an innovation in the German long-term yield. This implies that shocks common to the Spanish and German bond yields are attributed to the latter.

Chart 2

VAR1: impulse response of the long-term differential with Germany
to a shock in the equation of the inflation differential
(size of confidence bounds = 10%)

VAR1: impulse response of the short-term differential with Germany
to a shock in the equation of the inflation differential
(size of confidence bounds = 10%)

VAR1: impulse response of the inflation differential with Germany
to a shock in the equation of the inflation differential
(size of confidence bounds = 10%)

Chart 3

Chart 4

**VAR1: impulse response of the long-term differential with Germany
to a shock in the equation of the short-term differential**
(size of confidence bounds = 10%)

**VAR1: impulse response of the short-term differential with Germany
to a shock in the equation of the long-term differential**
(size of confidence bounds = 10%)

Chart 5

VAR1: Forecast error variance decomposition for the long-term differential

VAR1: Percentage of the forecast error variance of the long-term differential due to a shock in the inflation differential
(size of the confidence bounds = 10%)

Chart 6

VAR1: Forecast error variance decomposition for the short-term differential

VAR1: Percentage of the forecast error variance of the short-term differential
due to a shock in the inflation differential
(size of the confidence bounds = 10%)

Chart 7

VAR2: impulse response of the long-term differential with Germany
to a shock in the equation of the inflation differential
(size of confidence bounds = 10%)

VAR2: impulse response of the long-term differential with Germany
to a shock in the equation of German long-term interest rates
(size of confidence bounds = 10%)

Chart 8

VAR2: Forecast error variance decomposition for the long-term differential

VAR2: Percentage of the forecast error variance of the long-term differential due to a shock in the German long-term yield

(size of the confidence bounds = 10%)

Chart 9

APPENDIX III

**VARs: impulse response of the long-term differential with Germany
to a shock in the equation of the inflation differential**
(size of confidence bounds = 10%)

**VARs: impulse response of the long-term differential with Germany
to a shock in the equation of the Spanish long-term differential with Germany**
(size of confidence bounds = 10%)

VAR3: Forecast error variance decomposition for the long-term differential

VAR3: Percentage of the forecast error variance of the long-term differential due to a shock in the Spanish long-term differential
(size of the confidence bounds = 10%)

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4. German and Portuguese yields (model VAR2)

Chart 7 (top panel) shows that the inflation differential has a statistically significant impact on interest differentials, even after the inclusion of German long-term yields in the model. The IR remains significantly different from zero for a large part of the simulation horizon, though the peak is some 5 basis points below the peak predicted by VAR1 (similar results were obtained for the short-term differential). In addition, Chart 7 (bottom panel) shows a strong and significant effect of the German long-term yield, which becomes not statistically significant after 15 months.

Chart 8 (top panel) shows that the inflation differential now accounts for a share of FEV close to 25 percent in the long-run, against one close to 50 percent in VAR1 (nevertheless, this share remains significantly different from zero--not shown). Chart 8 (bottom panel) shows that German long-term yields account for a share of FEV close to 30 percent in the long-run, which remains significantly different from zero throughout the simulation period.

The study concludes that inflation differentials and German yields accounted--in almost equal shares--for more than 50 percent of the variance of long-term differentials with Germany in the sample period.

5. Spanish and Portuguese bond markets (model VAR3)

Chart 9 (top panel) shows that the introduction of Spanish long-term differentials in the model does not modify the strong link between inflation and interest-rate differentials found in VAR1 and VAR2. Similarly, the IRs of the rest of the model (e.g., those of the German rate or the short-term differential) are little affected by the introduction of the Spanish differential. Chart 9 (bottom panel) shows that the impact of Spanish differentials is small and positive only in the very short run, and is not statistically significant for most of the simulation period.

Chart 10 (top panel) shows that in model VAR3 the share of the variance accounted by the inflation differential is larger than in VAR2 and close to 50 percent (as in VAR1). In contrast, the share of the variance accounted by the German long-term yield declines and some variance is accounted by the Spanish differential, but it is not significantly different from zero (Chart 10, bottom panel).

The Banking System

Portugal's banking system underwent major changes in the first half of the 1990s. These changes have occurred with the privatization of most of the banks, the opening of the system to capital movements and foreign entry, and the liberalization of interest rates and credit as well as of the range of activities open to banks, motivated in part by the European single market program. ^{1/} This Appendix discusses the changing structure of the banking industry and the resulting issues for supervision and regulation.

1. Privatization, competition, and restructuring

All major banks had been nationalized in the wake of the revolution in 1974, and by the mid-1980s the share of state ownership was some 90 percent. This process was reversed beginning in 1989, with public offerings of shares of most of the banks.

With the completion of planned privatizations in 1995, four banks, together accounting for 33 percent of value added in the banking sector, remain in state hands. These include two major institutions: *Caixa Geral de Depositos*, Portugal's largest financial institution with a strong deposit base and an established position in lending to the household sector; and *Banco de Fomento e Exterior* (BFE), an institution that has traditionally provided long-term finance to the industrial sector, but is expanding into universal banking; it remains substantially state-owned, although 32 percent of the shares are now privately held. ^{2/}

The number of banks in the system increased from 35 in 1991 to 46 in 1994. This was associated with an increase in competition in the industry. Banks competed for market shares by expanding their branch networks: the total number of branches rose from 2,505 in 1991 to 3,261 in 1994--a 30 percent increase. The starting point, however, was one in which Portugal's density of branches was much lower than in other EU countries (Chart 1).

As new banks entered the industry, the concentration of market shares diminished, although not dramatically. Chart 2 shows Herfindhal coefficients for the Portuguese banks for 1991 through 1994. ^{3/} The market for deposits became slightly more competitive over this period; there was a larger reduction in concentration of market shares for domestic

^{1/} See SM/93/224 Supplement 1, 10/22/93, Portugal - Background Issues, Appendix III for a detailed discussion of liberalization measures.

^{2/} The latter includes a 12 percent shares held by the recently-privatized cement company Cimpor.

^{3/} Herfindhal coefficients are calculated as the sum of squares of market shares of all banks in the system; an increase represents greater concentration.

CHART 1
SELECTED COUNTRIES
Inhabitants per Branch

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APPENDIX IV

CHART 2
PORTUGAL
Concentration in Banking
(Herfindhal Coefficients)

Source: Bank of Portugal. Defined as sum of squares of market share (therefore ranging from 0 to 10,000).

credit. The latter corresponds to observations of increased price competition, especially in the market for housing and consumer credit, as shown by a reduction in the variance of the distribution of lending rate. Increased competition in consumer credit also reflects deregulation in this area. Competition in the market for deposits and loans to enterprises is also increasing, but more slowly. Increasing competition has been reflected in a decline in interest rate margins (Chart 3). Bank profitability ratios declined through the early 1990s (Chart 4). It is difficult to identify this with a long-term trend since credit ceilings were lifted only relatively recently.

The greatest change, however, is in the distribution of profits among different banks: this became much more differentiated over the course of the 1980s. This is not only the result of big banks performing better, but also of market segmentation: the largest banks (notably *Caixa Geral*) are those that control the relatively profitable retail markets, while small banks specialize in the wholesale market in which competition--including from foreign banks--is fiercer. There were also marked differences in the performance of state-owned and private banks: profits of the four state-owned banks rose 1.1 percent in 1994, while those of privately-owned banks were down 15 percent. The same trend continued in the first half of 1995, with the profits of *Caixa Geral*, in particular, rising by 7.5 percent against the background of a sharp fall in profits for many of the major privately-owned banks. ^{1/} This may reflect, to some extent, the profitable market niches--notably deposit taking and mortgage lending for the household sector--still occupied by the major state-owned banks.

Declining bank profitability and greater differentiation across banks generates pressure for increased efficiency. Overstaffing has been endemic to the Portuguese banking system, in some cases dating from the retention of staff returning from branches in the colonies when the latter became independent in the mid-1970s. Banks have not actually been reducing their staff: the total number of bank staff was virtually unchanged from 1991 to 1994. Instead, they reduced staffing ratios by opening new branches using surplus staff from existing branches. As a result, banks' efficiency measured as credit per employee rose strongly over the period, while credit per branch changed little (Chart 4).

A process of consolidation of the banking industry has begun, especially with mergers or acquisitions of some major banks to form large universal banking groups. The two largest operations involved the acquisition of *Banco Portugues do Atlantico* by *Banco Comercial Portugues* in March 1995, creating the second largest banking group; and the acquisition of *Banco Totta e Acores* by *Banco Pinto e Sotto Maior* to create what is now

^{1/} In 1994, only six banks actually incurred losses. Among these six, only one or two are viewed as a potential source of concern.

the third largest group. 1/ These acquisitions are still in the course of being digested: as with any acquisition, there is the necessity of reconciling the corporate cultures of the banks being combined, and some restructuring of these groups would be needed to reap efficiency gains; for instance, BCP had estimated that it would need at least two years to rationalize its group. Some restructuring is also dictated by the need to lower banks' participation in non-financial institutions to 35 percent, as required by law.

The acquisitions have reduced the capital base of the banking system as bank funds were used to purchase other banks from their non-bank previous owners. Bank capital decreased by some Esc 450 billion, about a fifth of the system's capital. Capital adequacy ratios nonetheless remained above the minimum levels required by the EU and the BIS. In 1994, the average capital ratio was 11 percent (against a minimum of 8 percent), and about 80 percent of this capital constituted tier-one capital, in excess of the requirements of the EC directive. The two large acquisitions brought some individual banks below the 8 percent capital requirement, but all banking groups had adequate capital on a consolidated basis, the basis to which international standards apply. 2/

Mergers and acquisitions in the banking sector require approval of the Bank of Portugal, which can block a merger on the grounds of capital inadequacy or excessive concentration of risks. There are no limits to foreign ownership, unless the bank is being privatized; in this case, the limits are established only for a specific institution and are valid only for a limited period of time after the privatization.

2. Supervision and regulation

The changes in the banking system pose new challenges for the system of supervision and regulation, especially with the greater sophistication and complexity of banking groups. There has been concern that the traditional prudential rules might not suffice after the recent and rapid transition from a highly regulated, specialized and state-owned banking system to a less regulated one characterized by private universal banks.

One important change in regulations affecting banking pertains to the new provisioning requirements. Unlike in other countries (with the exception of Spain), Portugal requires provisioning of a certain percentage of all loans. This general provisioning requirement was lowered from 2 to 1 percent of loans in 1995. In addition, special provisioning requirements

1/ Controversy surrounded the latter acquisition: the Securities Market Commission resigned in protest against a waiver of the rules for public offers.

2/ Unrelated to these acquisitions, there have been some problems with the smaller savings banks. Some of these have failed and been purchased by other institutions which honored their deposit liabilities.

CHART 3
PORTUGAL
Spreads Between Bank Lending and Deposit Rates
(In percent per Annum)

Source: Bank of Portugal.

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APPENDIX IV

Bank Profitability and Efficiency (End-of-Year)

Source: Bank of Portugal.

are imposed on a graduated scale to reflect the credit-worthiness of clients--including the specific risk of loans that were doubtful but not yet non-performing--country risk, and, beginning in September 1995, for market risk on securities that may be sold prior to maturity. As not all banks were in a position to make the required provisions right away, these were being phased in, with the stipulation that the new rules must be satisfied within one year for non-guaranteed loans and three years for guaranteed loans. Banks do not usually have provisions above the minimum required, since only the minimal provisions required by the Bank of Portugal are tax-exempt. The new provisioning requirements was an important reason for weak bank performance in 1994-95.

Another recent innovation is the Deposit Guarantee Fund, started at the beginning of 1995. ^{1/} Each bank's initial contribution to the fund was calculated on the average of deposits in the last two years and will be updated once a year. Banks were required to fund the scheme in cash, including the certificates of deposit held by the banks at the Bank of Portugal, which had been issued to mop-up the excess liquidity resulting from the reduction of reserve requirements; in practice, banks paid most of the contribution with these CDs. In July 1995 regulations were changed so that only 25 percent of a bank's contribution to the system need be made in cash, with the other 75 percent being provided as a guarantee. This system would be put in place gradually (starting by allowing 25 percent guarantee and 75 cash). Should any bank go bankrupt, the guarantee would have to be made good with Treasury bills. The funds in the deposit guarantee plan would not be fully adequate to save any bank, but were designed to reassure the public.

Another issue is that the increasing complexity of banking groups which enables transfers of funds among different entities in the group. These linkages make it difficult for either the regulators or market observers to measure the leverage of financial conglomerates--as, for instance, in the case in which a bank was acquired using funds from an insurance company, and then this bank's funds in turn were used to purchase another bank. In such a case, it is difficult to monitor flows of money between the banks and the insurance company. Another example is the links between banks and their affiliated mutual funds (see Box 1).

The working of market discipline in the Portuguese financial system is also impeded by the absence of accurate information, due to the fact that Portugal has the most stringent bank secrecy laws (even including Switzerland); for instance, in the case of acquisitions, the purchasing bank is not even supposed to know the deposits of the target bank.

^{1/} In mid-1995, this legislation was in the course of being changed to take the EC directives into account.

The additional complexities of regulation of large diversified financial groups can be illustrated with reference to the links between banks and affiliated mutual funds. During 1994, one mutual fund ran into difficulties, reportedly as a result of quoting its shares at a price exceeding that of its underlying assets by some 5 percent. In the event, redemptions of its shares exceeded sales, leading to large losses for the fund. To cover these losses, the affiliated bank then purchased bonds from the fund at artificially high prices (some 10 percent above those then prevailing in the stock exchange); since these bonds were purchased for the bank's investment account, the bank was not required to mark their value down to market prices. As a result, the loss will appear in the form of below-market investment income over the life of the bonds, rather than as a capital loss. This case raises questions regarding the supervision of mutual fund management; the integrity of pricing in the wholesale bond market; and also bank supervision, as losses arising from mismanagement of a mutual fund were transferred to become a claim on the capital of the bank.

The Bank of Portugal has been taking steps to improve the consolidated supervision of financial groups, drawing on a model from the Bank of Spain. In place of the now-obsolete division between monetary and non-monetary institutions, there will be a team for each banking group, working on all aspects of the group. The team would report to a coordinator, who in turn would report to the coordinator of several groups, who in turn would report to the department Director. These teams will be rotated periodically (every 2-3 years) to avoid the formation of inappropriately strong ties between supervisors and the institutions they supervise. Another essential part of the regulatory process concerns banks' internal controls: banks are required to report twice yearly on their internal control systems, and segregation of functions. This is an aspect that is checked during regular bank inspections.

With the formation of more complex banking groups, the coordination of different regulatory agencies is essential. The Bank of Portugal exchanges information with the Securities Market Commission (CMVM), the Deposit Guarantee Fund, and the Insurance Institute. The EU directive on Investment Companies had implications for the division of regulatory functions, and a related decree law specifies that for investment funds the CMVM covered investment companies' transactions on the market, while the Bank of Portugal was responsible for supervising the management of the funds. The details of how these functions would be divided were still under discussion at the time of the mission.

Another aspect of the increasing sophistication of financial institutions is banks' enhanced ability to help their customers minimize taxes. With the acquisition of banks by insurance companies, the resulting mixed financial groups have been able to sell their customers hybrid

products that enable them to avoid taxes. 1/ The introduction of commercial paper provided banks with the opportunity to avoid the stamp tax on bank credit: instead of receiving a loan, a company would issue commercial paper which would be purchased by the same bank. Portuguese banks have long had offshore operations in Madeira, which is part of Portugal but has a separate tax regime without withholding tax for non-residents; many also have operations outside Portugal which may attract funds from Portuguese residents for tax reasons. 2/ In some such cases, tax rules and administration will need to be updated to catch up with the trend of financial innovation.

1/ Banks cannot sell directly insurance to the public, but they can own up to 25 percent of an insurance company, and insurance companies can own banks.

2/ For instance, in 1994 one bank-affiliated mutual funds was active in transferring customers' funds to the Cayman Islands, accounting for substantial capital movements recorded in the balance of payments during 1994.

Portugal: Fund Relations

(As of August 31, 1995)

I. Membership Status: Joined 3/29/61. Portugal accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Fund Agreement effective September 12, 1988.

II. <u>General Resources Account</u> :	<u>SDR Million</u>	<u>% Quota</u>
Quota	557.60	100.0
Fund holdings of currency	264.97	47.5
Reserve position in Fund	292.63	52.5
Operational budget transfers (net)	17.00	

III. <u>SDR Department</u> :	<u>SDR Million</u>	<u>% Allocation</u>
Net cumulative allocation	53.32	100.0
Holdings	54.54	102.3

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

	<u>Approval</u>	<u>Expira-</u>	<u>Amount</u>	<u>Amount</u>
<u>Type</u>	<u>Date</u>	<u>tion</u>	<u>Approved</u>	<u>Drawn</u>
	<u>Date</u>	<u>Date</u>	<u>(SDR Million)</u>	<u>(SDR Million)</u>
Stand-by	10/07/83	2/28/85	445.00	259.30
Stand-by	6/05/78	6/04/79	57.35	0.00

VI. Projected Obligations to Fund: None.

VII. Exchange Rate Arrangements: Portugal participates in the exchange rate mechanism (ERM) of the European Monetary System (EMS). Under this agreement, Portugal maintains spot exchange rates of the currencies of other participants within margins of 15 percent above and below cross rates derived from central rates expressed in ECUs; the 15 percent margins became effective August 2, 1993. Between October 1990 and Portugal's accession to the ERM in April 1992, the exchange rate of the Portuguese escudo fluctuated around a long-term objective in relation to a trade-weighted currency basket. The basket consisted of five currencies, the deutsche mark (whose weight also reflected the Benelux countries), French franc, Italian lira, pound sterling, and Spanish peseta.

VIII. Article IV Consultation: Portugal is on a standard 12-month consultation cycle. The last Article IV consultation discussions were concluded at EBM/94/76 (8/29/94).

IX. Technical Assistance

<u>Year</u>	<u>Dept.</u>	<u>Purpose</u>	<u>Date</u>
1991	FAD	Treasury Management	3/91
1994	FAD	Strengthening the Tax System	4/94

X. Resident Representative: None.

List of Fund Studies

1994: SM/94/217, Supplement 1 (8/23/94)

Appendix I: Privatization in Portugal

Appendix II: The Real Exchange Rates and Competitiveness in Portugal

Appendix III: Portugal's Stock Market

1993: SM/93/224. Supplement 1. (10/22/93)

Appendix I: The Convergence Program and Prospects Over the Medium-Term

**Appendix II: From Fiscal Stabilization to Adjustment:
Fiscal Policy in Portugal from 1980-92**

Appendix III: Recent Financial Liberalization Measures

1992: None

1991: SM/91/197, Supplement 1 (10/7/91)

Appendix II: Monetary Control in Portugal: A Shift to the Market

Appendix III: Medium-term Scenarios for the Portuguese Economy

1990: SM/90/179 (9/7/90)

Appendix III: Liberalization of Capital Flows: Commitments vis-à-vis EC

Appendix IV: Bank Regulation and Supervision

Appendix V: Medium-Term Scenarios for Portugal

Appendix VI: Public Financial Flows Between the EC and Portugal

Appendix VII: Recent Savings Trends in Portugal: Is There a Cause for concern?

Appendix VIII: Privatization Progrma and Industrial Restructuring

Appendix IX: Effects of the Inclusion of Treasury Bills in the Aggregate Subject to Reserve Requirements