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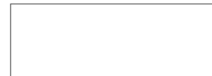
Portugal: Balance of Payments Easing



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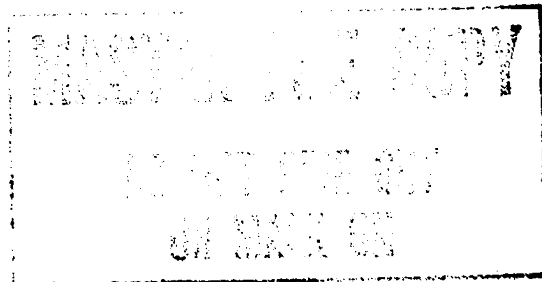
An Intelligence Assessment



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EUR 83-10270
December 1983

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Portugal:
Balance of Payments Easing

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An Intelligence Assessment

This paper was prepared by
Office of European Analysis. Comments and queries
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Iberia-Aegean Branch, EURA,

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Portugal: Balance of Payments Easing

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Key Judgments

Information available as of 21 November 1983 was used in this report.

Portugal is struggling to resolve its second balance-of-payments crisis in less than a decade. Following the successful 1977/78 IMF stabilization program, a number of adverse developments abroad and economic policies we consider inappropriate swiftly eroded Portugal's external position again. Last year the current account deficit soared to $3.2 billion, equivalent to 14 percent of GDP, while external debt approached 67 percent of GDP.

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Realizing that Portugal cannot finance large current account deficits over the long run, the Socialist–Social Democratic government of Mario Soares installed after the April election agreed to implement another IMF stabilization program. The government is introducing stringent measures to trim $2 billion off the current account deficit by 1984, even though this will produce a recession and higher unemployment. The Communist-led trade unions almost certainly will try to capitalize on these side effects, but we believe Lisbon is resolved to carry out its 18-month austerity plan.

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After suffering acute foreign exchange shortages early this year, Lisbon is beginning to repair its financial position. With the reductions in the current account deficits that we foresee both this year and next and the receipt of IMF assistance, Portugal will have most of the financing it requires through 1984. Bankers' attitudes toward lending to Portugal are improving, as evidenced by the success of Lisbon's recent request for a Eurodollar loan. We expect, however, that the Soares government will again have to sell gold this winter to pay off a $300 million loan from the Bank for International Settlements—in spite of the IMF's fears that further gold sales may damage Portugal's creditworthiness.

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Because of Lisbon's brightening financial outlook, we believe it highly unlikely that Portugal will need a US bailout, as it did in 1978. Lisbon has, however, requested a boost in US Commodity Credit Corporation credits—from $620 million this year to $850 million next year—to finance agricultural imports. And in negotiations concerning US use of the airbase at Lajes in the Azores, Portuguese officials have won a promise of $145 million in US security assistance next year and $213 million in 1985—roughly double the 1983 level.

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The forcefulness of the current government has convinced us that Lisbon will continue to make considerable headway toward curing its balance-of-payments ills during the coming year, but we are less certain about

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Lisbon's prospects in this regard beyond 1984. A history of political infighting, personal squabbles, and policy differences—not only between the Socialists and Social Democrats, but also within the Social Democratic leadership—lead us to believe that the present government may not be in power long enough to fulfill its promise to carry out an extended adjustment program. One potential source of discord is the presidential election in 1985. Prime Minister Mario Soares does not have the Social Democratic Party's support for his candidacy. If the Social Democrats were to back someone else, the coalition could collapse. In view of the record of stop-and-go economic policies since 1974, we suspect that a successor government might be tempted to shift gears, pushing the country toward a new round of balance-of-payments problems.

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Table 1
Portugal: Balance of Payments

Million US $

	1974	1975	1976	1977	1978	1979	1980	1981 [a]	1982 [a]	1983	1984
Trade balance	−2,002	−1,674	−2,175	−2,532	−2,408	−2,632	−4,206	−5,194	−4,853	−3,650	−3,030
Exports, f.o.b.	2,303	1,940	1,790	2,001	2,379	3,550	4,575	4,088	4,119	4,550	5,070
Imports, f.o.b.	4,305	3,614	3,965	4,533	4,787	6,182	8,781	9,282	8,972	8,200	8,100
Invisibles	1,173	855	886	1,037	1,582	2,580	2,948	2,344	1,614	1,650	1,800
Of which:											
Net tourism	259	101	182	266	431	695	859	777	611	700	800
Worker remittances	949	821	907	1,174	1,671	2,455	2,928	2,832	2,599	2,550	2,750
Interest payments	NA	NA	NA	142	387	536	733	1,099	1,337	1,350	1,450
Other	NA	NA	NA	−261	−133	−34	−106	−166	−259	−250	−300
Current account balance	−829	−819	−1,289	−1,495	−826	−52	−1,258	−2,850	−3,239	−2,000	−1,230
Medium- and long-term credit, net	274	−108	26	95	758	813	718	1,282	2,186	700	600
Short-term credit, errors, and omissions	−83	−89	105	−30	228	594	1,398	1,268	1,224	−100	
Monetary movements	638	1,016	1,158	1,430	−160	−1,355	−858	300	−171	1,400	630
Of which:											
IMF credit			176	83	53	41	146	72	24	370	600
Gold sales				534	357					1,000	

[a] Revised.

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Portugal: Balance of Payments Easing

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The Latest Crisis

The Portuguese economy in the late 1970s was barely beginning to recover from the 1973/74 oil price increases and the upheaval of the 1974 revolution when a new round of oil price hikes and misguided policy responses once again pushed Lisbon toward bankruptcy. Following improvements in 1978 and 1979, the current account deficit more than doubled from 1980 to 1981, to $2.9 billion. Because of the 1980 oil price shock and a smaller price increase in 1981, petroleum imports nearly doubled to about $2.6 billion. Despite Lisbon's success in trimming its trade deficit in 1982, the current account deficit widened by an additional $400 million. Invisibles, composed primarily of tourism earnings and remittances, earlier had largely offset the trade deficit but shrank by nearly 50 percent in just two years. (See table 1.)

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Table 2 *1975=100*
Portugal: Indicators of Competitiveness[a]

	Ratio of Consumer Price Indexes
1973	91.9
1974	101.1
1975	100.0
1976	102.0
1977	92.8
1978	83.5
1979	80.4
1980	80.5
1981	84.2
1982	83.1

[a] Compared to industrial countries. Adjusted for exchange rate movements.
Note: A decrease in the ratio indicates an improvement in competitiveness.

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Exacerbating Portugal's problems, Lisbon's exchange rate policy during the last three years has hindered, rather than promoted, export growth. In 1980, Portuguese officials revalued the escudo by 6 percent against a basket of 18 currencies in an unconventional effort to slow the pace of inflation. Although the Bank of Portugal later resumed monthly devaluations at a set rate, these were not enough to keep up with the inflation differential between Portugal and its major trading partners. Compounding these errors, the weight Portuguese officials assigned to the strong US dollar caused the escudo to appreciate against other European currencies. The resulting erosion of competitiveness, coupled with the worldwide downturn in trade, slowed the growth of exports. Despite Lisbon's decision to devalue the escudo by 9.4 percent in June 1982, export competitiveness was lower on the average in 1982 than three years earlier.[1] (See table 2.)

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Imports, meanwhile, remained buoyant because of the rapid growth of domestic demand—up 16 percent from 1980 to 1982, compared with the OECD average of about 1 percent. The upsurge resulted from Lisbon's easing domestic credit and boosting transfer payments in 1980, which prompted a strong rebound in private consumption and investment. As the trade account deteriorated, Lisbon once again applied the brakes, tightening monetary policy over the next two years. Because the policies Lisbon adopted were considerably less restrictive than those of the IMF program years, however, the growth of domestic demand leveled off at the relatively high rate of 4.3 percent. As a result, the cumulative growth of import volume from 1981 to 1982 was roughly twice as high as the increase in export volume.

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By discouraging saving, what we believe to have been the mismanagement of interest rates also contributed to the progressive deterioration of the current account

[1] There are several measures of competitiveness. We used the ratio of Portuguese consumer price inflation to a trade-weighted average of inflation in 14 industrialized countries, adjusted for exchange rate fluctuations.

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The First Oil Shock

Portugal experienced a balance-of-payments crisis just six years ago. The current account deficit ballooned to $1.5 billion in 1977, compared with a surplus of $348 million in 1973. This sharp reversal of Portugal's traditional current account surpluses reflected the oil price shock and the economic upheaval following the 1974 revolution. From 1973 to 1977, Portugal's oil import bill rose by 450 percent to nearly $750 million, accounting for roughly half the increase in Portugal's import bill. At the same time, Portuguese authorities—intent on redistributing income—permitted a 28-percent average annual increase in nominal wages. Because they did not depreciate the escudo fast enough to offset this wage explosion, export competitiveness fell sharply, exacerbated by the loss of colonial markets, the worldwide economic slowdown, and uneasiness abroad about the country's political future.

Unable to finance its deficits with commercial loans, Portugal quickly exhausted its hard currency reserves and turned to foreign governments and international institutions for assistance. The World Bank, the European Free Trade Association, and the UN Development Program boosted assistance; European central banks granted a total of $590 million in short-term loans against gold collateral; and the US Treasury—requiring repayment in kind—provided gold for sale on Portugal's account through the Bank for International Settlements. After pledging nearly half its gold, Lisbon still had a large financing gap, and the government in 1977 was obliged to sell over $500 million of gold. Another bailout was needed, and 14 countries formed a consortium in June 1977 to lend Lisbon $750 million. Of this, the United States contributed $300 million. For its part, the IMF extended $340 million, utilizing its oil and compensatory financing facilities, two credit tranches, and a gold tranche in exchange for a stabilization program that produced a spectacular recovery in Portugal's current account in 1978 by sharply curtailing domestic demand.

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deficit. While inflation rose by 3.4 percentage points in 1981 and a further 2.4 percentage points in 1982 (from 16.6 percent in 1980 to 22.4 percent in 1982), the Portuguese authorities boosted time deposit rates by only 1 or 2 percentage points. By 1982 the real rate of interest for time deposits ranged between −9.3 percent and 0.5 percent, well below the corresponding real rates of interest elsewhere in Western Europe. Capital flight, which, may have totaled $500 million in 1982, was clearly indicated by export prices that increased at a pace well below the inflation rate and by a sharp drop in tourist expenditures per night. Worker remittances were also affected, as guest workers abroad found themselves with less and less incentive to repatriate their earnings. In addition, negative real interest rates discouraged domestic saving, and a larger share of the increased consumption leaked into imports.

Structural weaknesses in the Portuguese economy and a number of external factors other than oil also contributed to the progressive widening of the current account deficit:

- From 1981 until early this year, Portugal suffered a prolonged drought that reduced hydroelectric output and crop yields, boosting oil and agricultural imports. Efforts to reduce the country's dependence on imported foodstuffs have run afoul of the inefficiency of the agricultural sector, where average yields have sagged since the 1975 expropriations of farmland.

- Export growth has been hampered by the concentration on low-technology goods, which have encountered growing protectionist sentiment in Western markets and stiffer competition from newly industrializing countries.

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Political Responses to Economic Crises

The revolution of April 1974 ushered in a leftwing military government whose economic policies were often dictated by popular pressure. Extensive nationalizations and expropriations of farmland followed on the heels of labor strikes and Communist-inspired squatting. At the same time, Portuguese authorities pushed hard to improve workers' living standards. When imports inevitably surged, the government took the politically expedient route of applying an import surcharge and drawing down foreign exchange reserves, rather than clamping down on domestic demand or devaluing the escudo.

The introduction of parliamentary democracy in 1976 heralded the beginning of an effort to address Portugal's deepening balance-of-payments problems, but political bickering and the constant turnover of administrations handicapped economic policy making. The elections in December 1979 finally gave a legislative majority to the Democratic Alliance (AD), a conservative coalition government, which was returned to office with an even larger majority in the scheduled election of 1980. The AD had the clout but not the will to make an adjustment program stick. Believing the turnaround in the balance of payments allowed it more leeway, the AD eased monetary policy to promote employment and investment and permitted the budget deficit to rise to over 10 percent of GDP. As the current account deficit quickly worsened, Lisbon negotiated a $1.5 billion medium-term Extended Fund Facility from the IMF in 1981. Anxious to avoid a backlash, however, the AD stopped short of signing the letter of intent. Lisbon decided to pursue its own austerity program, but its measures were not bold enough to prevent the current account from sliding further into the red.

- Since 1980 the economic slump in Western Europe has dampened export earnings, tourism revenues, and worker remittances.

Foreign Debt

A significant portion of Portugal's current account deficits has been financed by external borrowing. According to revised official estimates, the country's foreign debt nearly doubled from 1979 to 1982 to $13.6 billion—about 67 percent of the country's GDP. Short-term debt was approximately $4 billion last year, more than double the amount outstanding in 1979. The swift accumulation of debt reflects the borrowing activities of public-sector companies, which owed over 90 percent of the outstanding short-term debt and over 40 percent of the outstanding medium- and long-term debt in 1982. In compliance with the Bank of Portugal's regulations, public enterprises have financed imports of petroleum products and cereals with short-term trade credits. These firms have simultaneously undertaken some ambitious long-term investment projects, funding them with medium- and long-term loans. As foreign debt has mounted, debt service payments have soared. Excluding short-term rollovers, they amounted to $2.3 billion last year—equivalent to 27.6 percent of the country's foreign exchange earnings—despite falling interest rates. (See table 3.)

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Recent Austerity Measures

The disarray in Portugal's major political parties early this year delayed the introduction of an economic adjustment program. In December 1982 Prime Minister Francisco Balsemao, weary of political infighting among his coalition partners, submitted his resignation. The Democratic Alliance chose a successor, but the bleak prospects for the effectiveness of the new government prompted President Ramalho Eanes to set early elections for April. Balsemao stayed on as caretaker Prime Minister, and, although he could not persuade Parliament to prune government spending, he did push through a number of austerity measures, including substantial tax hikes; price increases of 15 to 30 percent for fuel, transportation, and electricity; and the tripling of the import surcharge. Subsequently, the government imposed a 17-percent wage ceiling. By this time, it was clear that Lisbon would again have to submit to an IMF stabilization program, but the caretaker government lacked the authority to negotiate an agreement.

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Prodded by the IMF, the caretaker government did, however, take the first steps toward adjusting exchange rate and monetary policy. After the realignment of the European Monetary System in March,

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Table 3
Portugal: External Debt Burden

	1977	1978	1979	1980	1981	1982 [a]
	Million US $					
Short-term debt	2,397	1,583	1,651	2,397	3,289	3,917
Of which:						
Public-sector companies		598	1,010	1,939	2,754	3,565
Medium- and long-term debt	2,230	3,837	5,616	6,581	7,726	9,665
Of which:						
Public-sector companies		1,384	2,385	2,664	3,220	4,121
External debt	4,627	5,420	7,267	8,978	11,015	13,582
	Percent					
Debt service payments/foreign exchange earnings	17.0	16.9	16.8	14.6	22.5	27.6
Total debt service payments/foreign exchange earnings (includes rollover of short-term debt)	62.5	62.2	36.9	31.3	48.1	65.9
External debt/GDP	28.4	30.5	36.4	39.5	49.7	66.7
Short-term debt/external debt	51.8	29.2	22.7	26.7	29.9	28.8
Public enterprises' debt/external debt	39.8	36.6	46.7	51.3	54.2	56.6

[a] Revised IMF estimate.
Note: Data prior to 1977 are extremely sketchy.

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Lisbon devalued the escudo by 2 percent and raised the monthly rate of devaluation to 1 percent. Although the Fund had recommended a much larger devaluation, the Portuguese confided to Embassy officials that they were unwilling to go along, fearing the potential political fallout on the eve of an election. In support of the devaluation, Lisbon simultaneously announced increases of 3 to 4 percentage points in deposit and lending rates. For the first time in over a decade, interest rates for some time deposits were significantly higher than the inflation rate.

The election produced a Socialist–Social Democratic coalition government that showed considerable spunk from the start. Within two weeks of taking office in June, the Soares government had announced a 12-percent devaluation of the escudo, raised petroleum prices 11 to 30 percent, and virtually eliminated subsidies for basic foodstuffs, causing their prices to rise 15 to 133 percent. Lisbon subsequently suspended public-sector investments and is now preparing to abandon some projects altogether. Despite a likely clash with the Communists, Soares has taken several additional steps to redress structural problems. First, the new government has opened up the banking, cement, and fertilizer sectors to private competition. To reform the agricultural sector, Lisbon has decreed measures to restructure government monopolies, return part of the farmland seized during the revolution to the original owners, and promote greater efficiency in the collective farms and cooperatives. The Soares government has also revised labor laws, which will allow temporary layoffs for a maximum of two years and permit shortened working hours. The only popular measure the new administration has offered is the repeal of the 17-percent limit on wage increases.

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The Next Stage: An IMF Package

Although the Soares government apparently believed that the measures it adopted in the early going would suffice to obtain a standby loan, the Fund has insisted upon additional policy changes and targets that Lisbon may find difficult, if not impossible, to meet. These include:

- Limiting the current account deficit to $2 billion in 1983 and $1.25 billion next year.
- Reducing the budget deficit from about $3 billion (12.6 percent of GDP) in 1982 to about $1.2 billion (6 percent) next year.
- Holding foreign debt to $14.6 billion in 1983 and $16 billion in 1984.
- Restricting domestic credit growth to 27.5 percent in 1983 and 21.5 percent for 1984.
- Increasing deposit rates by 2 percentage points and lending rates by 2.5 percentage points.
- Lowering or eliminating interest rate subsidies for housing, investment, agriculture, and exports.
- Eliminating price subsidies on milk, fertilizer, and transportation.
- Cutting wages by 4 percent in real terms.
- Restoring the import surcharge to 10 percent.

Budget and Foreign Debt Measures. In an effort to comply with the IMF's tough budget targets, Lisbon has agreed to implement further austerity measures. According to Embassy reporting, the Socialists have pushed through Parliament a one-time 2-percent tax on fourth-quarter incomes and tax hikes on automobiles, stamps, gambling, and real estate. The Soares government has also agreed to another rise in prices of imported subsidized goods and petroleum products at the beginning of 1984 and to monitor these controlled prices on a monthly basis so that future import costs to government trade monopolies will be completely covered. Also in the offing are price increases for goods manufactured by public enterprises, thus reducing operating losses subsidized by the state. Portuguese officials have found it difficult to cut spending this year on uncompleted investment projects, but they indicate that a much sharper cutback is planned next year. Portuguese estimates for 1983 and 1984 lead us to conclude that the budget deficit should remain under the Fund's ceilings.

Meeting the Fund's foreign debt targets also will require Lisbon to reform past practices. To stay within the IMF limits, Lisbon plans to curtail the overseas borrowing of public enterprises by forcing them to rely more heavily on internally generated capital. In our view, this step probably signals the central bank's intention to restrict short-term trade financing. Even if these policies succeed in holding foreign debt to $16 billion, this level of indebtedness will, in our estimate, be approximately 75 percent of GDP next year, which we project at approximately $21 billion.

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Credit Restraints. We believe that enforcing limits on domestic credit growth is the most difficult task confronting Lisbon. During the first half of this year, domestic credit rose at an annual rate of 28 percent, as the difficulty of obtaining international financing forced companies to seek loans from Portuguese banks. Recent increases in domestic lending rates and planned reductions of interest rate subsidies should discourage domestic borrowing. In our view, cuts in interest rate subsidies are particularly important, as the central bank subsidizes nearly 40 percent of the total credit granted by banks and institutions. Interest rate subsidies now range between 1.5 and 7.5 percentage points, allowing preferred borrowers to pay real interest rates of −4.4 to 2.8 percent.

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If higher rates fail to slow the growth of domestic credit, we expect the government to threaten stiffer penalties on banks exceeding their lending limits. In the process, however, many private-sector companies, already suffering cash flow problems, may go bankrupt. Given the high social costs of such developments, the Soares government may decide that it cannot afford to stay within the limits set by the Fund for next year.

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Raising deposit rates should help stimulate saving, curb consumption and capital flight, and help the balance of payments. Due to the quickening pace of inflation, real interest rates began to slide this summer. We estimate that the recent increases have nearly restored real interest rates to their March levels.

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Once Lisbon makes the price adjustments recommended by the Fund, we expect inflation to pick up again. At the end of September, inflation was running at 28.5 percent because of sharp increases in transportation prices. We believe that further price hikes for foodstuffs may boost the December-over-December inflation rate to 31 percent—2 percentage points above the IMF's target. For the year as a whole, we estimate that the inflation rate will be about 3 percentage points higher than in 1982. As smaller adjustments will be needed next year to keep domestic prices in line with international prices and with production costs, the Portuguese may be able to shave off 1 to 2 percentage points from the inflation rate. (See graphic.)

We believe the Soares government will have to exert greater control over wage gains in order to cut real wages as much as it has promised. Wage settlements in public-sector enterprises—which have usually set the pace for the private sector—probably will be more strictly supervised. If tighter domestic credit does not dissuade private-sector firms from granting large wage hikes, however, Lisbon may be forced to reimpose a wage ceiling.

The Domestic Economic Outlook

In contrast to the previous stabilization program, the IMF's prescription for improving Lisbon's external position over the next 18 months clearly depends to a large extent on slowing economic growth by reducing real domestic demand. Lower real wages and higher taxes will, we estimate, depress real disposable income and induce a fall in private consumption by about 1.5 percent next year. In addition, sharp reductions in government expenditures will cause public consumption to stagnate. Together with a more restrictive monetary policy and reduced public-sector investment, these policies should produce a decline in real domestic demand of perhaps 2.5 percent this year and 4 percent next year. Real GDP will grow by 0.8 percent in 1983, according to Lisbon's projections, but in 1984 we expect real GDP to fall by slightly more than 1 percent. (See graphic.)

The stabilization program unquestionably entails hardships for many Portuguese workers. By the end of 1984, real wages will, in our view, be at least 20 percent lower than in 1976 and unemployment will be higher. Lisbon's plan to close a number of publicly owned companies and to reduce the deficits of the remaining enterprises is certain to lead to extensive job losses. According to the press, 30 to 40 percent of the 250,000 public-sector employees may be laid off. If these reports prove accurate, this step alone would raise the unemployment rate from 8.8 percent to 11 percent. In the private sector, a large number of firms in financial difficulty—many already several months in arrears on their payrolls—are awaiting changes in the labor laws permitting them to shed excess laborers. To soften the impact of the changes, the Soares administration is formulating a comprehensive unemployment compensation plan.

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Prospects for the Current Account Balance

Although the Soares government earlier thought it could not possibly lower Portugal's current account deficit even to $2.2 billion this year, figures for the first half of this year suggest to us that Lisbon should come close to meeting the Fund's $2 billion target and may even overshoot it. Preliminary data show a $1.4 billion current account deficit for the first six months, approximately $800 million less than the deficit for the same period last year. Since Lisbon estimates that the third-quarter deficit has fallen by over $300 million to $100 million, we believe that the deficit for the second half probably will be no higher than $600 million.

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Preliminary figures indicate that most of the improvement in Portugal's external position has come from trimming its import bill. Imports fell by over $600 million during the first half of this year, compared with the same period in 1982. To buy time until other measures cut demand, the Balsemao administration drew down petroleum reserves—a one-time move that probably accounted for one-third of the decline in imports. Other factors holding down the import bill have been tighter credit, import quotas, delays in agricultural imports, administrative measures requiring the substitution of domestically produced capital goods for foreign merchandise, and declining food and petroleum prices. Because destocking petroleum reserves was a one-shot measure, we believe that improvements in the last half of the year will be less

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impressive. Moreover, rising food imports—necessitated by the drought earlier this year—may offset the savings from lower prices. Consequently, we estimate that for the full year Lisbon's austerity program may slash imports by a total of about $800 million.

We expect that export growth will contribute at least $400 million to the reduction of the current account deficit. The two devaluations, together with the accelerated monthly depreciation, will yield a 28-percent depreciation this year—about 8 percentage points higher than Portugal's inflation differential vis-a-vis its major trading partners. Exports should respond to this gain in competitiveness. For the full year, we think exports should grow in volume by about 9 percent—double the increase forecast by the IMF in May.

Invisibles earnings should, according to our projections, remain somewhat anemic this year. The only bright spot is likely to be net tourism income. Although first-half net tourism income was off somewhat compared with last year, the second-half results promise to be much better than the same period last year, as the 12-percent devaluation on 22 June should encourage hotel owners to repatriate the earnings they had channeled overseas. Worker remittances are likely to remain weak this year because of the government's delay in announcing a large devaluation of the escudo and because the strength of the US dollar will reduce the dollar value of remittances denominated in West European currencies. In fact, we believe that worker remittances will be slightly lower than they were in 1982. We also anticipate that dockyard strikes earlier this year and weak foreign demand for oil tankers will lead to a dropoff in revenues from ship repair. Meanwhile, interest payments should be up to $1.35 billion, equal to about two-thirds of the deficit.

Lisbon stands a good chance of surpassing its 1984 current account target. Given the restraint on domestic demand implied by lower credit and budget deficit ceilings, imports will undoubtedly continue to fall in 1984, perhaps by $100 million. Exports may be up $500 million, provided that Lisbon aggressively promotes exports. We believe that its efforts to do so will include an IMF-mandated adjustment of the monthly rate of depreciation to 1.5 percent to offset an inflation differential of 17 to 19 percentage points. With the economic recovery gathering momentum in Western Europe, net tourism receipts and worker remittances should also pick up. It should be noted, however, that we are assuming that more realistic interest rates will restore confidence in the financial system and discourage capital flight. Although interest payments will be over $1.4 billion, the invisibles surplus will, in our view, increase by $150 million. Together with the reduction of the trade deficit, this may bring the current account deficit below $1.25 billion. (See graphic.)

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Financing the Deficit

Lisbon has experienced considerable difficulty in satisfying its foreign exchange needs. Early this year, bankers were reluctant to increase their exposure in Portugal, and the Portuguese were able to raise a Eurodollar loan in June only after they scaled it down from $400 million to $300 million, submitted to harsher terms, and compelled four nationalized domestic banks to underwrite one-fifth of the credit. To be sure, Lisbon's substantial gold reserves—currently 634.6 metric tons, worth $8 billion—virtually preclude a liquidity crisis and make Portugal a better credit risk than many countries with foreign debt problems. The financial community, however, was uncertain about the country's political and economic future. As hard currency reserves began to dwindle to less than two weeks of imports, the authorities had to borrow a total of $1 billion from the Bank for International Settlements (BIS).

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A major problem has been the large volume of short-term debt maturing this year. Because short-term trade credits represent 28 percent of the total outstanding debt, Lisbon's financial position has been somewhat precarious. The refusal by Lisbon's commercial creditors to roll over about $400 million in trade credits during the first half of the year consequently played a large part in precipitating the foreign exchange shortage. Adding to these woes, the BIS refused to roll over a gold-backed, short-term loan for

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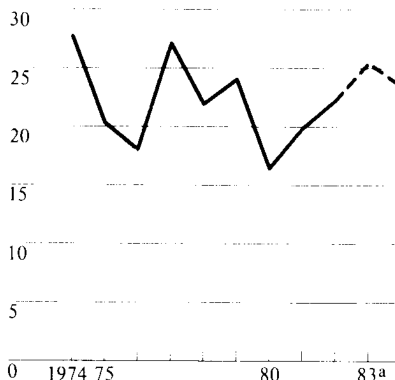
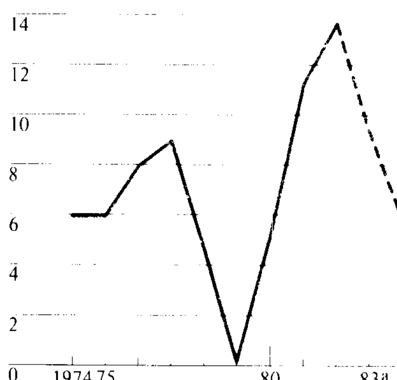
Portugal: Selective Economic Indicators, 1974-84

Percent





[a] Projected.

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$400 million, forcing the Portuguese to sell 29.4 tons of gold. A second BIS loan was specifically tied to the sale of 23 tons of gold. We believe Lisbon probably will sell part of its gold in December, as it is unlikely to have enough hard currency to pay off a third BIS loan for $300 million.

In the wake of the IMF agreement, Portugal's access to medium- and long-term commercial loans is beginning to improve. US bankers report that the $300 million Eurodollar syndicated loan Lisbon brought to the market in October was oversubscribed. Sixteen major banks—including five US banks—have indicated that they are willing to provide a total of $350 million. the favorable response to the loan is due partly to the fact that the higher spread—0.875 percentage point over LIBOR or 0.5 percentage point over the US prime rate, compared with 0.75 percentage point and 0.45 percentage point for the previous loan—more accurately reflects the financial risk of lending to Portugal.

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the loan will be signed on 28 November and that disbursement of the funds will take place immediately thereafter. Lisbon will also receive a two-year $150 million revolving acceptance facility for financing imports, which was marketed at the same time as the syndicated loan.

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Credits from other sources could total another $1 billion before the year is out. West Germany and the European Investment Bank have granted loans for approximately $100 million and $75 million, respectively, that will probably be disbursed this fall. In addition, roughly $300 million in mixed credits from the US Commodity Credit Corporation (CCC) will become available. On top of the first tranche of the IMF standby loan of about $100 million—disbursed

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early in October—Lisbon received a $135 million Compensatory Financing Facility (CFF) to cover shortfalls in exports, tourism income, and worker remittances that arose from March 1982 to March 1983. According to US Embassy reporting, a Portuguese application to the World Bank for a Structural Adjustment Loan would be favorably received. Meanwhile, we expect Lisbon to receive about $50 million under project loans and credit lines that have already been committed by the World Bank

As a result of the reduction of the current account deficit and the signature of the IMF letter of intent, financial pressures are likely to ease somewhat next year. Existing commitments from the IMF will meet most of Portugal's needs and help to avert further gold sales. In addition, Lisbon has disclosed that it plans to negotiate a three-year Extended Fund Facility (EFF) with the IMF, perhaps for $1.26 billion. If successful, this strategy would make a $210 million tranche available to the Portuguese at the end of next year, in addition to four tranches under the standby loan totaling about $300 million. To help finance agricultural imports, the Portuguese have requested a boost in US CCC assistance from $620 million this year, including mixed credits, to about $850 million for 1984. These increments in balance-of-payments support and US aid should help to counterbalance any tightness in the international financial market next year.

Despite the shaky financial position of the major publicly owned importing agencies, Lisbon has no current plans, according to the US Embassy, to seek a formal debt rescheduling.

Lisbon's strategy now is to refinance short-term trade credits with medium- and long-term loans. Because Portugal has a low credit rating and because medium- and long-term loans carry a higher risk, the Portuguese are not likely, in our view, to tie down enough of these credits to reduce the percentage of short-term debt below 25 percent.

Prospects for Staying on Course

In our opinion, the Soares government has the will to resist the pressures to relax its economic policies that will inevitably develop during the 18 months of the austerity program. According to the US Embassy, Lisbon anticipates that workers will not passively accept job losses and lower real wages, as they did in 1978, and that the financial distress of both public- and private-sector firms will create social and political tensions. We expect the Communist-dominated labor confederation, for example, to launch a series of strikes early next year in opposition to the adjustment program. A general strike, however, is unlikely, as the more moderate Socialist-leaning federation probably will not lend its support. In the meantime, the coalition government has announced that it will impose stiff jail sentences on strikers.

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After 1984, it is far from certain that Portugal's leaders will stay the course. As the current account deficit declines toward the end of next year and Portugal's financial problems abate, the Soares government probably will, we suspect, find it difficult to convince the public that the country must embark on a three-year adjustment program under the IMF's Extended Fund Facility to redress structural economic problems. Because of the high sensitivity of imports to an increase in income and because of the debt overhang, we expect the Fund to recommend constraining the growth of domestic demand. This prescription would not permit Lisbon to ease the burden of the austerity program being carried by the working class.

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Even if the Soares government proceeds with such an unpopular plan, the chances that the coalition will survive through 1987 to complete the EFF are, in our view, small. The Socialists and Social Democrats have a long history of policy differences, and the leaders of the two parties are personally incompatible. Prime Minister Soares will probably run for the presidency, but he does not have the blessing of his coalition partner. If the Social Democrats lend their support to another candidate, the strains within the coalition could lead to its downfall. If the coalition falls, we expect that the successor government would be tempted to reflate the economy—repeating the mistakes that led to the present crisis.

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