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The International Monetary Fund's
Standby Arrangements with Portugal.
An *Ex-Ante* Application of the
Washington Consensus

Ana Bela Nunes

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R. Miguel Lupi, nº 20
1249-078 Lisboa - Portugal
Telf. 213925974
Fax. 213925940
e-mail: ghes@iseg.utl.pt

Abstract

At two different moments (1978-1979 and 1983-1985), Portugal had to call upon the International Monetary Fund (IMF) for financial assistance in order to resolve serious balance of payment crises. In both cases, the terms for the implementation of IMF conditionality were agreed before the so-called Washington Consensus (WC) was established in 1989. The paper examines to what extent the Portuguese experience under the stand-by arrangements agreed with the IMF would later be embodied in the WC strong conditionality practices. Several similarities were apparent, since many of the WC prescriptions were basically influenced by IMF conditionality practices, which had been adapted during the 1980s to include further structural measures. Some significant differences can also be noticed: as the theoretical and ideological background of the WC would only be crystallized in the second half of the 1980s, the WC basically focused on Latin American developing economies, while Portugal, a European high-medium income country, had been implementing major institutional reforms since 1977, in order to meet the terms required to become an EEC member.

Resumo

Em dois momentos diferentes (1978-1979 e 1983-1985), Portugal teve que pedir assistência financeira ao Fundo Monetário Internacional (FMI) para resolver crises graves da sua balança de pagamentos. Em ambos os casos os termos do acordo foram definidos antes do chamado Consenso de Washington (CW) ter sido apresentado em 1989. O texto examina em que medida a experiência portuguesa em termos das medidas acordadas com o FMI veio a ser incorporada nas práticas propostas no CW. Algumas semelhanças parecem evidentes uma vez que muitas das políticas propostas pelo CW foram influenciadas pelas condicionantes impostas pelo FMI, que vieram ao longo da década de 1980 a incluir medidas estruturais. Contudo, existem algumas diferenças significativas: o quadro teórico e ideológico do CW só seria cristalizado na segunda metade dos anos oitenta; o CW centrava-se nos países em desenvolvimento da América Latina, enquanto Portugal era um país europeu de rendimento médio-alto que estava a implementar reformas institucionais desde 1977 com vista a preparar a sua adesão à CEE.

Key words: Washington Consensus; International Monetary Fund; Portugal stand-by arrangements

JEL classification : N14, N44, O23.

Plan

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1. Introduction

At two different moments and in two different contexts, Portugal has endured serious balance of payment crises, both of which were overcome through stand-by arrangements negotiated under International Monetary Fund (IMF) conditionality. The first difficulty of maintaining external equilibrium led to a stand-by arrangement agreed in May 1978 for a one-year period. To overcome the second period of external imbalance, a letter of intent was signed in September 1983, covering the period from 7 October, 1983, to 28 February, 1985. This letter of intent acknowledged the need for adjustment and, through it, Portugal undertook to make the required *adjustment effort*. A second letter of intent later rearranged the terms of this adjustment effort in June 1984.

In both these episodes, the terms for the implementation of IMF conditionality were agreed before the so-called Washington Consensus (WC) was established by the Washington-based international financial organizations in 1989.

The main aim of this paper is to compare the design of the conditionality practices implemented by Portugal (as an IMF member that had to call for financial assistance well before the 1990s) and the nature and scope of the original policy reforms recommended by the WC. The paper examines how much of the Portuguese experience under the stand-by arrangements agreed with the IMF was later to be embodied in the WC strong conditionality practices. Actually, the IMF was one of the most influential international financial organizations in establishing the original design of the WC, and the earlier conditionality practices were subjected to successive adaptations in order to adjust to the changes that had occurred in the international economic contexts of the 1970s and 1980s. Several similarities were apparent, while some significant differences can also be noticed.

Section 2 deals with the basic set of economic policy instruments that were supposed to be implemented by debtors according to the WC. Their embedded theoretical framework and the international context in which the consensus appeared will be considered. Section 3 revisits the historical background of the IMF stand-by arrangements with Portugal. The conditionality implemented in 1978-1979 and 1983-1985 is compared to the WC prescriptions that were formulated later on, and the adaptations introduced by the IMF in order to adjust to the new international economic environments are underlined. Some final remarks will be made in the last section.

2. The Washington Consensus

In 1989, the economist John Williamson identified a desirable set of economic policy reforms to be implemented by countries experiencing debt crises (Williamson, 1990). Their basic instruments were identified as ten consensual 'policy instruments' agreed upon by the Washington-based international financial organizations, namely the Bretton Woods institutions, the United States government's most influential economic and financial agencies, and the Federal Reserve Board. In fact, these economic policy prescriptions were very much in line with the IMF conditionality of the late 1980s, as acknowledged by Williamson himself a few years later when he revisited the presentation of 'his' original reforms, adding further qualifications and recent practices in assessing the implementation of the WC reforms (Williamson, 2004). The original programme focused on Latin American economies. Some of them had endured a severe debt crisis during the 1980s and had to submit to relatively strong conditionality enforced by the international financial organizations that had come to their rescue.

The first three policies in the WC referred to fiscal and budgetary aspects. The first of these was *fiscal discipline*, whose absence was correlated with balance of payment crises, as well as with high rates of inflation, and was blamed for its negative impact on resource allocation and income distribution. *Tax reform* (actually a reform of the tax system leading to a broader tax base and moderate marginal tax rates) was also advocated. Another important instrument was considered to be *reordering public expenditure priorities* away from subsidies, which were often accused of leading to resource misallocation, and towards investment in human capital, namely (primary) education, (primary, preventive) healthcare and public infrastructure investment.

A second subset of desirable policies was related to the monetary and financial area, namely interest rates and the exchange rate regime¹. *Liberalizing interest rates* was meant to avoid resource misallocation, while keeping them positive, albeit at a moderate level, was intended to discourage capital flight and hopefully to foster saving; accomplishing a *competitive exchange rate* was also considered essential, in order to promote export growth without producing inflationary pressures or reducing domestic investment resources. However, no prescription was provided as to how this rate should be determined².

¹ In view of the acute crises endured by East Asian economies in the late 1990s, Williamson acknowledged that he should have formulated these items differently as 'financial liberalization under prudential supervision', but it must be admitted that these were the least consensual of the policies recommended (Williamson, 2004).

² The original WC formulation did not focus on the best mechanism for determining the competitive exchange rate. Williamson recognized that the issue was rather controversial in 1989-1990 "(...) in fact Washington was already beginning to edge towards the two-corner doctrine which holds that a country must either fix firmly or else it must float "cleanly"." (Williamson, 2004:3). In fact, Williamson was convinced that an intermediate exchange rate regime was required to accomplish the competitive rate.

A third subset of policies focused directly on fostering certain aspects of international economic integration (operating in conjunction with exchange rate policy), namely trade policy and foreign direct investment (FDI) policy. *Trade liberalization*, namely import liberalization and especially the avoidance of import licensing, was considered to be highly important. Tariffs were considered relatively less pernicious, but their dispersion should be limited and intermediate goods, needed to produce export goods, should be exempted from any import tariffs; *liberalization of inward FDI* was another important prescription³

A fourth subset included the last three economic policies on the agenda. These three policies, privatization, deregulation and property rights, had a broader institutional and reformist scope. Positive effects were expected from *privatization* in the short run, namely a reduction in budgetary deficits and the expected increase in efficiency resulting from private management; market *deregulation* at large was considered to be essential (except for safety or environmental reasons and the need to control prices in a non-competitive industry). Regulation, especially through discretionary mechanisms, was considered detrimental to growth and potentially corruptive. *Property rights* were considered to be a useful device for reducing transaction costs and hopefully reducing the informal sector.

It is apparent that these policy instruments as a whole were not designed merely to solve short-term problems of external equilibrium or debt crises. Actually, they were policy reforms that were designed to sustain a balanced macroeconomic environment, namely one of economic growth, low inflation rates and a feasible balance of payments⁴. Many of those reforms had been included as part of a strategic programme in the report produced in 1986 by a group of Latin American economists and scholars in order to address the serious economic problems faced by Latin American countries (Balassa et al., 1986: 13-15).

The WC is an intelligible product of the economic history of the 1980s and even of the second half of the 1970s. The post-war Keynesian economic growth blueprint, whose effectiveness had been gradually diminishing since the late 1960s, faced almost consensual criticism when the first OPEC oil shock of 1973 led to stagflation (or even to slumpflation) in both developed and developing economies. Meanwhile, increasing public deficits were blamed for inflationary pressure, as well as for crowding-out and resource misallocation effects. The second oil-shock in 1979 led to a severe balance of payments disequilibrium in oil-importing economies, which turned into severe debt crises (especially in developing economies in all continents), fuelled by the policy of the USA

³ There was no consensus at that time about either comprehensive capital account liberalization or the best way to promote the entry of FDI.

⁴ Williamson recognized that equity had not been a major concern in the agenda “[equity] (...) did not play a larger role because I regret to say that I could not convince myself that the Washington of 1989 (or 2004 for that matter) agreed that equity was of any consequence.” (Williamson, 2004: 8). Equity was only present in the item relating to the reordering of public spending, whose guidelines were very much in keeping with the doctrine of the World Bank.

Federal Reserve. To fight inflation, the FED raised interest rates, thereby overvaluing the dollar, the currency in which most of the increasing external debt burdens were denominated. Meanwhile, after the mid-1960s, the import-substitution model was apparently unable to compete with the export-led model as a means of fostering economic growth in developing economies, as illustrated by some impressive performances in the 1980s in a number of East Asian economies.

In parallel to these facts, there was considerable rethinking and reformulation of the mainstream macroeconomic paradigm. This shifted away from the Keynesian paradigm and produced prompt effects in terms of the prescriptions and practices irradiating from the developed Anglo-Saxon economies. The New Classical School became the mainstream macroeconomic paradigm from the late 1970s onwards, in spite of the fairly limited resurgence of a neo-Keynesian approach in the mid-1980s. The supply-side tax approach, monetarist policy recommendations and a neo-liberal perspective were progressively disseminated in different doses and with different nuances in most economies.

There have been many negative reactions and several different interpretations of the term 'Washington Consensus' made over the last few decades. Some of these were produced in the very different historical contexts of the late 1990s and 2000s, when both the level of liberalization of capital accounts and flows and globalization at large had gone far beyond the prescriptions stated in the original formulation of the WC (Chang (ed.), 2001)⁵. Williamson himself has made defensive appraisals of those interpretations, refusing to allow the WC to be labelled as 'neo-liberalism' and 'market fundamentalism' or for it to be considered the cause of the Asian financial crises of the late 1990s (Williamson, 2003). It is, however, beyond the scope of this paper to examine this type of assessment here.

3. The IMF conditionality. The stand-by arrangements with Portugal

Portugal has had to call for financial assistance from the IMF on two occasions. The first time, a stand-by arrangement was agreed in May 1978, covering a one-year period. The second time that an arrangement was agreed was in September 1983, covering the period from 7 October 1983 to 28 February 1985.

Three fundamental aspects about these two cases seem relevant to our topic. The nature and scope of the Portuguese economic problems that needed to be overcome in each period; the adaptations that were made to the IMF conditionality practices in response to the changes in the

⁵ Many of these criticisms were diffuse, targeting international financial institutions in general, namely the IMF and the World Bank, as well as the ideological and political distortions that lay behind economic and financial practices. For a fairly comprehensive summary of the different critical views about the WC, see Mavroudeas; Papadatos, 2005.

international economic context; and finally a comparison between the IMF conditionality implemented in Portugal in each period and the original WC prescriptions.

3.1. The 1978-1979 stand-by arrangement

The nature and scope of the Portuguese external economic problems that led to the first stabilization programme negotiated with the IMF are no longer controversial and have been well documented and analysed (Constâncio, 1983; Lopes, 1983; Lopes, 1996; Mateus, 1998). The difficulties faced by the balance of payments in the second half of the 1970s were basically the outcome of a significant deterioration in the terms of trade, which was itself the consequence of a significant expansion in domestic demand, fuelled by an expansionary monetary policy, and the loss of competitiveness in internal and external markets. Both external shocks and institutional factors were to blame for this situation.

The first oil shock in 1973-1974 led to a huge increase in the overall price of Portuguese imports and to a 15% deterioration in the terms of trade, while the current account deficit reached 9.2% of GDP in 1977. In fact, the international economic crises, which set in during 1974-1975, reduced emigration flows, as well as the value of two items that had previously tended to compensate for the traditionally negative Portuguese trade balance: emigrants' remittances and tourism revenue. As happened in most of the non-oil producing economies, Portugal faced decreasing rates of growth (negative rates in 1975) and high inflation rates.

The revolutionary political and economic transformations that occurred in 1974 and 1975 and overthrew the authoritarian regime that had ruled Portugal for almost 50 years had far-reaching negative effects on the country's balance of payments through a variety of different mechanisms. This situation led to an increasing economic role on the part of the state through the ever greater implementation of direct mechanisms of economic regulation, namely in the area of investment decision-making and price fixing. These economic transformations were introduced in conjunction with a process of nationalization, resulting in a significant budgetary deficit for the administrative public sector, which amounted to 5.5% of GDP in 1975. In fact, the nationalization of the basic sectors of the economy, carried out between 1974 and 1976 (Nunes et al., 2005), led to the formation of a huge state enterprise sector that soon added to the financial stress of the administrative public sector and proved to be difficult to overcome. The main causes were, on the one hand, the international economic crises and the sudden rise in international prices, and, on the other hand, the fixing of the prices of basic consumer goods and services at artificially low levels. This price policy was designed to keep real wages high and represented a response to pressure from the trade unions, which had gained ground under the new regime and succeeded in achieving comparatively high wage increases (25% in real terms from 1973 to 1975 in spite of a negative GDP

growth rate in 1975 and losses in per capita GDP), especially in relation to the level of productivity. Other important factors fuelled the budgetary problem. The state had to rescue many small and medium-sized firms, which were faced with financial difficulties, as well as with the joint effects of high international prices and wage costs and the controlled price policy, either by subsidizing them or taking them over. The democratic governments fulfilled the population's expectations of catching up with the welfare state systems in place in the most developed European economies, leading to sudden high levels of public spending on healthcare and education, and a very generous and comprehensive social security programme. These budgetary problems led to increasing public debt. Public deficits had to be financed by borrowing from the Bank of Portugal, leading to an increase in the monetary base and the money supply and consequently to an acceleration in inflation. Meanwhile, significant capital flight took place, responding to the general lack of confidence in the exchange rate, negative real interest rates and political turbulence.

The suddenly initiated decolonization process, one of the main aims of the democratic regime, led to a significant reduction in Portuguese exports to the ex-African colonies, which could not be quickly redirected elsewhere as a result of both the international economic crises and the lack (and loss) of competitiveness of Portuguese products in both domestic and external markets. Moreover, there was a sudden increase in population, as more than 600,000 settlers living in the African colonies had to return to Portugal. This had a direct impact on the balance of trade due to increasing food imports, and further exacerbated the upward pressure on the budget deficit because of the need to support the returnees. The state decided to foster private investment on the part of returnees, but a significant proportion of the new labour force was employed in more or less artificial jobs either in the state enterprise sector or in the administrative public sector, which added both to the budgetary difficulties and the competitiveness problem besetting the Portuguese economy.

When political stabilization was achieved in 1976, the economic policy outlined in the medium-term plan for 1977-1980, which aimed at economic recovery, with high rates of growth and full employment, as well as income redistribution, still demanded high levels of public consumption and investment, as well as high real wages. The expansion of domestic demand was effective, but came at a high cost in terms of both inflation and external deficits. Inflation was now a product of the depreciation of the escudo and of the increase in many of the prices that had been artificially controlled in 1974-1975. Meanwhile, the expansion of the money supply as a mechanism for counteracting public debts remained in place, as did its impact on price levels. The current account deficit reached 9% of GDP in 1977, accompanied by huge increases in both public debt (the budgetary deficit rose to 7% of GDP in 1976 and 1977) and external debt, as domestic saving was far too small to finance this economic policy.

When Portugal concluded its first stand-by arrangement with the IMF, this body was already introducing some adaptations to its conditionality practices as a result of the new international economic environment, namely the shift from the international fixed exchange rate established in

the Bretton Woods agreement in 1944 to a flexible exchange rate regime from 1973 onwards, while the international economic crisis led to more acute external payment difficulties in many economies. Such a situation called for discretion in conditionality practices, larger amounts of assistance for longer periods (more than one year), and specificities in the design of the stability programme, especially when the external problem was the result of structural maladjustments (including price and cost distortions). It also required particular attention to be paid to the reduction of impediments to trade. In the precise period of this stand-by arrangement with Portugal, the IMF was already implementing further adaptations to conditionality. Members were required to ask for financial assistance promptly and to accept a medium-term programme, as well as to agree to close quantitative monitoring of the adjustment effort and the prior adoption of critical measures to ensure effective policy making (Gutián, 1995: 806-8).

The letter of intent signed by the Portuguese authorities on 8 May 1978 reflects only a few of these changes in the IMF conditionality practices (*Carta de Intenções do Governo Português ao FMI*, 1978). The length of the programme remained the usual one (one year), although in paragraph 1 (§ 1) of the letter the government committed itself to adopting “a medium-term strategy to restructure and increase the productivity of the industrial sector and engage in agricultural modernization”. Portugal was not sufficiently prompt in asking for this type of assistance to start a consistent adjustment effort. It was only in mid-1977 that Portugal was compelled to negotiate a stand-by arrangement as a condition for receiving medium-term credit granted by a consortium of fourteen countries and amounting to \$750 million. Actually, by then, Portugal had already used up several loans from international banking organizations and several European central banks, had drawn both its gold tranche and the first credit tranche from the IMF, and was forced to sell 111 tons of its significant gold reserves (Lopes, 1983: 482-3). On the other hand, the different policy instruments were adapted to the Portuguese particularities, while the periodical review of the programme’s implementation and the accomplishment of its targets were explicitly referred to in the letter of intent, and some measures had been adopted before the arrangement started, as referred to in § 6, 7 and 10⁶. § 14 to 17 reflect the particular attention that had been given, since the 1978-1979 changes to IMF conditionality practices, to measures designed to reduce impediments to foreign transactions.

The adjustment programme focused on reducing the current account deficit and its basic instruments were exchange rate depreciation and increases in interest rates. These two intertwined policies were already being implemented, but their rhythm increased significantly under the IMF

⁶ Flexibility of the exchange rate, the increase in the interest rates and a less rigid price policy to reduce price-cost distortions were all implemented during 1977. Their implementation was partly responsible for the very favourable results of the programme’s implementation. The favourable international economic environment was also an important factor in the success of the adjustment programme (Lopes, 1996: 144-7).

programme. These policies were included in the Washington Consensus, in regard to their most fundamental aspects. However, in the case of Portugal, interest rates were not liberalized, but were established according to a currency depreciation path (a crawling-peg system) to avoid speculative capital movements. A 3-4% negative differential in relation to the international level was maintained in order to prevent undesirable effects in terms of domestic production (Lopes, 1983: 485-6). As for exchange rate policy, no prescription as to how to determine it can be found in the WC programme, as was mentioned earlier. In the case of Portugal, an intermediate regime was chosen, as Williamson himself advocated (Williamson, 2004), with the crawling peg regime, introduced in August 1977, being kept in place during the implementation of the IMF arrangement⁷. To reinforce the effects of exchange rate depreciation, a system of ceilings was established for wage increases, an instrument that was absent from the WC design.

The programme reflects one of the IMF's main concerns ever since creation, namely the elimination of foreign exchange restrictions in order to achieve a liberal multilateral system of current international transfers. In its letter of intent, the Portuguese government undertook to progressively reduce the 30% surcharge on a sizeable proportion of imports (approximately 30% of the total), leading to its total abolition by October 1979 (§ 15), as well as to relax import quotas (§ 16) and ease import licensing in the case of those imports where there were no quotas (§14). The government also refrained from introducing exchange rate controls (or reinforcing existing ones) on current international payments and transfers, and from establishing any new bilateral payment agreements (§17). As mentioned earlier, one of the fundamental policy prescriptions of the WC focused on trade liberalization, especially the avoidance of import licensing. However, the liberalization of inward FDI, the other element in the WC relating to international economic integration, was absent from the letter of intent. Compared with what happened in some Latin American economies in the 1970s and 1980s, the Portuguese government in the late 1970s was no longer mistrustful of inward FDI and strengthened its commitment to EFTA and the EEC.

The adjustment in public finances was also considered to be an important element in the stabilization programme and as such was introduced into the letter of intent⁸. The crowding-out argument and its contribution to the highly-coveted increase in domestic saving were invoked as the reasons in favour of this. As far as public spending was concerned, this was realigned in keeping with the prescription outlined in the WC: away from subsidies (§10 and 12 of the letter of intent) and

⁷ In fact, this exchange rate regime was maintained until 1989.

⁸ This topic was rather controversial in the case of Portugal. Some argued that fiscal policy was to blame for the external deficit, while others considered that it had a positive effect by compensating for the deflationary impact of the balance of payments deficit. The latter view would seem to be supported by the apparently relatively small impact in previous years of the expansion of domestic demand on the external deficit, coupled with the fact that, although the effort to accomplish this target during the programme was rather disappointing, it did not jeopardize the balance of payment objective (Lopes, 1983: 499-500).

towards investment in public infrastructure. Ceilings were also introduced on increases in wages and pensions. At the same time, quarterly subceilings on credit to the public sector were introduced in the stand-by arrangement, although these were significantly exceeded, contributing to a deficit far above the forecast level.⁹ In fact, the public deficit had a stimulating effect on inflation, which in turn had a negative impact on real wages and, consequently, on external demand, ending up contributing to the improvement in the balance of payments. The letter of intent provided for a possible reinforcement of fiscal revenue, both in order to offset the reduction in import duties and to cut the public deficit, but it did not include any reform of the tax system in contrast to what was prescribed by the WC. As it happened, the structure of fiscal revenue in those years showed a significant reduction in indirect taxation and an increase in the proportion of direct taxation (Mata, 2001: 713), while the actual tax revenue collected was lower than expected. Since the stand-by arrangement had a time span of just one year, the letter of intent did not contemplate any structural measures, which might involve institutional reforms such as the ones prescribed by the WC, namely privatizations, the reinforcement of property rights and even market deregulation¹⁰. In fact, these policies reflected the new economic paradigm that was still in its first stages of becoming the mainstream paradigm and whose implementation was about to start in Great Britain and the United States.

Nevertheless, it is clear that this letter of intent was still very much in line with the IMF's traditional stabilization programme, designed to tackle problems that were similar in origin and which "(...) usually consisted of an agreed upon set of ceilings on fiscal deficits and domestic credit creation and a change to a new, fixed, nominal exchange rate [...] In some cases, price controls on state economic enterprises (SEE) insured that those SEEs would incur losses, which in turn were financed by loans from the central bank. In cases in which these SEEs deficits were important and increasing, [price controls] were removed" (Krueger, 2003: 301-2).

3.2. The 1983-1985 stand-by arrangement

The nature and scope of the Portuguese external economic problems that led to the second stabilization programme negotiated with the IMF are also well documented and analysed (Lopes,

⁹ In the stand-by arrangement, quarterly total credit ceilings were introduced, supposedly in order to limit the domestic increase in net credit to 23% of the initial money stock, apparently a moderate restriction in the effort to achieve inflation targets, but nonetheless more restrictive than would in fact be needed thanks to the effectiveness of the exchange rate devaluation and interest rate policy.

¹⁰ Law 46/77 of July 1977 had, in fact, established the limits of the public and private sectors in order to guarantee the freedom of private enterprise. However, this legislation was in line with the Constitutional law still in place, which was rather restrictive in terms of those sectors in which private enterprise was admitted (Nunes, et alii, 2005).

1983; Lopes, 1996; Mateus, 1998) and clearly acknowledged by the Portuguese authorities that signed the first Letter of Intent in September 1983. The difficulties experienced in the balance of payments in the first half of the 1980s were again basically the result of a significant deterioration in the terms of trade, whose main causes were relatively similar to the ones involved in the previous period: a significant expansion in domestic demand, now greatly fuelled by rapid increases in external indebtedness and the loss of competitiveness in external markets, reflecting the fact that no relevant structural adjustments had been produced to ensure a feasible and sustained external balance (Lopes, 1983: 501). Both external shocks and institutional factors, in other words an inadequate economic policy, were again to blame.

The deterioration in the terms of trade was greatly fuelled by the second oil shock of 1979 and the international economic recession that followed this, which in turn led to a decrease in both emigrants' remittances and external demand. The exchange rate against the dollar and international interest rates rose significantly, further exacerbating the sudden increase in the external debt and debt-servicing costs that had taken place between 1979 and 1982. In this latter year, the external debt amounted to 252% of the total exports of goods and services and had increased from one-third to two-thirds of GDP¹¹. By 1984, it amounted to 90% of GDP, pushing Portugal towards an imminent debt crisis, along the lines of what had been happening in some Latin American economies since 1982 (Mateus, 1998: 118). In 1982, the current account deficit amounted to 13.5% of GDP (Lopes, 1996: 137) and foreign exchange losses were also significant.

However, in view of this unfavourable international context, Portuguese economic policy proved unable to cope with the situation in due time, and the government in power in 1980 can even be said to have acted counterproductively. Domestic demand expanded as the growth in nominal wages accelerated and the public deficit increased to 12.5% and 8.5% in 1981 and 1982 respectively, while no reform was made of the tax system and the level of tax evasion also increased (Mateus, 1998: 118). Furthermore, these values do not include most of the significant deficits in the state enterprise sector caused by persistent inefficient investments and the high debt-servicing costs of the systematic indebtedness accumulated in a context of easy access to international capital markets and ever-increasing interest rates¹². In just three years (1979-1982), external debt almost doubled, reaching \$13.7 billion. At the same time, the Portuguese currency was revalued by 6% in February 1980. This exchange rate policy had a short-term effect on the inflation rate that was mildly positive, but it had a negative effect on the competitiveness of Portuguese exports. Relative labour costs increased, while productivity remained comparatively poor. Meanwhile, interest rate policy did not respond to the significant changes that had occurred both in domestic inflation rates and in

¹¹ Bad harvests in these years and the very low level of agricultural productivity added to the imbalances in the current account and led to high levels of food imports.

¹² According to IMF estimates, the overall deficit amounted to 18.5% of GDP in 1983 (Mateus, 1998: 118).

international interest rates. Regulatory mechanisms, particularly those relating to price fixing and import licensing, were resumed for a while after 1980, with negative effects in terms of price distortions.

At the time when Portugal concluded the first phase of its second stand-by arrangement with the IMF, the developing world, namely the Latin American and African economies, were already enduring a debt crisis that brought serious debt-servicing difficulties from 1982 onwards¹³. The volumes of debt in question, particularly the level of private indebtedness, were far too great for the IMF's resources to be able to support all the economies in crisis. Some changes were implemented by the Fund to meet the need for adjustment, financing and growth. IMF financial support was only supposed to complement financing from other international creditors under new 'modalities and techniques' ('concerted' lending packages). Sustained economic policies became crucial for tackling debt-servicing problems and "(...) conditionality practices focused also on structural reforms and microeconomic measures to ensure efficiency in resource allocation [through aggregate supply management] and use as a resumption of growth." (Guitán, 1995: 809). As the adjustment effort included structural reforms that were also intended to achieve economic growth, it was usually designed as a medium-term programme¹⁴.

It is apparent that this new version of the typical IMF adjustment programme thereafter became much closer to the one that the WC would later prescribe. The first letter of intent signed in September 1983 by the Portuguese authorities (*Carta de Intenções dirigida ao Fundo Monetário Internacional, 1983*), three months after a new government was elected, and the second letter signed in June 1984 (*Carta de Intenções dirigida ao Fundo Monetário Internacional, 1984*) contain only a few elements of the new design of the IMF conditionality and similarly only a few of the subsequent WC policy reforms. In fact, most of the new nature and scope of the IMF conditionality was only crystallized in the second half of the 1980s, after publication of the report on how to renew economic growth in Latin American countries (Balassa, et al., 1986) and after the new economic paradigm had started to gain momentum. According to Morris Goldstein, when outlining the main factors that had contributed to the increasingly 'intrusive' IMF structural policy conditionality, many developing economies were very critical of the IMF programmes that had been implemented until the early 1980s for "[...] being too demand-oriented and too short-run and not paying enough attention to economic growth, to supply-side reforms, and to income distribution. The disappointing growth performance of developing countries in the early 1980s added to those concerns (...)". As a

13 For a synthesis of the nature and scope of the crisis that beset Latin America in the 1980s, see Feldstein, 2003: 1-2. For a more comprehensive analysis, see Balassa, et al., 1986.

14 Equity and distributional concerns were made more explicit, while special facilities were established to tackle 'adverse contingencies' and to support low-income developing economies in implementing structural adjustment processes (Guitán, 1995: 811).

consequence, [...] “new lending windows with higher structural policy contents and with lending terms more favorable to low-income countries were created [...]” (Goldstein, 2003: 422).

The adjustment programme now covered a period of longer than one year (but less than the typical 3-year period) – from October 1983 to February 1985. It basically focused on controlling the expansion of domestic demand, through moderation of nominal wage increases and control of the public deficit, as summarized in §1. Restrictive monetary and budgetary policies were considered to be crucial elements for achieving the stabilization goals, as well as flexible exchange rate and interest rate policies. As had happened before and as was expected by the IMF, the Portuguese authorities implemented a prior package of economic and financial measures. In March, and again in August, 1983, interest rates were increased by 4 and 2.5 percentage points respectively; in March, the monthly devaluation rate of the crawling-peg regime increased from 0.75% to 1%, and in June a discrete 12% devaluation took place; in June, 1983, the first steps were taken towards introducing significant increases in a large range of subsidized prices, together with a freezing of the public sector investment programme, which was to be reassessed in the future; and an exceptional tax on profits was also implemented. Moreover, in view of Portugal's forthcoming accession to the EEC, the government had started to promote and design a series of structural reforms, which were also supposed to make a decisive contribution towards preventing the recurrence of similar crises, as well as towards increasing efficiency in resource allocation and achieving sustained growth. Decree-Law No. 406/83 of 19 November (based on Law No. 11/83 of 16 August and the revision of the Constitutional Law) opened up several sectors to private enterprise and allowed for the formation of mixed enterprises (Nunes et al., 2005); fiscal reforms were already planned by the time the first letter of intent was signed, as these were a necessary step in order to ensure that the Portuguese fiscal system conformed to that of the EEC.

According to the adjustment programme proper, the stabilization process relied heavily on an efficient control of the overall public deficit. This was to be achieved by a more effective fiscal administration and a fairly comprehensive and diversified policy for cutting public spending (reducing its ratio to GDP by 1.4 percentage points) and increasing public revenue (raising its ratio to GDP by 1 percentage point). In the short run, increases in the rate of indirect taxes represented the main instrument that was used. Structural reforms were designed to accompany these measures, expected to produce results within a few years, namely an overall reform of the tax system that would create a broader tax base and introduce greater income elasticity into the fiscal system, together with a reduction in tax exemptions and benefits. A reform of the system of social benefits, designed to control its growth, was also included in the programme (§ 5, 6 and 7). State enterprises were also to undergo strict controls of their financial situation. Ceilings were established for their levels of external indebtedness and domestic credit (§ 12 to 16), the level of investment in the state enterprise sector was to be significantly reduced, wages were to increase at a rate below that of inflation, and costs were to be reflected in final prices.

These instruments were still very much in keeping with the IMF's previous stand-by arrangement with Portugal, as has already been mentioned. However, they illustrated some of the most important policy reforms introduced through the WC. The structural reforms were now more explicit, and they had very similar wording to the formulation that would later be used in the WC, particularly in the case of the tax system reform (e.g. the establishment of a 'broader tax base'). Several instruments were specifically aimed at achieving a strict control of the money supply, and there was to be an expansion of domestic bank credit, by increasing the nominal rate of interest and imposing restrictions on subsidized interest rates (§ 10). Again, these instruments were in line with the WC's prescriptions on the liberalization of interest rates, which was also expected to produce positive effects in terms of private saving, and with the monetarist policy recommendations. A competitive exchange rate was considered crucial for achieving external equilibrium and the government committed itself to persisting with the crawling-peg regime, as established three months earlier, although it was considered that further adjustments might be necessary. As far as foreign economic relations were concerned, the letter of intent stipulated a reduction in the existing surcharge on imports from 30% to 10%, as well as reiterating the government's commitment not to introduce any restrictions on current international payments and transfers (§ 15). Ceilings were introduced for the level of external indebtedness and strict controls were implemented in this area. The government also refrained from introducing exchange controls (or reinforcing existing ones) on current international payments and transfers, or establishing new bilateral payment agreements. Again, all these measures follow the WC's main aim of fostering international economic integration. Some of the more institutional aspects in the WC's prescriptions were now either directly or indirectly reflected in the stand-by arrangement, especially if we include those measures whose implementation was brought forward in time. Regulatory mechanisms were reduced, namely price controls and impediments to the establishment of firms, which implied some improvement in the enforcement of property rights. The privatization of nationalized enterprises only began in Portugal in the late 1980s (Law No. 71/88 of 24 May). However, Decree-Law No. 406/83 of 19 November allowed for the formation of mixed enterprises in a number of industries and for the private management of state enterprises.

In fact, when the implementation of this programme was assessed in March 1984, it was acknowledged that it was not performing as well as expected. The annual rate of inflation had increased to an unprecedented value as a result of the currency devaluation and the increases in subsidized prices. As a result, a second letter of intent was addressed to the IMF in June 1984. The main aims were to tackle inflation (bringing it down from 34% to a rate of 23%), to reduce the overall public deficit (including the state enterprise sector) to 14.5% of GDP and the budget deficit to 7% of GDP, and to further reduce the deficit of the current account balance. Although there was a strengthening of the main instruments required for making further adjustments, much in keeping with what was already being implemented, liberalization and structural reforms were now more

apparent. Banks were given freedom to decide on the level of most of their interest rates and the Central Bank was to implement a flexible interest rate policy. Incentives were introduced to encourage personal financial savings. The exchange rate regime was kept under exactly the same lines and the commitment to free trade and a liberal system of current international payments and transfers was maintained (§ 9). A systematic structural adjustment to the state enterprise sector, implemented in conjunction with the World Bank, began in 1984, while the overall reform of the fiscal system, implemented within the context of Portugal's accession to the EEC, was reinforced, and the first results of this were to be included in the budget law of 1985.

4. Some final remarks

There are three main reasons for the apparent differences to be noted between the IMF conditionality imposed on Portugal during the two periods when Portugal needed special financial assistance to correct maladjustments in its balance of payments and the initial version of the WC policy reforms.

1. At the time when Portugal had to ask for financial assistance, the theoretical and ideological background of the WC had not yet been crystallized and, above all, it was not implemented in terms of economic policy layout beyond the Reagan-Thatcher-Kohl area. At that time, much of the IMF conditionality still focused on short-term macroeconomic stabilization programmes.

2. The Washington Consensus was basically concerned with Latin American developing economies, which had been enduring recurrent and acute debt crises since 1982. Portugal was actually a high-medium income European economy whose modern economic growth had taken off in the 1950s. In the second half of the 1970s, Portugal experienced severe macroeconomic imbalances as a consequence of short-term external shocks and the turbulence brought about by sudden changes in its economic system. But some of those imbalances were also severely felt by some more mature, highly developed European economies, namely the United Kingdom and Italy. The latter country was unable to stabilize its macroeconomic settings on its own and requested a stand-by arrangement twice in this period (Spaventa, 1983), while the former has a long history in the use of IMF's special lending facilities, including a period in 1976 (Crawford, 1983). In the early 1980s, Portugal experienced another acute external imbalance, again partly as a consequence of the effects of certain external shocks that were also felt in Latin American economies, and partly because of the unsuitability of its short-term economic policy. On both occasions, Portugal was able

to avoid default, contrary to what happened in some Latin American economies in the 1980s, such as Mexico in August 1982 (Balassa, et al.: 65-72).¹⁵

3. Portugal had applied to become an EEC member and some institutional reforms had been underway since 1977 in order to meet this commitment, safeguarding private property and creating a system based on a market economy. Those reforms were accelerated after 1982, precisely when the serious maladjustments in Latin American countries were beginning to trigger a series of severe debt crises that would continue throughout the 1980s and would lead to the creation and design of the Washington Consensus. The Portuguese reforms had resulted in a relatively favourable background when compared to the Latin American situation, which may also explain why the letters of intent appeared to be less concerned with structural reforms than would normally be expected from the WC prescriptions.

Nonetheless, some important similarities are apparent between the IMF conditionality imposed in the two stand-by arrangements negotiated with Portugal and the initial version of the WC prescriptions. The main reason for this is the fact that a significant part of the WC prescriptions, as acknowledged by Williamson himself, was basically influenced by IMF conditionality practices, which had been adapted during the 1980s to include further structural measures, as a means of sustaining macroeconomic balances in developing economies and fostering economic growth.¹⁶

¹⁵ Some similarities are, however, to be noted. No sooner had the positive effects of the economic policies implemented under the terms of the IMF conditionality begun to be felt in Portugal (1979) than a similar situation arose to the one that had often happened in Latin American countries: the return of external imbalances and the need to seek financial help once again: "(...) [the] government typically began to increase expenditures and ease the monetary situation. As that happened, the real exchange rate began appreciating, and, with it, the incipient current account deficit once again began increasing. Inflationary pressure accelerated, and with it the boom component of the cycle was once again in their way. The boom ended when the next exchange rate or debt crisis became too costly, and once again the IMF was approached [to resolve] the developing countries "stop-go" crisis." (Krueger, 2003: 307).

¹⁶ The IMF's awareness of the need for structural reforms was always clearly evident in general and could be noted in the particular case of Portugal in the late 1970s: "The letter of intent recognized that the balance of payments had been complicated by serious structural maladjustments in the economy and that a policy to overcome those maladjustments would be indispensable to correct the external imbalance on a more permanent basis. § Since the program was only for one year, it did not require structural adjustments (...)" (Lopes 1983: 501)

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Rua Miguel Lupi, 20 - 1249-078 Lisboa
Telf: +351 213925974
Fax: +351 213925940
email: ghes@iseg.utl.pt



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Rua Miguel Lupi, 20
1249-078 Lisboa
Tel. +351 213 925 974
E-mail: ghes@iseg.utl.pt

