Financial sector reform

PORTUGAL

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OECD ECONOMIC SURVEYS

1998-1999

PORTUGAL

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BASIC STATISTICS OF PORTUGAL

THE LAND

Area (thousand sq. km)	91.9	Major cities, resident population in thousands (1995):	
		Greater Lisbon	1 834
		Greater Porto	1 188

THE PEOPLE

Population (1.1.1997, thousands)	9 934	Civilian employment (1997, thousands)	4 530
Number of inhabitants per sq. km	108	As a percentage of total:	
Civilian labour force (1997, thousands)	4 855	Agriculture	13.6
		Industry	31.3
		Services	55.1

PRODUCTION

Gross domestic production in 1997 (million of euros)	89 350	Growth domestic product at factor cost by origin (1993, per cent of total)	
Growth domestic product per head in 1997 (euros)	9 000	Agriculture	5.8
Gross fixed asset formation in 1997:		Industry	37.8
Per cent of GDP	30.7	Services	56.4

THE GOVERNMENT

Public consumption 1998, per cent of GDP	16.6	Composition of Parliament, (number of seats):	
Public investment 1998, per cent of GDP	5.3	Social Democrats (PSD)	88
(Per cent of total investment)	17.5	Socialists (PS)	112
General Government current revenue, 1998, per cent of GDP	42.4	Communist Party/Ecological Party (''Greens'') (PCP/PEV)	15
		Social and Democratic Centre/Popular Party (CDS/PP)	15

FOREIGN TRADE

Exports of goods and services 1998, per cent of GDP	32.7	Imports of goods and services 1998, per cent of GDP	42.4
Main exports as a percentage of commodities exports, 1998 (SITC):		Main imports as a percentage of commodities exports, 1998) (SITC):	
Food, beverages and tobacco	7.3	Food, beverages and tobacco	12.9
Chemical and energic products	8.2	Chemicals and energetic products	18.0
Basic and semi-finished materials	17.6	Basic and semi-finished materials	5.9
Clothing	21.4	Clothing	10.4
Mineral and metal products	5.8	Mineral and metal products	8.6
Other manufactured products	39.9	Other manufactured products	44.2

THE CURRENCY

Monetary unit: Euro	Currency units per euro average of daily figures:	
	January 1999	200.482

This Survey is based on the Secretariat's study prepared for the annual review of Portugal by the Economic and Development Review Committee on 5 July 1999.

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After revisions in the light of discussions during the review, final approval of the Survey for publication was given by the Committee on 9 September 1999.

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The previous Survey of Portugal was issued in January 1998.

Assessment and recommendations

Economic performance has been remarkable and Portugal qualified for EMU

Portugal's economic performance has been remarkable since the mid-1990s. Real GDP growth, at first export-led, and then also boosted by gross fixed investment and private consumption, averaged 3.5 per cent annually. With a certain lag, the brisk expansion produced a rise in employment, and the unemployment rate has fallen in the past two years, stabilising at 5 per cent in 1998. The process of convergence of inflation rates brought the rise in the harmonised CPI down to 1.9 per cent on average in 1997, compared with 1.6 per cent for the euro area. At the same time, Portugal met the Maastricht criteria for fiscal deficit, the vigorous consolidation effort pursued during the few years prior to 1997 having made it possible to cut the deficit to 2.5 per cent of GDP that year. Portugal thus qualified for Economic and Monetary Union (EMU) from its inception. These results stemmed from an appropriate economic policy, but also from a favourable economic environment marked by a widespread fall in interest rates and commodity prices, and from a steep increase in European Union (EU) transfers from 1995.

Despite some less positive aspects in 1998...

Among the less positive aspects of Portugal's performance in 1998, the disinflation process was interrupted, the harmonised CPI rising by 2.8 per cent over the twelve months to December, well above the euro area average (0.8 per cent). Demand pressures, in a context of loose economic conditions, contributed to this. But temporary factors – a rise in the price of fresh foodstuffs, a hike in university fees and Expo 98 – played a major role. Underlying inflation, of 2.4 per cent at the end of 1998, was close to that a year earlier. With domestic demand continuing to fuel imports during most of the year, the trade balance

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worsened. The current account deficit widened from 5.4 per cent of GDP in 1997 to 6.6 per cent in 1999, over a third of it financed by net capital transfers from the EU.

... the prospects for 1999-2000 are fairly bright

Since the end of 1998, growth has shown signs of flagging as a result of the slowdown in Europe and the disappearance of temporary factors that had bolstered it in 1998 (major infrastructure projects and Expo 98). However, this cyclical slowdown should reduce the danger of over-heating; and it should be followed by a pick-up in the second half of the year, continuing in 2000. GDP growth, though significantly slower than in 1998, should thus remain around its potential rate. The unemployment rate is expected to stabilise and wage growth should moderate somewhat. By June 1999, the inflation rate had declined to 2.1 per cent (on a year-on-year basis). With the disappearance of the special factors that exerted an influence in 1998 and an easing of demand pressure, inflation in 1999 as a whole should be moderate, although still above the average for the euro area. These forecasts remain subject to uncertainties regarding the international environment, particularly short-term economic developments in Europe, but also concerning Portuguese economic policies, such as fiscal and structural reform.

Despite the buoyancy of the economy and the easing of monetary conditions...

The priority of macroeconomic policy has been to meet the Maastricht criteria. In 1998, Portugal's forthcoming participation in EMU led to a progressive easing of monetary conditions, with a sharp fall in interest rates in the closing months of the year. This decline took place at a time when economic activity was very buoyant, domestic credit was booming, inflation was rising, and the current account deficit was widening. The banking supervisory authorities and the Ministry of Finance took some measures at the beginning of 1999, which may ultimately contribute to slowing the growth of lending to households. Since January 1999, monetary policy has been under the management of the European Central Bank, whose decisions are taken in the light of developments in the euro area as a whole, as demonstrated by the interest rate cut in April 1999. For a country like Portugal, which is in a more advanced position in the cycle than the main EMU countries, the resulting monetary conditions may

not be appropriate. In these circumstances, the setting of fiscal policy is particularly important.

... fiscal consolidation stalled in 1998

The consolidation effort pursued between 1994 and 1997 made it possible to cut the general government deficit to 2.5 per cent of GDP, thanks to an average annual reduction in the deficit of nearly 1.2 percentage points (1 percentage point after adjustment for cyclical effects on revenue and expenditure). This result was largely facilitated by the reduction in the public debt burden, stemming mainly from lower interest rates, which accounted for about half of the fiscal adjustment between 1994 and 1997. The primary surplus (*i.e.* excluding interest payments) increased by ½ a point of GDP per year on average during this period. The tightening of fiscal policy was done without raising tax rates, by means of vigorous measures to improve the collection of taxes and social security contributions. However, current expenditures, especially those on education, health and social protection, rose steadily as a proportion of GDP. After the period of rapid fiscal adjustment, 1998 saw little progress on this front. Admittedly, the general government deficit fell to 2.3 per cent of GDP, which was slightly better than forecast. But in structural terms the deficit remained broadly unchanged and the primary surplus fell by nearly 1 percentage point of GDP, suggesting a markedly pro-cyclical policy stance. Bearing in mind the strength of activity and the easing of monetary conditions, the authorities should have grasped the opportunity to step up fiscal consolidation. This would have made it possible, not only to contain demand pressures, but also to create more leeway for the free play of the automatic stabilisers in the event of a future slowdown in activity.

The 1999-2002 programme lies within a strategy of budget deficit reduction, and that is appropriate...

The 1999 budget aims to reduce the deficit by 0.3 percentage point of GDP (compared with the 1998 outturn). Despite the reduction in certain tax rates, current revenue is set to rise as a share of GDP, thanks to more effective tax collection and the lagged effect of the strength of activity in 1998. In contrast with its recent trend, current expenditure excluding interest payments would stabilise as a proportion of GDP, education and health expenditure continuing, however, to rise more rapidly than GDP. The 1999-2002

programme provides for continuing fiscal adjustment in 2000 and the following two years, and a reduction of the deficit to 0.8 per cent of GDP in 2002. This medium-term objective is in line with the EU Stability and Growth Pact and would provide the necessary margin of manoeuvre for the free play of automatic stabilisers in the event of an adverse shock. It is essential that budget outcomes do not fall short of the objectives, which are based on assumptions of high GDP growth. Hence, if GDP growth is not as strong as assumed by the Portuguese authorities, to reach the objectives, new measures would have to be taken. On the other hand, if the risk of overheating arose, the government would have to consider going beyond the targets in order to ensure that Portugal remains on a sustainable non-inflationary growth path.

… but several challenges lie ahead for public finances

Half of the fiscal adjustment programmed over the three years to 2002 is to come from expenditure cuts, the other half from increased revenue. It is planned to widen the tax base and further improve tax administration, but reform measures still have to be introduced. Current outlays are projected to remain constant as a proportion of GDP, with interest payments falling and social outlays – for human capital development and health care – rising. Both the revenue and expenditure sides of the programme should be re-examined. Even though the budget deficit has been cut in line with the requirements of the Maastricht Treaty, the rapid rise in primary expenditure in recent years is nonetheless a source of concern. In order to reduce the weight of the public sector and to provide the margin of manoeuvre, which would allow a reduction in tax pressure, structural reforms are urgently needed to check the growth of current expenditure, excluding interest payments. In the longer term, this will also make it possible to ease the pressure that population ageing will necessarily put on public finance. The reforms of the health system and social security, which are under discussion, should be implemented in order to check the growth of expenditure, while improving the quality and efficiency of the systems (see below for suggestions in the health sector in particular). On the revenue side, the measures implemented from 1994 onwards produced a marked improvement in tax collection, though

the gains from them will gradually diminish. An overhaul of the tax system – including social contributions – should not be ruled out. Rather than tinkering with the system, a comprehensive approach, which also considers transfers, should be adopted, since this would be the best means of improving the efficiency and equity of the system as a whole.

The performance of the financial sector has improved significantly after wide-ranging reforms…

An area where reforms have already borne considerable fruit is the financial sector, which has undergone a sharp transformation in the past decade or so. In the mid-1980s, the sector was among the worst performers in the OECD, with financial intermediation almost exclusively in public sector hands, undercapitalised and inefficient institutions and thin markets. Since then, most indicators of performance have improved significantly, converging to – or even surpassing – OECD averages. The transformation of the financial system is likely to have had important spill-over effects on the rest of the economy and no doubt played a major role in Portugal's good macroeconomic performance of the past few years, leading to participation in EMU. The catalyst for this improved performance has been a series of step-by-step reform measures, to a large degree spurred by EU directives. These included interest rate deregulation, liberalisation of the regulatory framework, privatisation, modernisation of monetary policy instruments and freeing of international capital movements. Moreover, unlike in many other OECD countries, in Portugal the financial reform has not been accompanied by a boom-bust cycle associated with the deterioration of credit quality and the failure of financial institutions. Avoiding such an outcome has been the result of adequate supervision, cautious sequencing, and the pursuit of prudent macroeconomic policies. The conduct of monetary policy in particular, has been determinant in preventing an uncontrolled boom in private credit, even though the ERM crisis and a recession in Portugal in 1993 also played a role in limiting credit growth.

… but challenges persist, including those deriving from EMU

While reforms have been successful and financial institutions are healthy and relatively efficient, the Portuguese financial system still faces important challenges. Some of them derive from EMU, which represents a significant regime shift leading to a change in market conditions,

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especially through increased competition. EMU is also expected to accelerate pre-existing trends, such as technological change and securitisation, putting the banking system under further pressure to consolidate. Compared with banks in other EMU countries, however, Portuguese banks seem to be in a good position to face these challenges. As a "late-comer", Portugal's efforts to incorporate new technology are quite recent, so that operational systems tend to be relatively up-to-date. Moreover, the use of electronic means of payment is among the widest in the OECD area. The existence of excess capacity is also less obvious in Portugal than elsewhere in the EU, suggesting that pressure for consolidation may be less strong. Finally, lower operating costs and brighter prospects for the domestic lending and securities markets may allow Portuguese banks to maintain relatively high levels of profitability in the short run. Still, given the relatively small size of domestic financial institutions, the Portuguese financial system is not expected to be exempt from EU-wide pressures for consolidation, as banks are likely to be confronted with a decline in profitability in the medium run.

Policy issues in the financial sector relate to prudential regulation and supervision as well as consolidation of the banking system

In the financial area, the main policy issues facing the authorities are, in large part, related to prudential regulation and supervision, and the process of consolidation in the banking industry. Policy challenges related to technological change – such as the widespread use of smart cards as cash purses and of the Internet as a delivery channel for financial services – include the adaptation of disclosure regimes, the control of flows outside the banking system and issues of national jurisdiction and contract enforcement. Concerning the restructuring of the banking industry, the key challenges are to ensure that it happens in an orderly way, that it does not increase systemic risks and that it enhances – rather than distorts – competition in the industry. For that purpose, remaining obstacles to the adjustment of capital and labour should be lessened. The segmentation of pension systems, which affects in particular the banking sector where employees have a separate scheme, should be reduced and transferability rules eased. This would further enhance the flexibility of the labour market. Furthermore, mechanisms for guaranteeing effective

market access should be established by competition authorities, which should monitor private arrangements, especially those that impede corporate take-overs, to ensure that they do not limit competition. Finally, the ownership structure of financial institutions needs to be conducive to competition. The largest state-owned financial group has been operating well to date. Nevertheless, the experience of other OECD countries shows that such institutions, when fully subject to market forces, lead to greater efficiency in the longer term.

Moreover, a recent credit boom, led by mortgage and consumer lending, has caused some concern

The most immediate policy concern, however, derives from the sharp growth of lending to households in the past two years. This has brought to the fore the role national supervisory authorities can play in enhancing financial stability, as bank failures might lead to systemic problems, the cost of which would ultimately rest with national fiscal authorities, thus raising moral hazard issues. Bank lending, on the whole, seems to have been quite prudent: there are as yet no clear signs of asset price bubbles; default rates are low; and household indebtedness is close to average levels for the euro area. Nonetheless, the authorities should remain vigilant. Recent growth rates in lending are not sustainable over a long period, and the widespread use of variable interest rates for mortgages could lead to a wave of defaults in a hypothetical situation that would combine an upward movement in interest rates with a cyclical downturn in the Portuguese economy. Moreover, the recent credit boom has come at a time when signs of overheating were starting to emerge and monetary policy was being determined by developments in the euro area. In early 1999, the authorities tightened eligibility requirements for mortgage subsidies, increased required provisions on consumer credit, and applied moral suasion. This may ultimately help limit the growth of credit aggregates. Other measures could be appropriate. Mortgage subsidies could be eliminated altogether, though this would be unlikely to affect credit demand significantly, since eligibility requirements are already quite tight, with subsidies benefiting only low-income households. Prudential considerations may also warrant further action. Required provisions could be raised further, and moral suasion stepped up, but there are limits

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to this course of action, since it could put Portuguese banks at a competitive disadvantage compared with other EU countries. In any case, if the pace of credit creation were to threaten the macroeconomic equilibrium, budget policy would be the appropriate instrument to deal with this.

Even though labour market performance has been relatively favourable, action needs to continue on a wide front...

Real wage flexibility has facilitated labour market adjustments in the past, and recourse to "atypical" forms of employment (fixed-term contracts, "false" self-employment) has often made it possible to circumvent over-rigid regulations. But the profound structural changes under way in the Portuguese economy for more than a decade are set to continue, which will, in turn, necessitate a highly adaptable and mobile labour force to lessen the cost of those changes, and to strengthen the potential for adjustment within EMU. In the Social Pact signed in 1996, the authorities and the social partners entered into specific commitments, which are broadly in line with the *OECD Jobs Strategy*. In 1998, the government set out the priorities of employment policy in the Action Plan for Employment, designed at the national level with active participation from the social partners, and within the framework of the EU; this plan aims at improving the efficiency of the existing policy actions. Several initiatives were introduced to improve education and training, to make active labour policy more effective by acting both preventively and remedially, and by targeting programmes better. At the same time, the authorities recognise the importance of having sufficiently flexible regulations to foster job creation, and they are anxious to preserve – and even strengthen – work incentives. A revision of the legal regime governing redundancies has accordingly been approved by Parliament, which reduces compensations firms have to make when laying off workers; the unemployment insurance system has been reformed to reduce the effects of the unemployment "trap"; the legislation regulating "atypical" forms of work is being modernised and enforcement of labour standards has been strengthened; social security contributions for the self-employed have been brought into line with those for employees; and more flexibility has been introduced into the pension scheme. Also, a regulatory reform is under way to simplify the administrative burden that weighs on firms, especially

the smallest ones, this kind of action being conducive to a more business-friendly climate.

… but the plethora of existing instruments also needs to be rationalised further

The measures taken in recent years go in the right direction, but it is too soon to evaluate their effectiveness. The successive adjustments that have been made, just recently with the Action Plan, for instance, seem well thought-out when considered individually, but they have resulted in new mechanisms being piled on top of existing measures. The priority now is to carry out a comprehensive review of all the existing programmes with a view to rationalising them, and to introduce a mechanism of systematic evaluation.

The state continues to withdraw from production, and network industries are being liberalised

The privatisation programme, one of the most ambitious in the OECD area, has laid the basis for future growth through increased product market competition and enhanced productivity gains. In the last ten years, more than 100 enterprises have been sold, with privatisation revenues averaging more than 2 per cent of GDP per year. Progress in this area has continued in 1998 and early 1999 and has been accompanied by the development of the relevant regulatory framework, notably in the telecommunications and electricity sectors. Some barriers to competition remain, however. In the electricity sector, private firms are allowed to participate in building new power stations, while for transmission and distribution there is an access system based on a tariff structure established by the regulatory entity. But there are barriers to consumer choice, with only customers above a minimum level of consumption allowed to choose their supplier. The liberalisation of the electricity sector is to continue over the next few years in line with EU directives. However, in the context of an integrated energy policy, the authorities should consider liberalising the electricity sector ahead of the EU deadline. This would lead to a faster reduction of electricity tariffs. In the telecommunications sector, there are still some barriers in the fixed line sub-sector (voice telephony), where Portugal Telecom enjoys certain privileges. The sector is scheduled to be fully liberalised by January 2000, according to the deadlines set by EU directives.

While progress has been made in reforming the health care sector, much remains to be done

The reform of the health care sector is a priority. To address problems such as increasing health care costs and relatively poor resource allocation, the authorities have taken some measures, but a lot remains to be done. Identity cards have been introduced and the unlimited deductibility of health expenditures has been revised. This is expected to reduce fraud and frivolous demand for health services. A review of the regulatory framework has also started. Measures adopted will allow, *inter alia,* the possibility of "opting-out" of the national health system, which should help reduce overlapping insurance coverage. Other measures, proposed by the government but still requiring parliamentary approval, include the easing of entry restrictions in the pharmacy sector, the elimination of disincentives for the production and sale of generics, and the liberalisation of non-prescription drug sales in outlets other than pharmacies. These proposals go in the right direction and their approval would strengthen competition in private health provision, benefiting consumers and lowering the cost of health care in general. The authorities have also started to introduce new organisational models, such as new remuneration models for general practitioners and new management structures for hospitals, including giving them the status of a public enterprise or introducing private management. These reforms are still in their early "pilot programme" stages, but initial results are encouraging. In time, they should lead to a more efficient provision of health care by the public sector. The authorities should waste no time in widening the scope of these models and implementing new ones nation-wide. A revised financial arrangement for funding health care spending is expected to be sent to Parliament in 2000. This should be complemented by measures that would make budget allocations more therapy-based and give managers more autonomy and responsibility in order to create a hard-budget constraint for public health care institutions. Finally, problems of moral hazard arising from public sector doctors with private practices also need to be addressed.

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Growth would benefit from further enhancement of human capital and infrastructure

The upgrading of human capital and the development of infrastructure are key elements of any approach at boosting sustainable growth of output and employment in the long term. Structural funds received from the EU on an increasing scale over the past ten years or so have contributed to efforts in these areas. These transfers (which as a counterpart have entailed high levels of public investment and social spending, as well as private funding) have been used to co-finance projects improving infrastructure and human resources, and to help the productive sector in areas such as investment and technological innovation. The longer-term supply-side effects of these investments (both in tangible and intangible forms) are likely to be significant, boosting productivity and thereby enhancing real income convergence with average EU levels. Looking ahead, efforts will need to continue within a comprehensive development strategy. The government has prepared a national plan for economic and social development to 2006, that aims at overcoming, within one generation, the economic and social gaps vis-à-vis European partners. In addition, the authorities are finalising the Programme for Regional Development that will be the basis for negotiations of the Community Support Framework 2000-2006 with the EU.

Summing up

Portugal's economic performance has been remarkable in recent years. In 1998, the fifth year of expansion, GDP growth was nearly 4 per cent, the unemployment rate was one of the lowest in Europe, and the general government deficit was close to the euro area average. Although inflation remained relatively high in 1998, it moderated somewhat in the second quarter of 1999. The current account deficit, which is financed in large part by EU transfers, has widened. Portugal's good performance in recent years enabled it to qualify for EMU at its inception, as well as to make progress in the "catching up" of the real economy, with GDP per capita moving closer to the EU average. These results were due to a favourable external environment, but also to the cautious thrust of macroeconomic policy and progress in structural reform. EU membership has also played an appreciable role. EU transfers have had a significant effect in boosting demand, although it is through their supply-side impact that they contribute in the longer term to

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economic performance, by helping to finance the development of human capital and infrastructure. It is important that the authorities pursue the process of fiscal consolidation that is foreseen in the 1999-2002 programme. Achieving the fiscal targets will require considerable efforts, on the structural front in particular, since the programme is based on assumptions of strong productivity growth and increasing labour force participation. While continuing to enhance human capital and the infrastructure, efforts should focus on reform of the health and social security systems, and on the tax system, where an overhaul would seem appropriate. Also, further progress on job policies and more competition in product markets would enable the Portuguese economy to cope more effectively with unexpected developments and to improve the conditions for strong, sustainable growth of output and employment.

I. Recent developments and prospects

The current cycle placed in perspective

The economy entered its sixth year of expansion in 1999, private consumption and investment spending being boosted by rising disposable income, lower interest rates, the rapid growth of domestic credit and the pro-cyclical stance of fiscal policy. Real GDP growth, which had reached 3.7 per cent in 1997, accelerated slightly in 1998 to about 4 per cent, a rate significantly higher than the EMU average (Table 1). There were some signs of a slowdown towards the end of the year, however, resulting from the completion of large infrastructure projects and the disappearance of temporary factors, such as Expo 98, which closed in September. At the same time, export demand was affected by the slowdown of economic activity in Portugal's main economic partners, such as Germany and France, this weakness persisting in early 1999. Household spending continued to grow rapidly, however. Thanks to the buoyancy of employment, the unemployment rate fell, reaching 4.8 per cent in the first quarter of 1999.

The expansion of economic activity in the cycle starting in 1994 has gradually become more broadly based: initially, the recovery was export-led; then, from 1996, an investment boom developed (Figure 1). In 1998, private consumption became the main engine of growth. During this period, the negative contribution of the external balance increasingly placed a brake on activity, the effect being of the same magnitude as at the peak of the previous cycle. Overall, the current cycle has been characterised by a much more modest growth of domestic demand and GDP than in the expansionary phase of the previous cycle (1985-1992). Inflation remained much lower over the past five years and the fall in unemployment occurred later (Figure 2). But the current account balance widened significantly over the past three years, whereas it was close to equilibrium in 1985-1992. Due to the strength of economic growth, the gap between potential and real output, which according to the OECD Secretariat's estimate was close to 2 per cent in 1994 and still ¾ per cent in 1997, had virtually disappeared by 1998. This adjustment contrasts with that in 1985-92, which saw the emergence of a positive gap of over 3 per cent. In 1999, GDP growth is expected to remain close to its potential growth rate according to the OECD Secretariat's estimate. At this

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Table 1. **Macroeconomic performance at a glance**

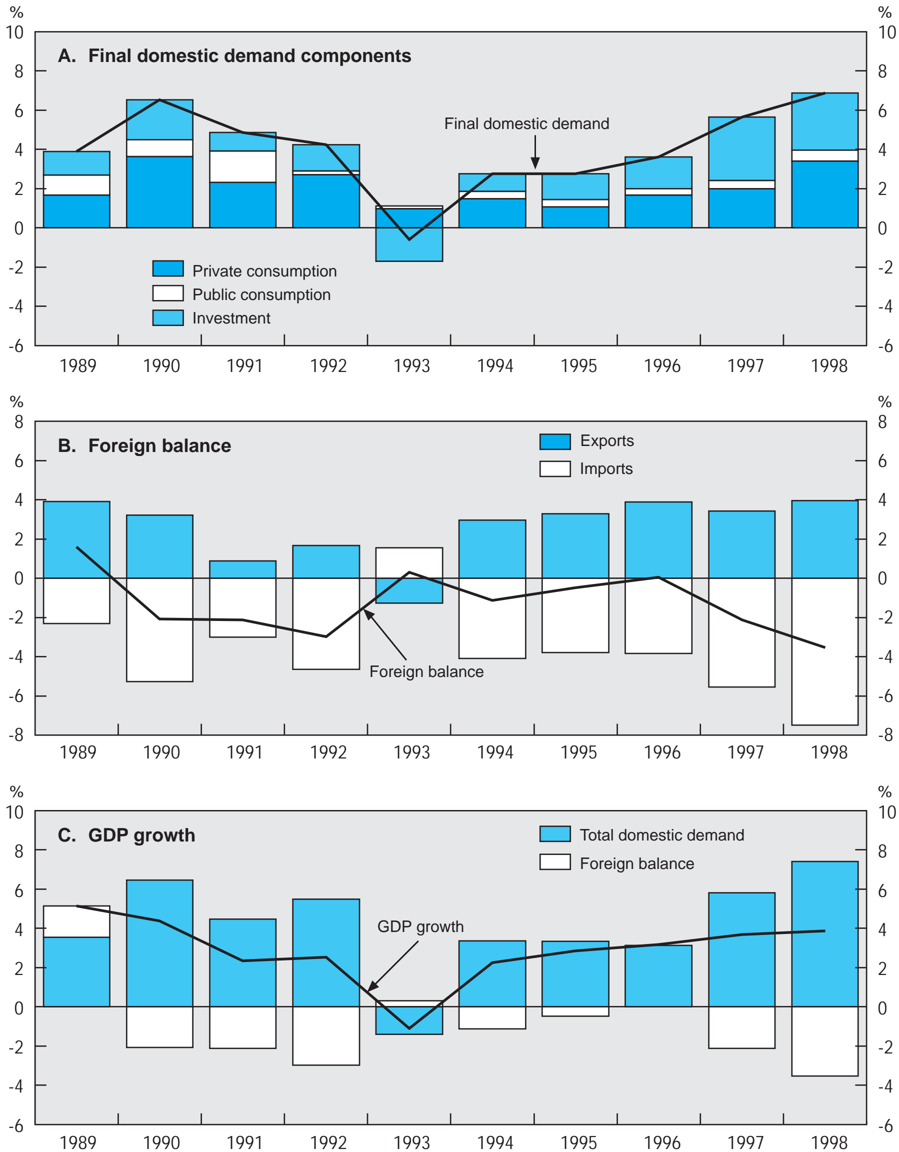
Percentage changes

	Portugal				EMU average			
	1995	1996	1997	1998	1995	1996	1997	1998
Real GDP	2.9	3.2	3.7	3.9	2.1	1.6	2.5	2.9
Total domestic demand	3.0	2.8	5.2	6.5	1.9	1.1	1.9	3.4
Inflation[1]	4.5	3.6	2.0	2.8	2.7	2.5	1.9	1.3
Unemployment rate (per cent)	7.2	7.3	6.7	5.0[4]	11.9	12.3	12.4	11.7
Saving ratio of households[2]	10.3	10.2	10.2	9.6	12.1	11.5	11.3	10.9
General government balance (per cent of GDP)								
Actual	–5.7	–3.3	–2.5	–2.3	–4.8	–4.1	–2.5	–2.1
Cyclically adjusted	–4.8	–2.5	–2.1	–2.1	–4.1	–3.1	–1.6	–1.6
Current account[3] (per cent of GDP)	–0.2	–2.1	–2.7	–4.3	0.7	1.1	1.6	1.4

1. Data refer to the private consumption deflator. In 1998, the average change in the harmonised CPI was 2.2 per cent for Portugal and 1.1 per cent for the EMU average.
2. In per cent of household disposable income.
3. For Portugal, data refer to the old methodology (see Table 3, footnote 4). For EMU, data are based on OECD definitions; intra-euro area trade in goods and services is excluded, but no adjustment is possible for investment income and transfers due to insufficient information.
4. Rate under the new methodology (see Table 5, footnote 3).

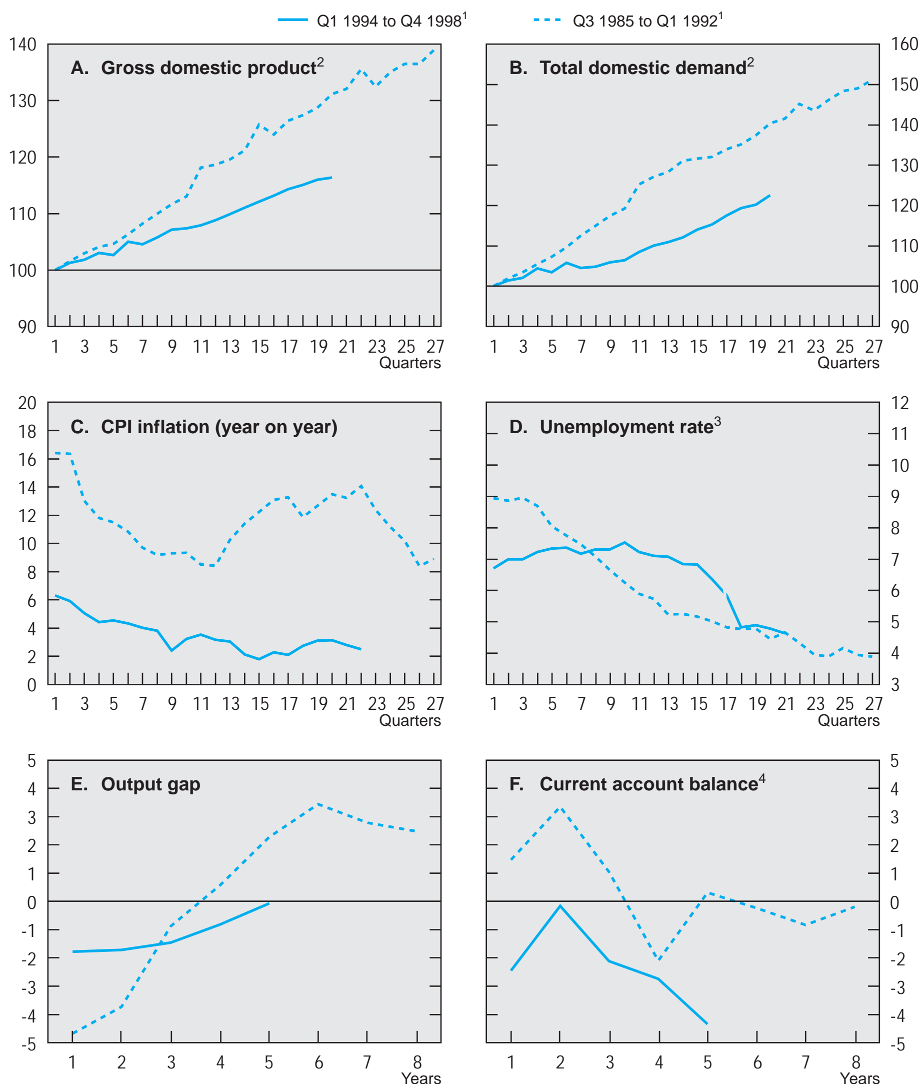
Source: OECD Secretariat.

Figure 1. **Contributions to real GDP growth**[1]
Percentage points



1. Changes as a percentage of real GDP in the previous period. OECD Secretariat estimates for 1998.
Source: OECD Secretariat.

Figure 2. **Comparison of two cycles**



1. Annual data over the two cycles are 1994 to 1998 and 1985 to 1992, respectively. Quarterly data are shown until Q1 1999 for panel D and until Q2 1999 for panel C.
2. Volume indices of seasonally-adjusted data.
3. Data are seasonally adjusted. Break in first quarter 1998 due to changes in the survey methodology.
4. Per cent of GDP; data refer to the old methodology (see Figure 5, footnotes 1 and 2) to allow comparison.

Source: OECD Secretariat.

point in the cycle, the slowing of economic activity is welcome, since it should help to ease demand pressures. The steady trend towards disinflation observed in recent years, in convergence with the other euro area countries, was interrupted in 1998. Having declined to 2.1 per cent in June 1999 (harmonised rate), inflation still remains above the euro area average.

Economic activity is slowing despite buoyant domestic demand

The easing of monetary and fiscal policy underpinned household consumption and private investment in 1998, and output growth accelerated slightly. However, the gradual slowdown in export demand and the disappearance of temporary factors that had also contributed to the expansion, affected growth towards the end of 1998 and early this year.

Boosted by the strong climate of confidence and higher real disposable income, in 1998 household consumption rose at a record rate for the current cycle – estimated at over 5 per cent, compared with 3 per cent in 1997 (Table 2). In 1998, for the second year running, the rise in real disposable income was above 3 per cent, mainly on account of the exceptional dynamism of employment, while real wages continued to rise at a moderate pace. Furthermore, net transfers to households grew significantly, and even though only preliminary estimates are available, it seems likely that the income of the self-employed was boosted by strong output growth. Also, lower interest rates reduced household debt service;[1] consumer credit, which had been rising for several years, grew further, to 10.7 per cent of GDP in 1998 (compared with 5 per cent in 1994). The "feel-good factor" encouraged household consumption, precautionary saving probably decreasing as a result of the fall in unemployment, and there was a fairly marked drop in the saving ratio in 1998. More generally, the household saving ratio has been on a downward trend since the mid-1980s, in conjunction with the liberalisation of financial markets, disinflation, and more recently, the fall in real interest rates. It fell particularly rapidly between 1990 and 1995, probably more so in Portugal than in the other euro area countries (from roughly similar saving ratios in the early 1990s, the ratio in Portugal fell by 5 percentage points overall up to 1998, compared with about 2 percentage points in the euro area). In the first quarter of 1999, private consumption indicators pointed to a slowdown, while the indicator of household confidence, which is usually fairly volatile, signalled no change in trend. In particular, as in the euro area as a whole, household confidence remained at the same favourable level as during 1998; business confidence, in contrast, deteriorated during the first five months of 1999.

Government consumption grew by 3.3 per cent in real terms in 1998, marking an acceleration on the previous year. General government purchases of goods and services, and in particular expenditure on social functions – education

Table 2. **Demand, output and prices**
Percentage changes, volume, 1990 prices

	1995 current prices[1]	1995	1996	1997	1998
Private consumption	10 262.6	1.6	2.5	3.0	5.2
Government consumption	2 795.0	2.2	2.0	2.5	3.3
Gross fixed capital formation	3 734.4	4.8	5.7	11.3	9.5
Private	3 150.4	4.3	4.6	12.3	10.9
Government	584.0	7.6	11.8	6.4	2.4
Final domestic demand	**16 792.0**	**2.5**	**3.3**	**5.1**	**6.1**
Change in stockbuilding[2]	114.9	0.6	–0.5	0.1	0.5
Total domestic demand	**16 907.0**	**3.0**	**2.8**	**5.2**	**6.5**
Exports of goods and services	4 878.8	9.1	10.2	8.4	9.3
Imports of goods and services	5 968.1	7.8	7.5	10.4	13.3
Change in foreign balance[2]	–1 089.3	–0.5	0.1	–2.1	–3.5
GDP at market prices	**15 817.7**	**2.9**	**3.2**	**3.7**	**3.9**
Inflation					
GDP deflator	–	5.1	2.8	3.0	3.4
Private consumption deflator	–	4.5	3.6	2.0	2.8
Memorandum items:					
Household real disposable income	–	1.7	2.0	3.2	3.6
Household saving ratio[3]	–	10.3	10.2	10.2	9.6
Output gap[4]	–	–1.7	–1.5	–0.8	–0.1

1. Billion escudos.
2. As a per cent of GDP in the previous year.
3. In per cent of household disposable income; the household sector also includes the self-employed; estimates as of 1996.
4. As a per cent of potential GDP.

Source: Ministry of Finance; OECD, *National Accounts*; OECD Secretariat estimates.

and health – was the main reason for this increase. Public employment rose moderately, mainly as a result of the hiring of certain employees previously on temporary contracts. As this is no longer a factor in 1999, government consumption has probably grown more moderately since the beginning of the year.

The pick-up in investment occurred with a certain lag after the beginning of the business cycle. Overall, gross fixed capital formation grew by 40 per cent in real terms from its trough in 1993. Boosted from 1995 by major infrastructure projects (including a bridge over the Tagus and the preparation of Expo 98), government investment slowed in 1998. For the past two years, private investment has become the most dynamic component, growing on average by 11½ per cent a year, and stimulated by the buoyancy of domestic activity and the rise in

foreign orders. The pick-up in private investment was facilitated by improved corporate profitability in recent years and by the steady decline in interest rates. Business surveys show that self-financing was the main source of investment for enterprises, followed by bank loans (respectively 54 per cent and 26 per cent of total financing). In recent years, firms saw their net interest payments fall, while their borrowing from banks rose.[2] Purchases of capital goods increased by nearly 14 per cent a year in 1997 and 1998, while capacity utilisation rates rose. Both domestic production and imports of capital goods benefited from the surge in investment. In 1998, the effects of the reduction in public works began to be felt on construction, which fell. But residential investment remained fairly buoyant, with unprecedented rates of increase in the number of building permits issued up to the end of the year. Business surveys indicate that investment demand by manufacturing firms abated at the beginning of 1999, production prospects for investment goods having deteriorated sharply.

Total investment amounted to 27.4 per cent of GDP in 1998, just slightly below the peak of the previous cycle (1989-90) (Table 3). Gross domestic saving, which peaked at 27.5 per cent of GDP in 1989-90, fell until 1995 and then levelled off at about 20 per cent of GDP. Increased public saving in the past few years only partially offset the fall in private saving (households and enterprises), which in 1998 was about 9 points below its level at the end of the previous cycle. Foreign saving (the counterpart of the external deficit) increased steadily over the period, from 1.2 per cent of GDP in 1989-1990 to 6.6 per cent in 1998. Over the same period, there was a significant increase in transfers from the European Union. In the long run, it is likely that EU transfers and emigrants' remittances will decline (these, added to domestic saving, have been a major source of investment financing). By then, however, Portugal should have completed the process of "real" convergence with the EU, and investment needs are expected to be more in line with those in the more advanced EU countries.

Exports of goods and services continued to rise rapidly in 1998 in volume terms, though there was a sharp deceleration in the second half of the year. After five years of strong growth, they were nearly 60 per cent higher than at the beginning of the cycle (at constant prices). There had been a similar boom in exports during the second half of the 1980s, just after Portugal joined the European Community. Import volumes, which had grown more moderately at the beginning of the cycle, accelerated sharply in 1997 and 1998, led by the boom in private consumption and investment. Overall, the negative impact of the external balance, which was modest in 1994-1996, increased to 3.5 percentage points of GDP in 1998. Weaker domestic demand in early 1999, by dampening import demand, could lessen the negative effect of the external balance on growth this year.

OECD 1999

Table 3. **Aggregate saving and investment**[1]

Percentage of GDP

	1989-90	1991-93	1994	1995	1996	1997	1998
Gross capital formation	**28.7**	**25.3**	**23.9**	**24.3**	**24.5**	**26.3**	**27.4**
Gross domestic saving	**27.5**	**22.5**	**19.4**	**19.7**	**20.3**	**20.9**	**20.8**
Private	27.7	23.8	22.3	22.1	20.0	19.9	18.9
Public[2]	–0.2	–1.3	–2.9	–2.4	0.3	1.0	1.9
Foreign saving	**1.2**	**2.8**	**4.4**	**4.6**	**4.2**	**5.4**	**6.6**
Memorandum items:							
Household saving (in per cent of GDP)[3]	12.3	11.7	7.8	8.0	7.4	7.3	6.7
Current plus capital account of the balance of payment[4]	–	–	–	–	–2.1	–2.7	–4.3

1. Saving and investment data are based on the national accounts for 1989-95; as of 1996 data are Bank of Portugal estimates.
2. General government; data for 1996 to 1998 are estimates based on the budget.
3. The household sector comprises households (including the self-employed) and private non-profit institutions.
4. The balance of payments statistics for the years 1996-98 were reformulated at the start of 1999 in order to incorporate the methodological recommendations of the 5th edition of the IMF Balance of Payments Manual. In the new presentation, the current, capital and financial accounts are presented separately. The current account preserves the contents of the previous current account, excluding basically capital transfers (mainly EU structural transfers). The capital account includes these capital transfers and also the acquisition/disposal of new non-produced non-financial assets. In this sense, the new current and capital accounts correspond to the previous current account concept. There were other data revisions reflecting improved coverage and quality of statistical information. Balance-of-payments statistics previous to 1996 still await the same kind of revisions, and so cannot be compared with data for the recent past. This implies that, at the moment, there is a break in the series for Foreign Saving.

Source: Ministry of Finance; Bank of Portugal; OECD, *National Accounts,* OECD Secretariat estimates.

The unemployment rate has fallen and stabilised at a low level

With a certain time lag following the pick-up in activity, the labour market has shown signs of improvement in the past two and a half years, having benefited in 1998 from particularly favourable, but partly temporary, factors, including Expo 98. According to the preliminary estimates available, employment has grown in 1998 and early 1999 at an annual rate of about 2.5 per cent, spurred by the boom in the construction sector and services (Table 4).[3] In industry by contrast, employment growth has been less buoyant, especially as a result of the ongoing restructuring in the textiles and clothing sectors, a process which has been

Table 4. **Labour market indicators**

Percentages

	1993	1994	1995	1996	1997	1998[1]	1999 Q1
	Percentage changes from a year earlier						
Civilian labour force	–0.5	1.3	–0.3	0.7	1.4	0.6	1.2
Employment, total	–2.0	–0.1	–0.6	0.6	1.9	2.5	2.5
Male	–2.6	–0.5	–0.9	0.5	1.6	1.6	1.8
Female	–1.1	0.4	–0.3	0.7	2.3	3.7	3.3
Agriculture	–1.6	1.6	–2.6	8.5	13.7	–3.1	–4.0
Industry	–2.7	–0.4	–2.1	–2.1	2.6	0.6	1.8
Services	–1.6	–0.2	0.7	0.6	–1.0	5.3	4.5
Dependent employment	–2.8	–2.0	–1.0	–0.4	1.4	3.9	4.1
	Per cent						
Participation rate[2]	67.7	67.5	67.2	67.5	68.5	70.3	–
Male	77.2	76.4	75.4	75.5	76.4	78.5	–
Female	59.0	59.3	59.4	59.9	61.1	62.5	–
Unemployment rate, total[3]	5.5	6.8	7.2	7.3	6.7	5.0	4.8
Male	4.7	6.0	6.4	6.5	6.1	4.0	4.0
Female	6.5	7.8	8.0	8.2	7.6	6.2	5.7
Youth (15-24)	12.7	14.7	16.1	16.7	14.8	10.3	9.8
Long-term unemployment[4]	29.3	34.2	39.3	42.0	43.6	45.3	–
Type of employment (per cent of total)							
Full-time	92.8	92.4	92.5	91.3	90.0	89.1	89.1
Part-time	7.2	7.6	7.5	8.7	10.0	10.9	10.9
Job vacancies/total labour force	0.13	0.12	0.16	0.17	0.22	0.25	–

Note: Data for employment refer to the quarterly labour force surveys.
1. The sample used until 1997 represents persons of 14 years and over. Since 1998 it represents persons of 15 years and over. For 1998, growth rates are second half of 1998/second half of 1997; ratios in per cent are annual averages.
2. As a per cent of the working-age population.
3. As a per cent of the labour force of the group or age group. Break in series in 1998. (Rate shown under the new methodology is about 3/4 percentage point below the rate under the previous methodology.)
4. 12 months and over as a per cent of total unemployment.

Source: Ministry of Labour and Solidarity.

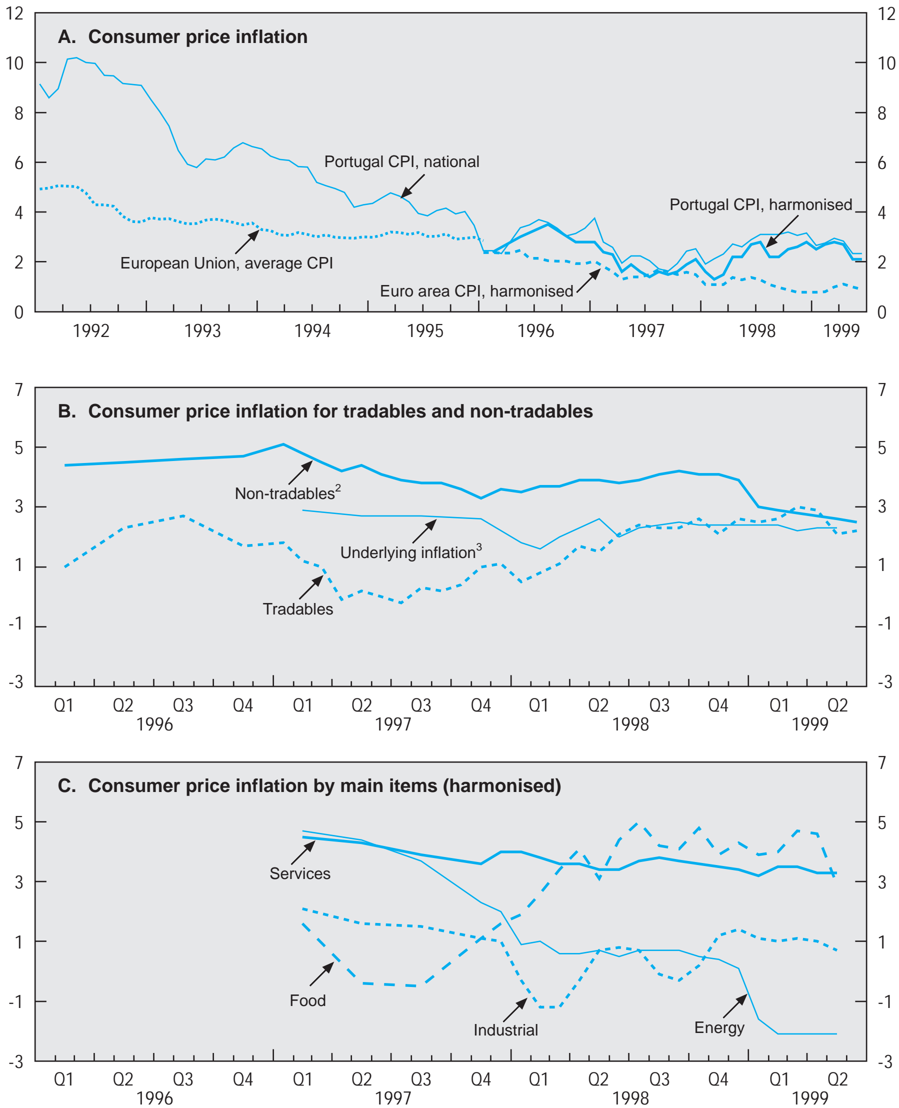
underway since the early 1990s. Dependent employment was the main beneficiary of the expansion in 1998 and early 1999, growing by nearly 4 per cent (annual rate) – essentially in the form of fixed-term contracts. The proportion of indefinite-term contracts, which had been declining for several years, stabilised. Self-employment fell, reversing the trend in previous years; but its share in total employment (about 26 per cent) is still higher than in most European OECD countries, with the exception of Greece and Turkey. The proportion of part-time work continued to increase in 1998, but at around 11 per cent of total employment, it remained one of the lowest in the OECD. In the first quarter of 1999, in spite of the slowdown in economic activity, employment growth remained buoyant, in particular in the services sector and in construction activity.

The steady growth of employment since 1997 resulted in quite a marked fall in unemployment. Participation rates also picked up, reflecting the arrival on the labour market of the youth and male categories of labour, the decline of which in previous years probably reflected, in part, "discouragement" effects resulting from the sluggish labour market.[4] The unemployment rate was down by 0.6 percentage point in 1997 from a year earlier. A break in the series at the beginning of 1998 affects labour market data. From the data available, a further improvement in the situation can nonetheless be inferred thereafter, with the unemployment rate falling to 4.8 per cent in the first quarter of 1999. On an annual average basis, unemployment was thus cut to a rate close to the structural rate (estimated by the OECD Secretariat to be 5 per cent for a comparable definition).[5] The youth unemployment rate, which is one of the lowest in Europe, was particularly sensitive to the improvement in the economic situation. Down sharply from its peak in 1996 (16.7 per cent), it averaged 10.3 per cent in 1998, falling further in the first quarter of 1999. Even though the overall unemployment rate in Portugal is not particularly high compared with other European countries, the impact of long-term unemployment has long been a matter of concern; it had risen steadily until mid-1998, but declined in the second half of that year.[6] The implementation of structural reforms in line with the *OECD Job Strategy*'s recommendations should improve the working of the labour market and by the same token reduce long-term unemployment, or at least make it possible to consolidate the progress made to date (see Chapter IV).

The process of disinflation was interrupted in 1998, temporary factors having played a major role

The process of inflation convergence under way since the start of the decade was practically completed in 1997, when the rise in consumer prices averaged 1.9 per cent (harmonised rate) compared with 1.6 per cent for the euro area (Figure 3, panel A). In 1998, disinflation was interrupted and the 12-month

Figure 3. **Inflation developments**[1]
Percentage changes



1. Year-on-year rates.
2. Including services and construction.
3. Excluding food and oil products.

Source: Bank of Portugal; INE; OECD Secretariat.

rise in the consumer price index reached 2.8 per cent in December, compared with 0.8 per cent in the euro area.[7] However, by June 1999, the inflation rate had declined to 2.1 per cent (year-on-year). Temporary factors, in particular the behaviour of food prices, played a major role in inflation developments over the last 1½ years. The inflation gap with the euro area, which widened in 1998 and narrowed in the first half of 1999, was also affected by the response of the Portuguese authorities to changes in world crude oil prices, which differed from those of most other euro area countries.[8] Reflecting these factors, as well as the exchange rate depreciation in 1997, the price of tradable goods rose sharply in 1998, but then came down again during the first half of 1999. Prices of non-tradables were also affected by special factors in 1998: the steep hike in university fees in January 1998, which affected education prices; Expo 98, which put pressure on hotel and catering prices. With the disappearance of these factors, the rise in the price of non-tradable goods and services slowed in the first half of 1999. The underlying inflation rate, which excludes food and energy prices, has remained broadly stable for the past couple of years.

The inflation differentials for the main components of the CPI between Portugal and the rest of the euro area have reflected these various factors. In contrast with Portugal, there was no exceptional increase in food prices in the euro area in 1998. Consumer prices for industrial products, which are subject to the keenest competition, remained virtually flat in 1998 and early 1999 in both Portugal and the euro area. In contrast, over that same period, the prices of services rose more sharply in Portugal than in the euro area.[9] In 1998, this partly reflected Portugal's cyclical position in relation to the other countries and the pressures created by Expo 98. Beyond these short-term phenomena, differences in the inflation rate may persist during the process of catching-up from lower price levels. Indeed, for economies at the same stage of development in the euro area, lasting inflation gaps are unlikely to accumulate and create large differences in price levels. But inflation gaps could persist during a period of catch-up between less advanced economies in terms of productivity – among which Portugal – and more advanced economies. During this period, real wages may grow at a higher rate than in more advanced countries. Consumer prices will rise more rapidly, since the price level in the sector that is not exposed to competition – which is comparatively low – will tend to converge with that of prices in other EU countries.[10]

The buoyancy of the labour market in the past two years does not seem to have put excessive pressure on wages. Contractual wage increases slowed, from 3.6 per cent in 1997 to 3.3 per cent in 1998 (Table 5). In the first five months of 1999, they were still between 3 and 3½ per cent. There was also some slowdown in effective wages – with rises respectively of 5.1 and 4.8 per cent in 1997 and 1998 (1999 data are still incomplete). The gap between effective and contractual wage increases tends to vary from one year to the next. This is one of the

Table 5. **Wages and labour costs**

Percentage changes

	1993	1994	1995	1996	1997[1]	1998[1]
Average earnings[2]	6.4	5.9	6.2	6.3	5.1	4.8
Contractual wages[3]	7.4	5.0	4.7	4.5	3.6	3.3
Minimum wage[4]	6.5	4.0	5.5	5.0	3.8	3.9
Compensation per employee						
Total economy	8.5	5.9	6.9	6.3	5.3	5.8
Manufacturing	8.3	6.6	5.6	5.0	5.6	5.1
Labour costs per unit of output						
Total economy	7.9	2.4	3.7	3.6	3.3	4.0
Manufacturing	7.6	2.8	–1.9	0.9	0.7	2.4
Memorandum items:						
CPI	6.8	5.4	4.2	3.1	2.3	2.8
Real average earnings	–0.4	0.5	1.9	3.1	2.7	1.9
Labour productivity (total economy)	0.6	3.4	3.1	2.6	1.9	1.7

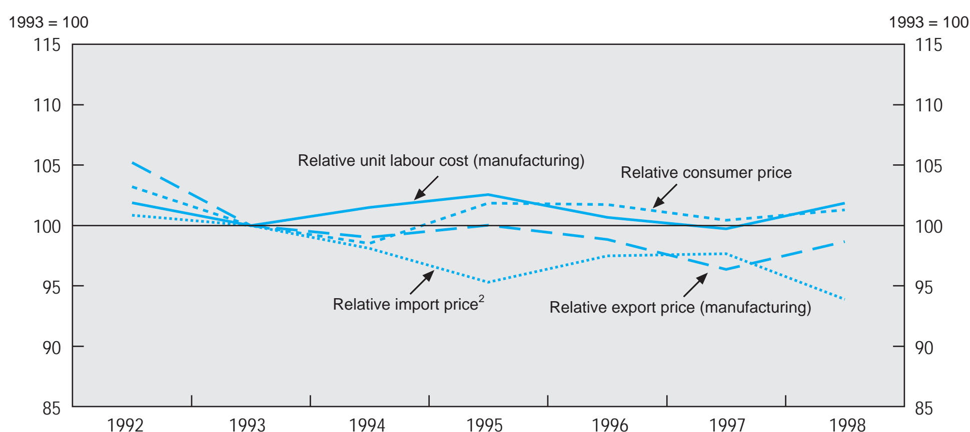
1. Estimates.
2. Excluding public administration and non-market services.
3. Contractual wage rates in the non-agricultural sector.
4. Minimum wages for workers 18 and over, in the non-agricultural sector; the minimum wage is set to rise by 4.1 per cent in 1999.

Source: Ministry of Labour and Solidarity; Ministry of Finance; INE; OECD Secretariat.

factors that gives nominal wages a high degree of flexibility to labour market conditions.[11] The pick-up in inflation in 1998 implied a more marked slowdown of wage earnings in real terms, with real wage growth down to 1.9 per cent in the private sector. This relative wage restraint – even though the unemployment rate had fallen to a historical low – was probably due in part to the nature of the jobs created. In 1998, job creations were concentrated in construction and the services sector, especially tourism, most of them involving fixed-term contracts.

In manufacturing, the growth of per capita compensation slowed somewhat. But productivity gains did not keep pace with wage growth, so that unit labour costs increased slightly. Portugal's competitive position hardly changed between 1992 and 1998, but the effects of the massive depreciation of the currencies of the emerging Asian economies – whose weight as exporters to the euro area has risen significantly in the past fifteen years – were nonetheless reflected in a small deterioration in 1998. The various indicators give a mixed picture of Portugal's cost-price competitiveness compared with the early 1990s. On the one hand, relative unit labour costs in manufacturing and relative consumer prices are still close to their level at the start of the decade. On the other, manufacturing relative export unit values suggest a slight improvement in Portugal's competitive position over the period (Figure 4). In assessing these trends, it is necessary to take account of the fact that Portugal's cost and price levels were initially lower

Figure 4. **Portugal's competitive position**[1]



1. Indices in common currency. An increase indicates a loss in competitiveness, except for relative import prices for which it indicates a gain of competitiveness.
2. Index of Portugal's import unit values divided by the deflator of Portugal's global demand (total domestic demand and exports).

Source: OECD Secretariat.

than in most OECD countries. Furthermore, in the period following Portugal's accession to the European Community, the remarkable export boom was due to other factors besides cost-price competitiveness, including the effects of large-scale investment, which helped structural adjustment.

The foreign balance has worsened

The more advanced position of Portugal in the business cycle compared with several of its main trading partners, caused the trade deficit to widen in 1998, despite an improvement in terms of trade; the current account deficit rose to 6.6 per cent of GDP from 5.4 per cent in 1997 on the new balance-of-payments methodology.[12] The financial account showed very large inflows, mainly due to the increase in banks' liabilities *vis-à-vis* foreign banks, which more than offset net direct investment outflows. The errors and omissions items also showed a moderate deficit, so that overall international net reserves hardly changed. In the first four months of 1999, the trade deficit and the current account deficit were higher than their levels a year earlier (Table 6).

Table 6. **Summary balance of payments**[1]

Billions of escudos

	1996	1997	1998[2]	1998 Jan.-Apr.	1999 Jan.-Apr.
Current account	**–701**	**–962**	**–1 296**	**–453**	**–528**
Trade balance	–1 446	–1 761	–2 200	–667	–748
Invisible balance	745	799	905	214	220
Capital transfers	**346**	**470**	**459**	**119**	**106**
of which: official	346	458	459	–	–
Financial account	**566**	**925**	**1 098**	**493**	**605**
Direct investment (net)	91	107	–206	–18	–24
Portfolio investment (net)	–234	357	27	–375	4
Other investment	827	685	1 352	812	557
Financial derivatives	–4.6	–4.0	20.2	13	6
Official reserve assets[3]	–113	–220	–96	61	63
Errors and omissions	**–211**	**–433**	**–261**	**–159**	**–183**
Total	0	0	0	0	0
Memorandum items:					
Short-term assets of banks	–102	–1 184	–682	–62	710
Short-term liabilities of banks	1 073	1 552	1 835	857	–330

1. New methodology (see Table 3, footnote 4).
2. Provisional.
3. – = increase in reserves.

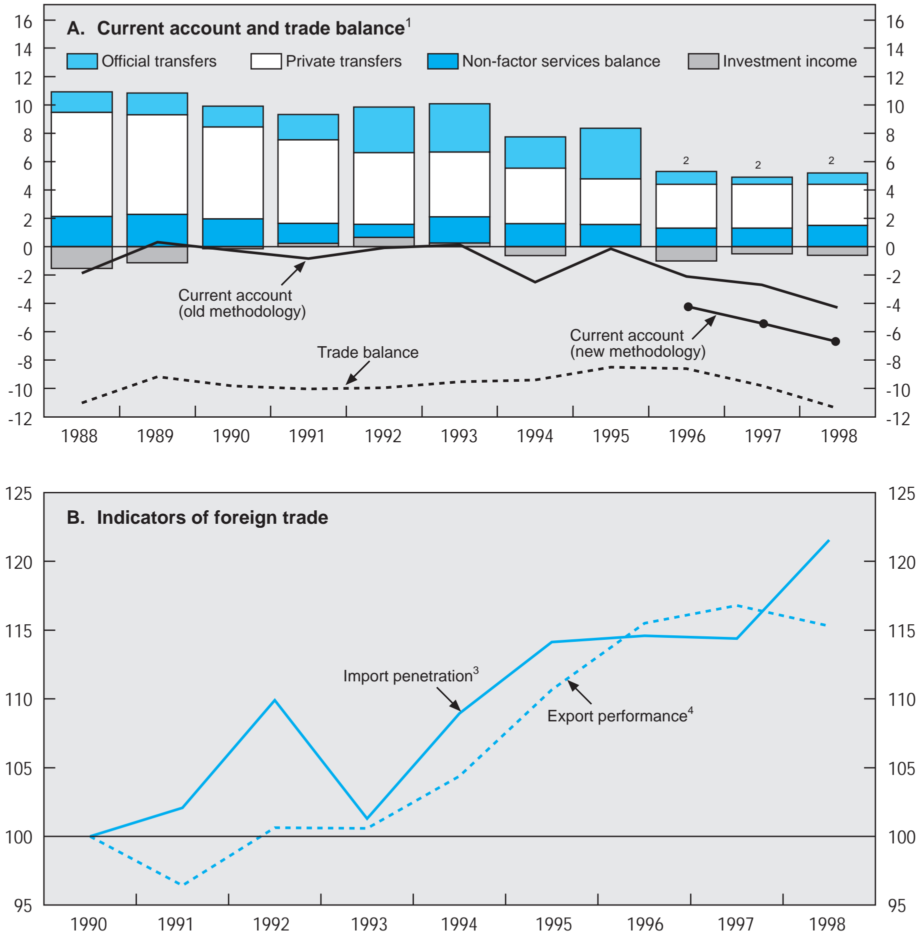
Source: Bank of Portugal.

Current account balance

The current account deficit has widened in recent years, from 4.2 per cent in 1996 to 6.6 per cent in 1998, following a considerable worsening of the trade balance, while the surplus on invisibles remained markedly positive (Figure 5). Import penetration, which had stabilised between 1995 and 1997, increased in 1998 due to strong consumption and private investment growth, with households' automobile purchases expanding at unprecedented rates. In addition, the fall in agricultural production swelled food imports that year, in the context of falling import prices measured in escudos. The trade deficit thus rose to 11.3 per cent of GDP in 1998.

Merchandise exports were still rising briskly in early 1998, but after the summer, slower demand in the EU, the destination of 81.5 per cent of Portugal's exports, checked their growth. After some gains in market share in 1997, manufacturing exports slowed in 1998 to below the growth of Portugal's export markets. Portugal, by virtue of its product specialisation, is exposed to competition from Asian countries in third markets – especially from China, Indonesia and Hong Kong, China, whose exports are concentrated on products with relatively low

Figure 5. **Foreign trade and the current account**
Per cent of GDP



1. As of 1996, the current account balance is presented under both the old and the new methodology. Its components are presented under the old methodology until 1995 (included), and under the new methodology thereafter.
2. Under the old methodology, all transfers (private and official, current and capital) were recorded in the currento account. Under the new methodology, current tranfers (private including migrant's remittances and official) are still recorded in the current account; while capital transfers (private and official) are recorded in the capital account.
3. Volume index of Portugal's imports divided by index of Portugal's global demand (total domestic demand and exports).
4. Volume index of Portugal's manufactured exports divided by volume index of Portugal's export market.

Source: Bank of Portugal; OECD Secretariat.

technology content (textiles, clothing, footwear and other consumer goods).[13] Although indicators of overall competitiveness do not show a clear deterioration, this specialisation may have contributed to the loss of market share in 1998. Exports of machinery, cars and chemicals (representing nearly 40 per cent of exports) continued to grow at year-on-year rates of above 15 per cent by volume, but no increase was recorded in clothing and footwear exports (21 per cent of exports). In January-April 1999, total merchandise exports remained practically unchanged in value terms from the same period a year earlier. The terms of trade improved overall in 1998, as Portugal, like other net oil importers, benefited from the drop in world crude oil prices, but the trend was reversed at the start of 1999.

The annual surplus on the invisibles account (services income and net transfers) has been more or less stable at 4.5 per cent of GDP since 1996 (Table 7). It consists of three main items: *i)* net tourism revenues, which rose from 400 billion

Table 7. **Current account of the balance of payments**[1]

Billions of escudos

	1996[2]	1997[2]	1998[2]	1998 Jan.-Apr.	1999 Jan.-Apr.
Imports, f.o.b.	5 381.3	6 106.7	6 880.8	2 250.2	2 333.7
Exports, f.o.b.	3 935.7	4 346.0	4 680.5	1 582.9	1 585.2
Trade balance	**–1 445.6**	**–1 760.7**	**–2 200.3**	**–667.3**	**–748.4**
(In per cent of GDP)	(–8.6)	(–9.9)	(–11.3)	–	–
Invisible balance	**744.6**	**798.9**	**904.8**	**214.2**	**220.1**
Services	218.2	234.0	284.2	11.5	31.2
Transport	–49.8	–63.5	–66.4	–23.5	–28.5
Travel and tourism	387.2	430.9	523.6	105.2	92.6
Other private services	–83.1	–102.4	–132.0	–56.1	–24.2
Government services	–36.1	–31.0	–41.0	–14.1	–8.7
Factor income	–155.5	–78.7	–105.6	–47.9	–22.0
Labour income	7.3	4.6	13.1	1.4	1.6
Investment income	–162.8	–83.3	–118.7	–49.3	–23.6
Transfers	681.9	643.6	726.2	250.6	210.9
Official	154.3	86.2	153.0	71.3	24.6
Private	527.6	557.4	573.2	179.4	186.3
Current account	**–701.0**	**–961.8**	**–1 295.5**	**–453.1**	**–528.3**
(In per cent of GDP)	(–4.2)	(–5.4)	(–6.6)	–	–
Memorandum item:					
Total transfers[3]	1 027.6	1 109.4	1 182.4	369.6	316.9
(In per cent of GDP)	(6.1)	(6.2)	(6.2)	–	–

1. New methodology (see Table 3, footnote 4).
2. Provisional.
3. Private and official, current and capital.

Source: Bank of Portugal.

escudos in 1996 and 1997 to more than 500 billion in 1998 (2.7 per cent of GDP), thanks mainly to Expo 98; *ii)* emigrant workers' remittances, which averaged 3 per cent of GDP over the past three years; *iii)* current official transfers (mainly EU transfers), amounting to slightly less than 1 per cent of GDP per year over the past three years. The other components of the invisibles account are small compared with these three items, and vary little from one year to the next. If capital transfers, which are now recorded in the capital balance, are included, net EU transfers represented 3.1 per cent of GDP in 1997 and 1998, the amount having doubled since 1995, with the implementation of the Delors II plan and the cohesion plan for the four least rich EU countries.[14] In conclusion, in the past few years, half of the trade deficit has been financed by transfers (private, official, current, and capital), the remainder being financed primarily by tourism and capital inflows.

Financial account

In the period 1996-98, Portugal recorded large net capital inflows, mainly involving capital transactions.[15] Portuguese banks' net foreign assets fell steeply as a result of the increase in their short-term liabilities, principally *vis-à-vis* foreign banks. For a few years, from 1995 to 1997, the direct investment balance was moderately positive (after having been in large surplus at the end of the 1980s and the start of the 1990s). But in 1998, this item moved into deficit, due to the fact that Portuguese outward direct investment expanded strongly while inward direct investment, after expanding fairly strongly in 1997, returned to a more moderate level in 1998.[16] Brazil was again a major investment destination, attesting Portuguese firms' growing interest in the privatisation of state enterprises in that country. In 1998, as in previous years, most of Portuguese direct investment abroad was made by non-financial enterprises, with the financial sector also a major outward investor. Concerning foreign direct investment in Portugal, most of the inward flows went to the financial and manufacturing sectors. Portfolio investment flows – traditionally more volatile – moved from a deficit in the mid-1990s to a surplus in 1997, returning to close to equilibrium in 1998. Transactions in negotiable paper between residents and non-residents continued to rise, in line with the trend of the past few years, reflecting Portugal's growing integration in international financial markets. In 1998, furthermore, financial transactions were probably boosted by the official announcement in May that Portugal would participate in the third phase of EMU; this affected public debt management in particular (Chapter II) and offered Portuguese and foreign investors new investment opportunities with a reduced exchange rate risk. The errors and omissions item – which is usually considered to consist essentially of capital movements – has continuously shown a deficit since 1995. As net flows of all these items of the balance of payments almost offset one another, international net reserves hardly changed in 1998 and in early 1999.

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The short-term outlook is relatively favourable

Real output growth is likely to slow, easing to a still respectable rate of just over 3 per cent in 1999 and 2000 (Table 8). Following its surge last year, total domestic demand may grow more slowly, pulled by private consumption, but with only a slight fall in the saving ratio. This ratio may then stabilise at the relatively low level reached in the recent period. Low interest rates will help to sustain private investment, but public spending, after two years of expansion, is unlikely to contribute significantly to growth in 1999 – the surveys on investment intentions for this year indeed show a marked divergence between private and

Table 8. **Short-term projections**

Percentage changes, volume (1990 prices)

	Estimates 1998	Projections	
		1999	2000
Demand and output (volume)[1]			
Private consumption	5.2	3.8	3.1
Government consumption	3.3	2.8	2.5
Gross fixed capital formation	9.5	6.3	7.0
Final domestic demand	6.1	4.3	4.1
Change in stockbuilding[2]	0.5	–0.2	0.0
Total domestic demand	**6.5**	**4.1**	**4.1**
Exports of goods and services	9.3	6.3	7.3
Imports of goods and services	13.3	7.3	7.8
Change in net exports[2]	–3.5	–1.7	–1.6
GDP at market prices	**3.9**	**3.1**	**3.2**
Inflation			
GDP deflator	3.4	2.9	2.5
Private consumption deflator	2.8	2.5	2.3
	Per cent		
Unemployment rate	5.0	5.0	5.0
Household saving ratio[3]	9.6	9.1	9.1
Current account balance (per cent of GDP)			
New methodology	–6.6	–	–
Old methodology[4]	–4.3	–4.5	–4.7

1. At 1990 constant prices.
2. Contributions to GDP growth (as a percentage of previous year's GDP).
3. As a percentage of disposable income; the household sector also includes the self-employed.
4. Under the old methodology, all transfers from the EU (current and capital) were recorded in the current account (see Table 3, footnote 4).

Source: *OECD Economic Outlook 65*, June 1999.

state-owned enterprises. Real export growth, reflecting the slowdown that occurred in Europe in late 1998 and early 1999, is likely to be more moderate for this year as a whole. But the expected pick-up in demand in the European countries during the second half of 1999 should lead to an export recovery continuing into next year. Given the openness of the Portuguese economy, the sharp deceleration in domestic demand relative to 1998 will lead to a corresponding slowdown in imports, so that the contribution of net exports to growth, which was substantially negative last year, should be much less so in 1999 and 2000.

With growth close to its potential as estimated by the OECD Secretariat, the output gap, which closed over the past two years, should remain at around zero in 1999 and 2000. The unemployment rate should therefore remain stable close to 5 per cent, with employment growth slowing. Job creation is nevertheless likely to continue in services and construction. Some moderation of wage growth is expected. Admittedly, the pick-up in inflation at the end of 1998 may affect wage rounds this year – the increase in the minimum wage for 1999 was 4.1 per cent, a little steeper than in the two previous years – but the data available at the beginning of 1999 did not indicate any significant shift of trend in pay agreements. In addition, the loss of momentum in the labour market since the end of 1998 should serve to limit wage drift. Inflation, measured by the private consumption deflator, is projected to be moderate in 1999 as a whole with the disappearance of the special factors that operated last year, but is likely to remain above the average for the euro area.

The projections presented here (as published in the *OECD Economic Outlook* 65 of June 1999) are based on the following assumptions:

- The fiscal policy stance will be slightly restrictive, with the general government deficit narrowing to 1.8 per cent of GDP in 2000 (compared with 2.3 per cent in 1998);[17] the cyclically-adjusted balance will improve by ½ per cent of GDP over two years.
- Monetary conditions will be easy, on the assumptions made for the euro area.
- Portugal's export market growth for manufactures will slow significantly in 1999 but pick up next year.[18]
- With the upturn in world prices for crude oil, no significant improvement in the terms of trade is expected over the projection period.

The uncertainties attaching to the projection chiefly concern the external sector. Exports of consumer goods (about one-third of merchandise exports) are liable to two risks. First, there could be an unexpected deterioration in consumer confidence, with a consequent rise in the saving ratio in Europe. Second, although it has been assumed that Portugal's global market share will remain unchanged, the possibility of a further fall in Portuguese export market shares cannot be excluded. Furthermore, the persistence of a wide differential in domestic demand

growth between Portugal and its partners could adversely affect the trade balance more rapidly than expected. On the domestic front, the risks seem less pronounced. The closing of the output gap in 1998 warranted fears of overheating and stronger demand pressures, especially since Portugal no longer has the monetary tools with which to dampen expectations. And there was indeed a risk that the spurt in inflation in 1998 would trigger a price-wage spiral. But the externally induced slowdown in growth, together with the disappearance of the special factors represented by the conclusion of major infrastructure projects and Expo 98, should be useful in this regard, since they lessen the risks of overheating.

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II. Macroeconomic policy

In the years preceding 1997, the overriding goal of the Portuguese authorities was to meet the Maastricht criteria and thereby to participate in the Economic and Monetary Union (EMU) from its inception. After several years of reductions in the budget deficit, accompanied by a downward convergence of interest rates and inflation amidst exchange rate stability, this goal was successfully achieved. Compared with other European countries, the process of deficit reduction was made easier in Portugal by a sharp increase in current revenues, associated with the cyclical strength of the economy and substantial yields from better tax collection. This created a virtuous circle that allowed for a rapid reduction in interest rates and a marked drop in public debt servicing costs. Also contributing to the good Portuguese macroeconomic performance in the run-up to EMU was the large-scale privatisation process: this generated revenues equivalent to 6.2 per cent of GDP between 1994 and 1997, a large share of which was used for debt redemption. As a result, Portugal was the only prospective euro country where the budget deficit criterion was met in the context of rising primary expenditures.

Since 1997, the main challenge facing the Portuguese authorities has been to prevent overheating and the emergence of excessive internal and external imbalances. For Portugal, EMU membership has implied a progressive easing of monetary conditions, culminating in a sharp drop in interest rates in late 1998, followed by a further decline in euro rates in early 1999. This major monetary easing took place when the economy was in a more advanced position in the business cycle than the euro area as a whole, with booming domestic credit creation, rising inflation, and a widening current account deficit. On the whole, the policy mix was inadequate and fiscal policy did not contribute to cooling domestic demand in 1998. Although the budget deficit was slightly smaller than targeted, on a cyclically-adjusted basis – adjusting for the impact of economic activity – the deficit remained broadly unchanged and the primary surplus narrowed significantly. Fiscal policy is geared towards meeting the requirements of the Stability and Growth Pact, which calls for medium-term budgetary balance or surplus. To achieve this, Portugal's Programme for 1999-2002 envisages a drop in

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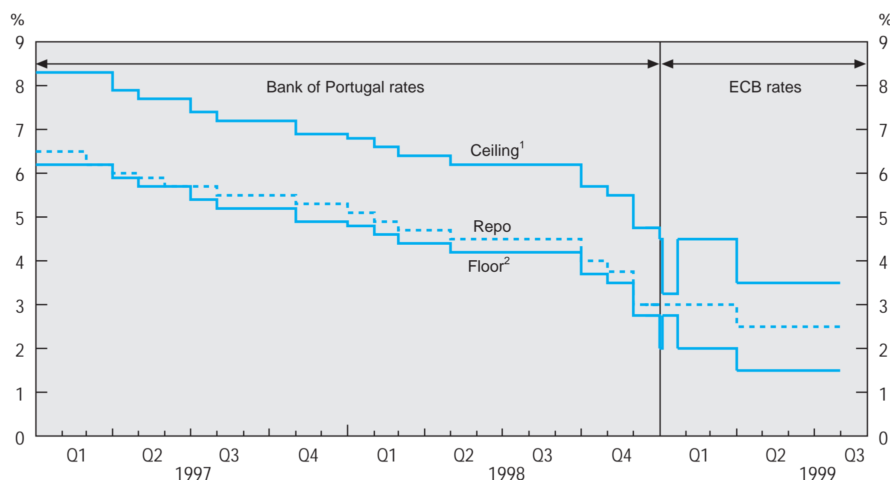
the general government borrowing requirement to 0.8 per cent of GDP by the end of the period, in the context of robust economic growth. Since fiscal policy is now practically the only macroeconomic policy tool available to the Portuguese authorities, it is essential to fully meet the budget targets. Furthermore, if the risk of overheating arose, the government would have to consider going beyond the targets in order to ensure that Portugal remains on a sustainable non-inflationary growth path.

Monetary policy

Monetary and exchange rate policies

For monetary policy, 1998 was a transition year. Although the Bank of Portugal still had the institutional autonomy to freely set interest rates at the national level, in practice, monetary policy was constrained by the need for policy-controlled rates to converge with those in other euro countries. Between January and May, when Portugal's participation in the first group of countries adopting the euro was confirmed, the Bank of Portugal reduced the rate on regular operations (the "repo" rate) from 5.3 to 4.5 per cent in four steps, bringing

Figure 6. **Policy-controlled interest rates**



1. Provision of liquidity rate.
2. Absorption of liquidity rate.

Source: Bank of Portugal; ECB.

the differential with the German "repo" rate down to 1.2 percentage points. Between May and October however, no reductions took place (Figure 6). Concerns about inflation – which started to move up in February 1998 and continued on an upward trend during the summer – are likely to have played a role in the Bank of Portugal's decisions to delay rate cuts. The pause in monetary easing was also in part associated with the turbulence in international financial markets, and as such it mirrored developments in other prospective euro countries, such as Italy and Spain. Convergence resumed in mid-October: in three steps in the space of seven weeks, the Bank of Portugal's repo rate was decreased by 1.5 percentage points. The last step, on 3 December 1998, was taken in a co-ordinated fashion with other prospective euro area countries that, with the exception of Italy, brought the "repo" rate down to 3.0 per cent. Subsequently, this rate was reduced (in April 1999) to 2.5 per cent by the European Central Bank.

Market rates continued to follow official rates down in 1998 and early 1999. Shorter maturities experienced a steep decline, as the money market differential with core EMU countries narrowed to zero by the time the euro was introduced. Long-term interest rates also fell sharply: yields on 10-year government bonds came down from 5.4 per cent in January 1998 to 3.9 per cent in January 1999, as the "flight to quality" in international financial markets led to significant capital inflows into Portugal and several other OECD countries (Figure 7, Panel A). Since then, however, Portuguese long-term interest rates have rebounded, like those in other euro countries, reaching 4.8 per cent at the end of June. The differential between the yields on German and Portuguese 10-year government bonds has remained relatively constant since late 1997 at between 20 and 40 basis points (Figure 7, Panel B). World-wide financial turbulence led only to a minor widening of this differential during the summer of 1998, but by October it had fallen back to pre-crisis levels. Present differentials seem consistent with differences in liquidity and credit risk and are similar to those experienced by other smaller euro-11 countries.

As was also the case for the other prospective EMU currencies, the convergence of the escudo towards its ERM central parity in 1998 took place smoothly. In the case of Portugal, this convergence meant an exchange rate depreciation of about 1.5 per cent against the Deutschmark in the year to September 1998, since the escudo had stayed consistently above its bilateral central rate against the German currency until then. Over the rest of 1998, the escudo fluctuated little against the Deutschmark, remaining close to the fixed bilateral parity. The effective exchange rate of the escudo declined by 1.2 per cent during 1998 and a further 1.7 per cent during the first half of 1999 – this being due in the latter period to the evolution of non-EMU currencies, especially the US dollar and the British pound.

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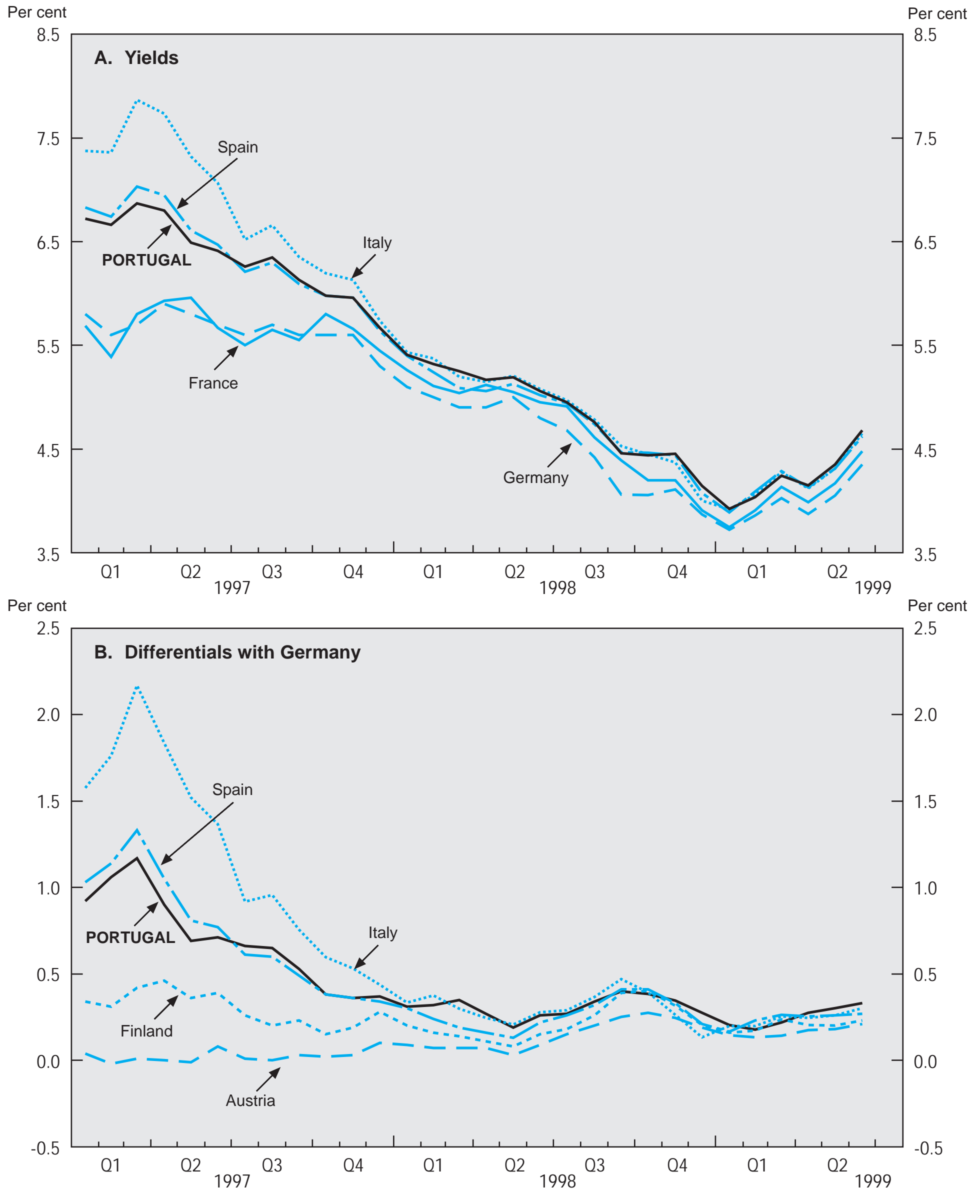
Figure 7. **Long-term interest rates**

10-year government bon yields



Source: OECD Secretariat.

Credit and money aggregates

Boosted by buoyant economic activity and declining interest rates, total domestic credit expanded by an average 16 per cent in 1998, with credit to the private sector surging by 22 per cent (Figure 8). Bank credit to both non-financial enterprises and households grew very rapidly – by an average 21 and 28 per cent, respectively. In late 1998 and early 1999, bank credit to the private sector accelerated further,[19] but this may have been in part linked to an anticipation effect, since households' eligibility requirements for mortgage subsidies were tightened in mid-1999. Although mortgage credit has been the most dynamic component of domestic credit, consumer credit has also recorded impressive growth rates since early 1998 – a development which led the Bank of Portugal to tighten provision requirements for prudential reasons in mid-1999 (see Chapter III). The sharp growth in domestic credit has taken place in spite of a steep decline in net credit to the general government – minus 20 per cent on average in 1998. This reflected not only a reduction in the public sector's borrowing requirement and privatisation, but also the recourse to alternative sources of finance, including the issuance of longer-term treasury bonds on the international market.

Compared with total domestic credit, the broad liquidity aggregate (L-) and the broad monetary aggregate (M2) grew much less rapidly – 6.5 and 8 per cent, respectively, in 1998. As in previous years, this moderate growth reflected, in large part, a negative foreign counterpart to money creation, mostly a result of a reduction in banks' net foreign assets (non-monetary capital outflows were accompanied by monetary inflows in the form of an increase in banks' liabilities towards their foreign subsidiaries – see the section on capital movements in Chapter I). Nonetheless, as a result of portfolio shifts associated with the decline in interest rates, which reduced the opportunity cost of holding more liquid forms of money, the narrow monetary aggregate (M1) grew by 15 per cent in 1998.

Monetary conditions

On virtually all accounts, monetary conditions have eased markedly over the past couple of years – a view confirmed by a crude indicator combining real short-term interest rates with the real exchange rate of the escudo (Figure 9). Given that until late 1998 the economy was growing rapidly, inflation was rising and the current account deficit was widening, the question arises whether monetary conditions were not too loose. While the economy is now slowing, thus lessening concerns over overheating, it will be essential to closely monitor the evolution of inflation and, if necessary, the authorities should stand ready to take further action. This most likely would involve tightening fiscal policy, since monetary policy is conducted for the euro area as a whole. Prudential requirements are not an appropriate tool for macroeconomic management and should be set independently from macroeconomic developments.

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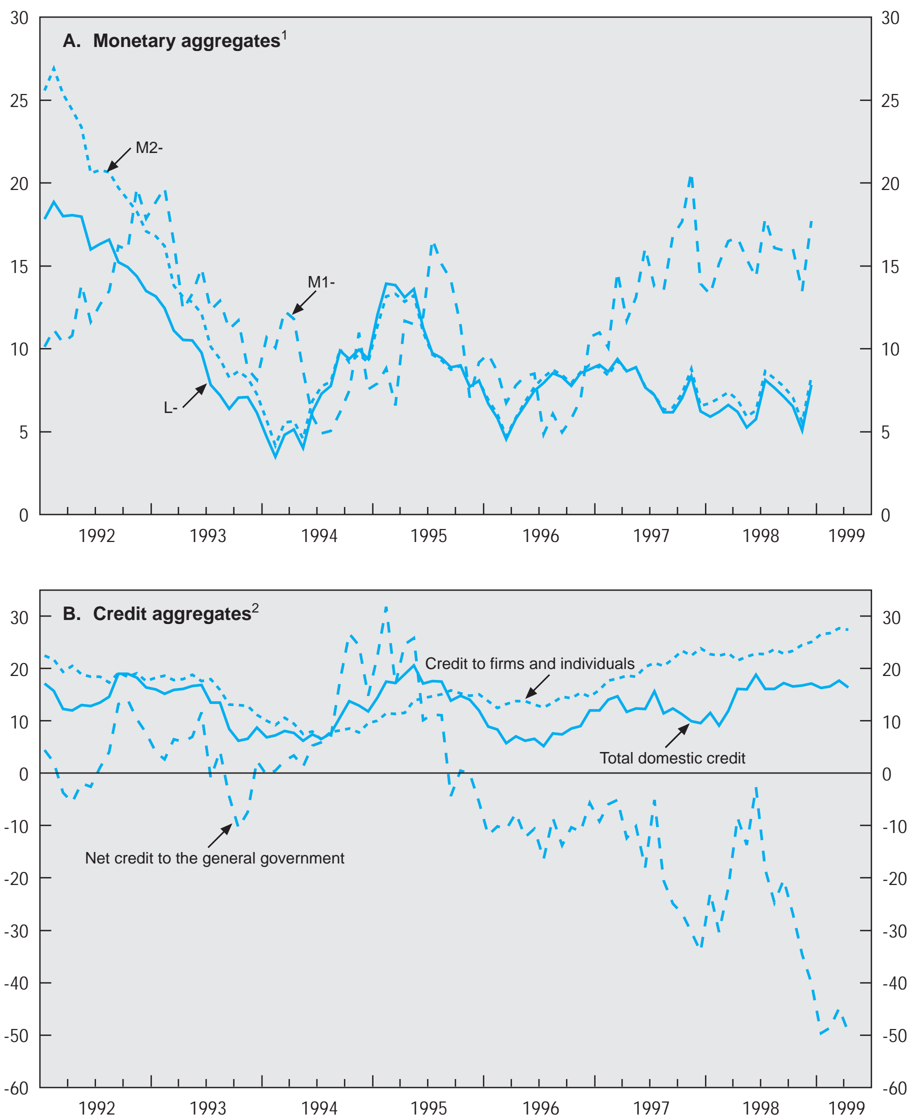
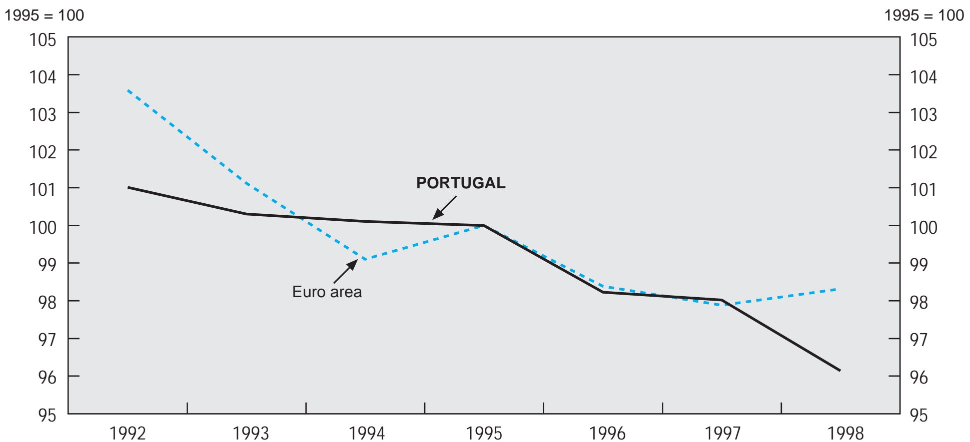
Figure 8. **Monetary and credit aggregates**
Year-on-year percentage changes



1. End of month figures. Series are no longer available as of January 1999 with the introduction of the euro.
2. Weekly average figures.

Source: Bank of Portugal; OECD Secretariat.

Figure 9. **Monetary conditions indicator**[1]



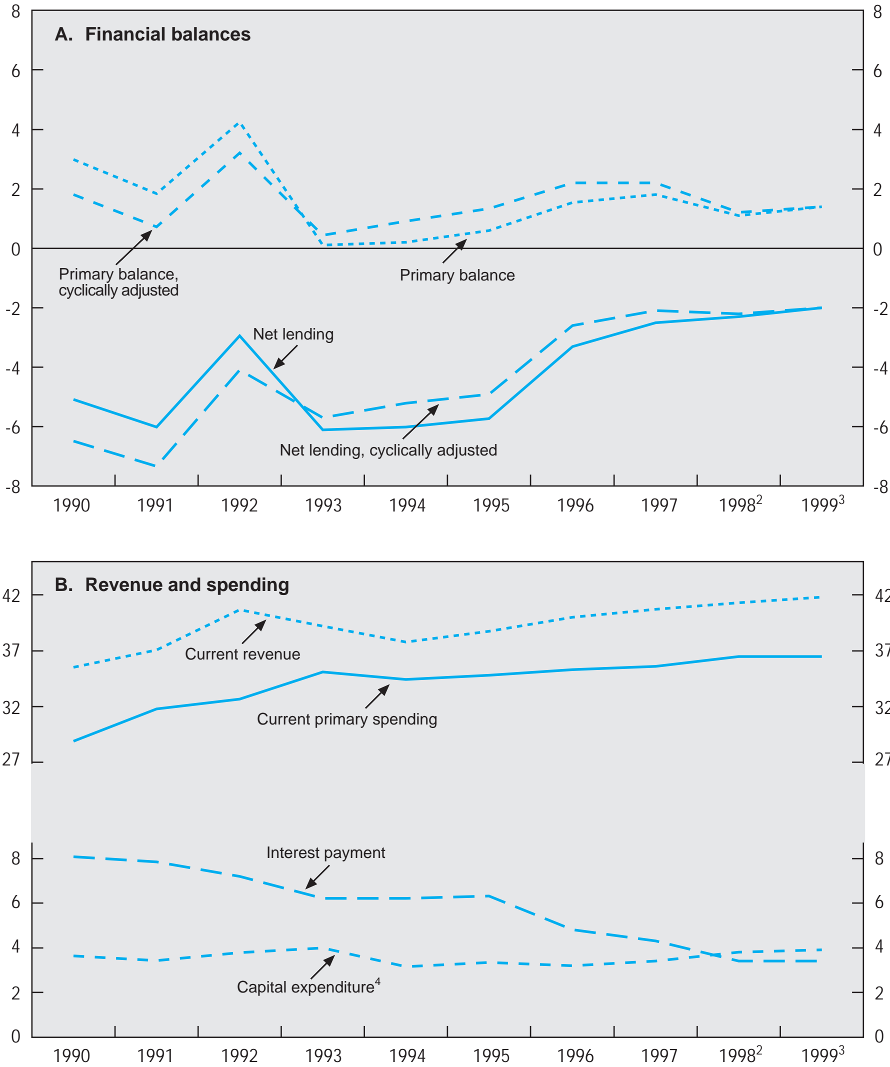
1. The Monetary Conditions Indicator is defined as MCI = (r-r*) + (e/e*-1)/w, where:
   r is the real short-term government bonds rare, CPI deflated;
   r* the long-term average of r (over the 1992-1998 period);
   e the real effective exchange rate, based on unit labour costs;
   e* the long-term average of e (1992-1998);
   1/w the weight of the exchange rate (0.35 for Portugal, 0.15 for the euro area).
   A decline of the MCI implies relatively loose financial conditions (compared with a long-term average).

Source: OECD Secretariat.

Fiscal policy

Since the beginning of the present economic expansion in 1994, the budget deficit has been gradually reduced by a cumulative 3.7 percentage points of GDP, with outturns consistently better than budgeted. Current receipts have grown significantly, with no important tax-raising measures being implemented (see below). Higher revenues accounted for the entire deficit reduction between 1994 and 1998, since total outlays increased slightly faster than nominal GDP (Figure 10). This has been a result of both cyclical gains and the one-off effect of the Mateus Plan, which rolled back tax evasion and speeded up the collection of taxes and social security contributions. On the spending side, the small increase in total outlays as a percentage of GDP masks a significant change in the composition of spending. Public debt servicing costs declined sharply as a percentage of GDP – by a cumulative 2.8 percentage points in the four years to 1998 – but were more than offset by increased primary spending (plus 3.6 percentage points of GDP). About two-fifths of that increase went into capital expenditures, with the

Figure 10. **Fiscal indicators**[1]
Per cent of GDP



1. General government, national accounts basis.
2. Estimates.
3. Projections.
4. Defined as the sum on fixed investment, net capital transfers received by the government and other capital transactions.

Source: OCDE Secretariat.

Table 9. **General government financial accounts**[1]

Per cent of GDP

	1994	1995	1996	1997	1998 Budget	1998 Outturn[2]	1999	2000	2001	2002
							Stability and Growth Programme			
Current receipts	**37.8**	**38.8**	**40.0**	**40.7**	**40.4**	**41.3**	**41.7**	**41.9**	**42.1**	**42.2**
Direct taxes	9.0	9.3	10.0	10.4	10.5	10.3	11.1	–	–	–
Social security contributions	10.9	11.3	11.6	11.9	11.6	12.1	11.8	–	–	–
Indirect taxes	13.8	14.0	14.3	14.3	14.0	14.8	14.7	–	–	–
Other current receipts	4.0	4.2	4.0	4.2	4.2	4.1	4.2	–	–	–
Current disbursements	**40.6**	**41.1**	**40.1**	**39.9**	**39.1**	**39.9**	**39.8**	**39.9**	**40.0**	**39.8**
Government consumption	17.6	17.7	18.2	18.4	18.3	18.8	18.8	–	–	–
Subsidies	1.2	1.1	0.7	0.6	0.6	0.7	0.7	–	–	–
Interest on public debt	6.2	6.3	4.8	4.3	3.6	3.4	3.4	3.3	3.1	3.0
Other transfers paid	15.6	16.0	16.4	16.6	16.6	17.0	17.0	–	–	–
Current balance	**–2.9**	**–2.4**	**–0.1**	**0.8**	**1.3**	**1.5**	**1.9**	**2.0**	**2.1**	**2.4**
Capital receipts	**1.8**	**1.9**	**3.2**	**2.9**	**2.9**	**2.6**	**2.9**	**2.7**	**2.8**	**2.9**
Capital outlays	**4.9**	**5.3**	**6.3**	**6.3**	**6.4**	**6.4**	**6.8**	**6.2**	**6.1**	**6.2**
Gross investment	3.6	3.7	4.1	4.3	4.3	4.2	4.3	–	–	–
Capital transfers	1.3	1.5	2.2	2.0	2.1	2.2	2.5	–	–	–
Overall budget balance	**–6.0**	**–5.7**	**–3.3**	**–2.5**	**–2.5**	**–2.3**	**–2.0**	**–1.5**	**–1.2**	**–0.8**
Memorandum items:										
Primary balance[3]	0.2	0.6	1.5	1.7	1.1	1.1	1.4	1.8	1.9	2.2
Primary current spending	34.4	34.8	35.3	35.6	35.5	36.4	36.4	36.6	36.9	36.8
Overall budget balance (cyclically adj.)[4]	–5.1	–4.8	–2.5	–2.1	–2.3	–2.1	–2.0	–1.8	–	–
Primary balance (cyclically adj.)[4]	1.0	1.4	2.2	2.1	1.1	1.3	1.4	1.5	–	–

1. National accounts basis.
2. Estimate.
3. Excluding "interest on public debt".
4. Cyclically adjusted, *i.e.* adjusted for the impact of the cycle on receipts and expenditure.

Source: Ministry of Finance and OECD Secretariat.

rest being directed towards current spending, mostly on social sectors – a reflection of higher spending in education and health, as well as of the extension of the social safety net.

Compared with the recent past, the 1999-2002 Programme (aligned on the EU's Stability and Growth Pact) foresees a somewhat different path for deficit reduction in the next few years (Table 9), with contributions from both higher revenues and lower outlays (as a percentage of GDP). Current revenues are expected to continue to grow in relation to GDP – by a further 0.9 percentage point between 1998 and 2002 – without an increase in tax rates. The effects of the Mateus Plan were concentrated in the 1996-1997 period, but there is still room for improving the efficiency of tax administration. Total outlays should fall slightly as a percentage of GDP – by 0.3 percentage point. This drop in spending is projected to come in large part from a decline in capital outlays, with current spending remaining broadly unchanged as a share of GDP. Given that interest payments on the public debt are projected to fall by 0.4 percentage point of GDP, current primary spending is programmed to rise further. Indeed, the authorities are committed to further increases of spending in social areas, and the effect of recent measures, such as the creation of a minimum guaranteed income, is still to be fully reflected in spending levels.

Developments in 1998

In contrast to previous years, progress in reducing the budget deficit in 1998 was modest. Even though the outturn was better than budgeted for the fifth consecutive year and the general government borrowing requirement decreased marginally, the deficit remained broadly unchanged in cyclically-adjusted terms, and the primary surplus fell by nearly a full percentage point of GDP on that same basis, pointing to substantial fiscal loosening. Part of this result can be explained by the Eurostat-mandated reclassification of certain privatisation revenues late in the year, which limited the improvement of the budget position.[20] But, in view of a situation of incipient overheating and the easing of monetary conditions discussed above, the fact that the budget balance was not allowed to better reflect the working of the automatic stabilisers can be seen as a missed opportunity to pursue fiscal consolidation and ward off the risk of inflation.

The 1998 budget targeted a deficit of 2.5 per cent of GDP – 0.4 percentage point below the 1997 target but the same as the 1997 outcome – in spite of the cyclical strength of the economy. Provisional figures show that the general government's net borrowing requirement declined to 2.3 per cent of GDP. This decline was accounted for by the state sector, the borrowing requirements of which dropped by 0.7 percentage point of GDP in comparison with the 1997 outcome (Table 10). Other government entities – regional and local administrations, autonomous services and funds and social security institutions –

Table 10. **Revenues and expenditure at different levels of the general government**[1]

Per cent of GDP

	1995	1996	1997	1998 Outturn[2]	1999 Budget
State					
Current receipts	22.4	23.4	23.7	24.0	24.7
Current expenditure	24.9	24.7	24.3	23.8	24.0
Net capital expenditure	2.7	2.8	2.8	2.9	2.9
Borrowing requirements	5.2	4.1	3.4	2.7	2.3
Autonomous services					
Current receipts	2.0	7.3	7.3	7.6	7.9
Current expenditure	1.9	7.2	7.3	7.7	7.7
Net capital expenditure	0.2	–0.1	–0.5	–0.5	0.1
Borrowing requirements	0.2	–0.1	–0.5	–0.4	–0.1
Regional and local government					
Current receipts	3.6	3.6	3.8	3.9	4.0
Current expenditure	3.2	3.4	3.4	3.4	3.4
Net capital expenditure	0.4	0.4	0.7	0.6	0.6
Borrowing requirements	–0.05	0.2	0.4	0.2	0.0
Social security institutions					
Current receipts	13.4	14.4	14.8	14.9	14.6
Current expenditure	13.8	13.5	13.6	13.9	14.1
Net capital expenditure	0.1	0.0	0.4	0.8	0.3
Borrowing requirements	0.4	–0.9	–0.8	–0.2	–0.2

1. National accounts basis.
2. Estimate.
Source: Ministry of Finance.

experienced a narrowing of their traditional fiscal surpluses of the order of 0.5 percentage point of GDP, mostly as a result of an increase in social security institutions' net capital expenditures.

General government current revenues increased slightly as a percentage of GDP in 1998, the result of unexpectedly buoyant domestic demand and improved tax collection. General government capital revenues on the other hand, declined by 5 per cent, a result of lower interest income on government's financial assets. State tax receipts increased by close to 11 per cent, compared with a budget estimate of 7 per cent (Table 11).[21] Boosted by the growth in consumption, revenues from indirect taxes grew by about 11 per cent, with excise taxes on automobile sales soaring by 25 per cent. Revenues from fuel taxes also increased significantly, as excise taxes on gasoline were raised to offset most of the decline in international oil prices. Direct tax revenues also benefited from buoyant economic activity, which boosted profits and incomes. Corporate income taxes grew particularly fast – by 18 per cent against 10 per cent in the original budget. Finally,

Table 11. **State tax receipts**[1]

Percentage changes

	1996 Billions of escudos	1997 / 1996	1998 Budget / 1997	1998 outturn[2] / 1997	1999 Budget / 1998 estimates[3]	1999 Budget / 1998 outturn[2]
Direct taxation	**1 524.2**	**10.6**	**8.8**	**10.8**	**8.3**	**9.5**
Personal income tax (IRS)	1 022.6	2.9	8.3	6.8	7.3	10.1
Corporate income tax (IRC)	488.3	26.3	10.0	18.0	10.4	9.0
Other direct	13.3	24.1	–5.5	–1.8	–10.5	–10.5
Indirect taxation	**2 127.2**	**8.5**	**5.6**	**10.6**	**7.1**	**4.8**
Value added tax (IVA)[2]	1 131.1	13.5	5.5	10.8	6.5	3.6
Fuel tax (ISP)	448.3	–0.3	2.9	11.1	8.6	7.4
Car tax (IA)	154.8	5.5	8.9	24.6	8.8	0.1
Tobacco tax	161.0	7.0	6.4	8.8	6.8	6.1
Stamp tax	184.4	1.2	1.5	–0.1	5.7	7.7
Other	47.6	14.5	31.6	1.8	9.3	12.5
Total	**3 651.4**	**9.3**	**6.9**	**10.7**	**6.5**	**6.8**

1. Public accounts basis. The state excludes autonomous services, regional and local governments and social security institutions.
2. Outturn estimated in February 1999.
3. Preliminary estimates made in September 1998, at the time the 1999 budget was prepared.

Source: Ministry of Finance.

the effect of measures to reduce arrears owed to the tax administration and social security institutions continued to bear fruits, generating additional revenues estimated at a cumulative 250 billion escudos (over 1¼ per cent of 1998 GDP) in the three years to 1998.

On the expenditure side, general government current outlays increased by 7.5 per cent, close to nominal GDP and in line with original budget projections. As a result of the sharp fall in interest rates, public debt servicing costs dropped by 14 per cent instead of the 8 per cent projected in the budget. These gains were almost entirely offset by primary current spending overruns, however. Current primary spending jumped by 10 per cent, almost 2 percentage points above original budget projections, as both government consumption and transfers increased rapidly. At the state level, current expenditures increased by 5.0 per cent, slightly below original budget projections. State consumption was boosted by a sharp increase in the wage bill, in spite of a relatively moderate increase in employment (Table 12). This was mostly a result of a grade reclassification exercise affecting certain categories of state employees, including teachers, which pushed up the wage bill way beyond the statutory public sector wage rise of 2.75 per cent. The increase in transfers by the state was in large part related to payments to the health care and social security sub-sectors, including

Table 12. **State expenditure**[1]

Percentage changes

	1996 Billions of escudos	1997 / 1996	1998 Budget / 1997	1998 outturn[2] / 1997	1999 Budget / 1998 estimates[3]	1999 Budget / 1998 outturn[2]
	Economic classification					
Current expenditure	**4 232.5**	**4.4**	**5.6**	**5.0**	**5.7**	**6.1**
Wage bill	1 450.1	8.3	8.3	8.6	5.1	5.6
Purchase of goods and services	221.9	–8.4	9.0	2.0	6.5	12.8
Interest payments	740.6	–8.3	–7.7	–13.7	–3.2	–0.2
Transfers	1 688.3	8.9	7.1	8.0	9.7	8.4
to other public bodies	1 413.7	7.6	8.2	8.1	10.9	10.0
to other	274.6	15.7	2.0	7.2	3.6	0.4
Subsidies	99.2	–8.1	5.7	26.1	–9.3	–7.1
Other	32.4	17.0	40.0	9.6	12.5	1.9
Capital expenditure	**539.3**	**8.2**	**6.7**	**11.2**	**7.7**	**2.2**
Investments	133.3	5.9	8.9	–1.0	3.1	5.2
Capital transfers	403.5	8.5	4.8	15.1	7.9	0.3
to other public bodies	376.3	7.0	3.0	14.2	7.1	–0.7
to other	27.2	30.5	25.0	25.3	16.8	11.3
Other	2.5	65.5	132.8	16.8	112.2	111.6
Financial transactions	**14.0**	**13.5**	**41.0**	**3.2**	**38.5**	**83.8**
Total[4]	**4 866.8**	**4.9**	**7.4**	**5.9**	**8.1**	**7.8**
	Functional classification					
Defence and security	**758.4**	**1.7**	**4.7**	**6.9**	**5.6**	**6.7**
Social functions	**2 440.1**	**9.2**	**8.9**	**9.3**	**6.7**	**6.7**
Education	873.8	9.8	9.5	9.2	7.6	7.3
Health	753.0	6.4	6.3	7.1	6.9	6.5
Others	813.3	11.2	10.5	11.4	–	6.1
Economic functions	**383.1**	**–0.3**	**4.4**	**6.5**	**0.0**	**–2.1**
Other	**1 204.3**	**–0.3**	**0.3**	**–3.4**	**5.8**	**5.9**

1. Public accounts basis. The state excludes autonomous services, regional and local governments and social security institutions.
2. Outturn estimated in February 1999.
3. Preliminary estimates made in September 1998, at the time the 1999 budget was prepared.
4. Includes "Reserve Clause" (Cláusula de Reserva) and "Order Accounts" (Contas de Ordem).

Source: Ministry of Finance, State Budget.

expenditures on account of the recently introduced minimum-guaranteed income. Finally, led again by infrastructure spending, gross fixed capital formation remained broadly unchanged, amounting to 4.2 per cent of GDP, compared with an EU average of 2.4 per cent.

The 1999 budget

The 1999 budget was drawn up within the framework provided by the EU-wide Stability and Growth Pact and the related 1999-2002 Programme prepared by the Portuguese authorities. The underlying assumptions made in September 1998, when the budget was being prepared, included output growth of between 3.5 and 4.0 per cent and consumer-price inflation of 2.0 per cent. The general government borrowing requirement was budgeted to fall to 2.0 per cent of GDP. In spite of a small reduction in certain tax rates, current receipts were expected to increase by 0.4 percentage point of GDP, mostly as a result of better tax collection and strong domestic demand growth. Current disbursements were budgeted to grow slightly slower than nominal GDP, leading to a widening of the current budget balance surplus. Net capital outlays would remain broadly unchanged in terms of GDP, growing by 0.1 percentage point of GDP.

Main tax measures programmed in the budget included the transformation of certain personal income tax credits into tax deductions, the reduction of marginal tax rates for lower income categories through the creation of a new, lower personal income tax bracket, and the reduction of corporate income taxes for certain small and medium-sized enterprises. The main objectives of these measures were to increase the progressivity of the tax system and reduce tax pressure. The Portuguese authorities estimated that these changes in the tax system would lead to a reduction in revenues equivalent to 0.2 per cent of GDP. Buoyed by the expected growth in disposable income, state revenues from personal income taxes were nonetheless budgeted to increase by 7.3 per cent, slightly above the 6.5 per cent average growth in total tax receipts.[22] Indeed, the growth of revenues from most other taxes was expected to come down compared with 1998. This was also the case for social security contributions, where growth was seen as easing to 5.1 per cent in 1999. This deceleration would be the result of slower nominal GDP growth as well as diminishing returns from tax efficiency measures. The authorities estimated that gains from these measures would amount to 0.3 per cent of GDP in 1999, against 0.5 per cent in 1998 and 0.6 per cent in 1997.

General government current expenditure was budgeted to grow by 5.7 per cent in 1999, in line with nominal GDP. Interest payments on the public debt and other transfers paid were to remain constant at 3.4 and 17.0 per cent of GDP, respectively. Within the state sector, the redirection of outlays in favour of social spending was expected to continue, with a large increase in the budget for education and health. Spending on social functions was budgeted to slow down somewhat, although still increasing faster than GDP, so that it would reach 55.3 per cent of state expenditures, up from 48.7 per cent in 1995. The state sector wage bill was also projected to grow at a more moderate pace than in recent years – 5.1 per cent instead of an average 8.5 per cent a year in 1997 and 1998. This would come mostly from slower public sector employment gains and from the fact

that previous years' job reclassification measures were not expected to be repeated. Capital outlays of the general government were expected to increase by over 12 per cent, reaching 6.8 per cent of GDP in 1999. Finally, the state's treasury operations underwent a major revision this year, which in time is expected to lead to better control of disbursements and more efficient management of public spending.

Preliminary data available for the first quarter of 1999 suggest that the execution of the budget is proceeding favourably. State tax receipts have grown by 13 per cent, significantly above expectations. Adjusting for changes in the schedule of corporate income tax payments, the authorities estimate that total revenues have been growing at an 11 per cent annual rate, compared with 6.5 per cent in the budget. Especially buoyant have been revenues from consumption taxes, including value-added and automobile taxes. This result, however, should not be extrapolated for the rest of the year, since economic activity may slow down further. In fact, the authorities have taken measures to rein in spending, using the margin foreseen in the budget to place part of planned disbursements into a contingency fund. Finally, given the recent euro-wide reduction in interest rates, it looks increasingly likely that public sector debt servicing costs will be lower than budgeted.

Public debt and debt management

Gross public debt fell to 57.8 per cent of GDP in 1998, compared with a cyclical peak of 65.9 per cent in 1995. Contributing to this fall have been a steady decline in general government borrowing requirements and high privatisation revenues. Since 1989, privatisation revenues used for debt redemption have totalled 11.7 per cent of GDP, of which 3.5 per cent accrued in 1997 and 1.5 per cent in 1998 (Table 13). The composition of the state's debt has also changed significantly: while domestic debt (*i.e.* denominated in escudos) has fallen sharply, external debt (*i.e.* denominated in foreign currencies, including currencies which were to become part of the euro as of 1999) has continued to increase, reaching 15.1 per cent of GDP in 1998 – up from 11.7 per cent in 1996 (Table 14). Most of this debt is now euro-denominated, however, and as such, carries no foreign exchange risk.[23] In fact, the sharp increase in external debt is a reflection of the authorities' strategy in preparing for the introduction of the euro. This strategy has aimed at enlarging the ownership of Portuguese public debt, especially within the euro area, ensuring minimum levels of liquidity and increasing the visibility of issues. In practice, this has translated into the launching in 1998 of domestic instruments in the new euro market, including the issuance of eurobonds denominated in core euro-area currencies, but fungible with domestic bonds after January 1999 – the time of their re-denomination into the new single currency. Other actions to implement this strategy have included the broadening

Table 13. **General government deficit and other transactions**

Per cent of GDP

	1995	1996	1997	1998	1999	2000	2001	2002
				Estimate	Stability and Growth Programme			
Overall deficit	**5.7**	**3.3**	**2.5**	**2.3**	**2.0**	**1.5**	**1.2**	**0.8**
Other transactions[1]	**1.2**	**–0.4**	**–1.8**	**–1.9**	**0.1**	**–**	**–**	**–**
Privatisation receipts for debt redemption	–0.8	–1.7	–3.5	–1.5	–0.5	–0.5	–0.5	–0.5
Net assets	0.4	0.0	0.4	0.1	–	–	–	–
Change in government deposits	2.3	–0.3	0.3	0.7	–	–	–	–
Accounts receivable and payable and short, medium, and long-term credit	–1.0	1.0	–0.1	–0.1	–	–	–	–
Adjustment for exchange-rate changes	–0.3	–0.3	0.8	–0.1	–	–	–	–
Other adjustments[2]	0.6	0.9	0.3	–1.0	–	–	–	–
Total change in general government gross financial liabilities	**6.9**	**2.9**	**0.7**	**0.4**	**2.1**	**–**	**–**	**–**
Memorandum item:								
General government gross financial liabilities[3]	65.9	64.9	61.7	57.8	56.8	55.8	54.7	53.2

1. Minus sign indicates a contribution to the reduction of the deficit.
2. Includes debt settlements and adjustment for complementary period.
3. Public debt in the Maastricht definition.

Source: Ministry of Finance.

Table 14. **Total gross debt of the state sector**[1]
Stocks outstanding, end of period, as a percentage of GDP

	1995	1996	1997	1998[2]
Domestic debt[3]	54.3	54.2	49.6	45.8
Saving certificates	8.6	13.3	13.3	12.5
Treasury bills	8.5	8.0	5.8	2.0
Investment funds	9.7	5.3	0.2	0.1
Fixed-rate Treasury bonds	14.0	16.4	21.3	23.4
Floating-rate Treasury bonds	4.5	7.1	7.3	6.7
Other[4]	9.0	4.0	1.6	1.1
External debt[5]	12.1	11.7	14.2	15.1
Marketable	9.8	..	12.3	13.4
Non-marketable	2.4	..	1.9	1.8
Total debt	66.5	65.9	63.7	60.9
Memorandum item:				
Total public debt (Maastricht definition)	65.9	64.9	61.7	57.8

1. National definition. The state sector excludes autonomous services, regional and local governments and social security institutions.
2. Estimate.
3. Debt denominated in escudos.
4. Including Auctioned Credit for Public Investment (CLIP), Accrued Interest Bonds (OCA) and non-marketable debt.
5. Debt denominated in foreign currencies, including currencies which were to become part of the euro as of 1999.

Source: Ministry of Finance and Bank of Portugal.

of the group of "Primary Dealers" to include non-resident financial institutions and the creation of a second tier group of participants in the Portuguese Treasury market.

Other major trends in public debt in the past two years have included the increased use of fixed interest rate instruments and the steady rise in the average maturity of Portuguese debt. Considering the state sub-sector, for which detailed data are available, the share of fixed-rate instruments more than doubled from 23.5 to 47.9 per cent between 1996 and 1998, while the average maturity increased from 3.6 to 4.7 years.[24] This was part of a management strategy intent on minimising the budget impact of changes in interest rates while at the same time benefiting from the steady convergence of interest rates between Portugal and the core euro area countries. To that effect, the issuance of long-term fixed rate bonds was stepped up, including through the launching of a 15-year maturity line for Treasury bonds. This strategy seems to have borne fruit, as the implicit interest rate on state debt fell from over 10 per cent before 1996 to 6 per cent in 1998.

The state's net financing requirement for 1999, which takes into account other transactions including privatisation receipts, is estimated by the authorities at 310 billion escudos (1.5 per cent of GDP), while amortisation is expected to

reach 2 050 billion escudos (10 per cent of GDP). As a relatively small borrower that no longer needs to establish a yield curve for the domestic currency, the authorities can now reduce the number of debt instruments on offer in order to increase the liquidity of remaining instruments. It can also adopt a more flexible and opportunistic debt placement strategy, taking advantage of market conditions as they develop. Hence, the Portuguese public debt agency has proposed that most of its 1999 financing needs be met with the issuance of fixed rate euro-denominated treasury bonds, with the rest coming from euro-denominated treasury bills and savings certificates.[25] No issuing of floating rate bonds or foreign currency debt is foreseen in 1999.[26]

The 1999-2002 Programme

As part of its efforts towards strengthened surveillance and co-ordination of economic policies, the EU Pact for Stability and Growth calls on EMU participants to submit their medium-term budget objectives for annual review (Box 1). The Pact requires that countries allow a sufficient safety margin over the medium term so that, in the advent of adverse shocks, automatic stabilisers can come into play without breaching the budget deficit limit of 3 per cent of GDP. For Portugal, the estimated effect of a 1 per cent increase in the output gap is a widening of the fiscal deficit equivalent to between 0.4 and 0.5 per cent of GDP.[27] Given that the mean value of the maximum output gap recorded in Portuguese recessions since 1975 has been 3.9 per cent, this would translate into a medium-term fiscal objective of a maximum deficit in the 1.0 to 1.5 per cent range, on a cyclically-adjusted basis.

Portugal's 1999-2002 Programme, submitted in December 1998, envisages a reduction of the budget deficit to 0.8 per cent of GDP in 2002 (see Table 9). The Programme's underlying assumptions include real output growth of 3.3 per cent, consumer price inflation of 2 per cent and employment growth of 0.6 per cent (annual averages over the 1999-2002 period). On this growth assumption, the OECD Secretariat estimates that the output gap will be of the order of plus ¾ to 1 per cent in 2002.[28] If these medium-term budget objectives are met, net lending will be of the order of 1¼ per cent of GDP on a cyclically-adjusted basis, which is broadly consistent with the requirements of the Stability and Growth Pact. Furthermore, with expected privatisation revenues of 100 billion escudos a year (equivalent to 0.5 per cent of GDP), the public debt[29] would continue on a downward trend, falling from 58 in 1998 to 53 per cent of GDP in 2002 (see Table 13).

The fiscal adjustment proposed in the Programme implies a reduction of the deficit of 1.2 percentage points of GDP between 1999 and 2002. About half of the adjustment is expected to come from a reduction in expenditures relative to GDP, and the rest from an increase in revenues. On the revenue side, capital

Box 1. The EU's Stability and Growth Pact

The Pact for Stability and Growth, finalised at the Amsterdam Summit in June 1997, consists of two Council regulations. One clarifies the Maastricht Treaty's provisions for an Excessive Deficit Procedure and the other strengthens the surveillance and co-ordination of economic policies. The Pact also calls on participants in the monetary union to commit themselves to aim at a medium-term budgetary balance or at a surplus.

Avoiding excessive government deficits (above 3 per cent of GDP) is considered essential for the success of Economic and Monetary Union. The Maastricht Treaty already included a procedure aimed at discouraging, and reducing when one occurs, excessive deficits. The 3 per cent reference value, however, can be exceeded if: *i)* the origin of the excess lies outside the normal range of situations (exceptionality); *ii)* the excess is limited in time (temporariness); and *iii)* the excess is small enough for the deficit to remain close to the 3 per cent reference value (closeness). These three conditions need to apply simultaneously. The Treaty, however, does specify a precise interpretation of these constraints.

The Stability and Growth Pact gives a more specific interpretation of exceptionality and temporariness. For countries participating in monetary union, the Pact considers a general government deficit above 3 per cent as excessive unless the country is in economic recession. A recession is defined as an annual fall in real output (GDP) of at least 0.75 per cent. Implementation of the Excessive Deficit Procedure depends on the severity of the economic decline. If economic output in a Member state declines by 2 per cent or more, and provided the deficit is temporary, exemption from the Excessive Deficit Procedure is granted. In the event GDP falls by between 0.75 per cent and 2 per cent, exemption can be granted in special circumstances by the Council of Ministers. The country would need to convince the Council that the economic decline was "exceptional" in terms of its abruptness or in relation to past output trends.

Failure to adhere to the Pact could result in the imposition of sanctions. Initially, these would take the form of non-remunerated deposits starting at 0.2 per cent of GDP and a variable component rising in line with the size of the excessive deficit. Such deposits are limited to a maximum of 0.5 per cent of GDP, but would accumulate each year until the excessive deficit is eliminated. Provided the excessive deficit is corrected within two years the deposits are returned to the country. Otherwise, the deposits could ultimately be converted into a fine.

receipts are programmed to grow in line with nominal GDP, while current revenues are due to increase by a cumulative 0.5 percentage point of GDP. To achieve this, the authorities plan to reinforce the fight against tax evasion, modernise the tax administration, implement a series of reforms to make the tax system fairer and more efficient and take measures to widen the tax base. In particular, the authorities intend to create a single tax on individuals' net wealth. On the spending side, the entire downward adjustment, equivalent to 0.6 per cent of GDP, is expected to come from a reduction in capital outlays, mostly capital transfers. At around 4 per cent of GDP, general government gross fixed capital formation is

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expected to remain among the highest in the euro area. Current expenditures, on the other hand, are expected to remain unchanged as a share of GDP. As public debt falls as a share of GDP, interest payments are projected to decline by 0.4 percentage point of GDP. This would be entirely offset by an increase in current primary spending, however. As in previous years, this would mostly be the result of increased spending in social areas, including education and health. To achieve these targets, a pluri-annual programme for current spending is under preparation. The authorities expect that recently introduced measures to modernise administrative procedures will lead to more rigorous spending control and allow for improved medium-term strategic planning.

According to the OECD Secretariat, in order to achieve the targets set in the Programme, the authorities will have to introduce new budget measures as early as in 2000, especially if the structural causes of the public spending increases of recent years are not addressed. In fact, interest rates are unlikely to decline further, the fight against tax evasion is bound to bring diminishing returns, and the sustainable non-inflationary rate of growth of the economy may be somewhat lower than the 3.3 per cent rate of growth assumed in the Programme. As noted, the authorities do envisage taking a number of measures, including a reform of the tax system, which would also be welcome on the grounds of efficiency and equity.

Progress in structural reforms, notably in the areas of health and social security, would also help Portugal pursue fiscal consolidation, especially over the longer term. Demographic changes are bound to increase pressure on the pay-as-you-go pension system, as well as on the health sector. The OECD Secretariat estimates that, without reforms and given present population trends, pension payments could double between 2000 and 2035 to about 14 per cent of GDP.[30] The financial implications of demographic changes can be highlighted by the equilibrium contribution rate (ECR), defined as the contribution rate that balances the pay-as-you-go pension system at a given rate of productivity growth. This is likely to increase from 18 per cent of total wages at present to 25 per cent in 2020 and to 43 per cent in 2050. Concerning health, total expenditure on the sector is close to the OECD average, but exceeds the EU average by 0.5 percentage point of GDP. Public expenditure on health has increased by 1.5 percentage points of GDP since EU accession in 1986 and the sector has been the main source of spending overruns in the past few years. Progress in the implementation of structural reforms in the social security and health systems is discussed in Chapter IV.[31]

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III. Financial sector reforms

The Portuguese financial sector has undergone a significant transformation in recent years. Until the late 1980s, state ownership of financial institutions and a myriad of direct controls were more typical of a centrally planned than of a market economy. As a result, financial institutions were inefficient and undercapitalised and markets were thin. Today, most institutions are private, well capitalised and relatively efficient. In the meantime, financial sector performance indicators have improved significantly, converging or even surpassing OECD averages. This success is due in large part to a reform process, which, pushed to a large extent by European Community (EC)[32] membership, involved a careful and gradual sequencing of steps, accompanied by prudent macroeconomic management. Portugal's experience may be valuable for other countries that are now embarking in thoroughgoing financial sector reforms, since it was able to enjoy the fruits of liberalisation – such as increased efficiency of financial intermediation – without experiencing some of the post-liberalisation problems that occurred in several other countries, including the failure of financial institutions.

The Portuguese financial system today resembles that of other EU countries and as such is facing the same type of challenges, including those related to changes in market conditions deriving from EMU. Given relatively low operating costs, up-to-date technology and good prospects for the domestic lending and securities markets, Portuguese institutions are perhaps in a better position than many to face these challenges. Still, there are some policy issues that need to be addressed by the Portuguese authorities. Although monetary policy and competition rules are to a large extent designed at the EU level, national authorities have an important role in their implementation. Moreover, there are issues related *inter alia* to labour markets, regulatory and legal frameworks, and supervision that need to be addressed by national authorities. For instance, barriers to labour mobility may diminish the ability of the banking system to adjust to new market conditions, whereas the absence of the appropriate legal framework has hampered the development of mortgage-backed securities. Finally, the rapid expansion of bank lending in the past two years has come at a time when some imbalances were appearing – including an increase in the inflation differential

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between Portugal and the rest of the euro zone, and a widening of the current account deficit. Although it is too early to say whether prudential concerns are warranted, the supervisory authorities will need to remain vigilant.

The financial system before reforms

The Portuguese financial system in the 1980s still bore the imprints of measures introduced in the wake of the 1974 revolution. The financial sector, like other strategic industries, had been nationalised, so that financial intermediation was almost exclusively in public hands. Moreover, direct controls severely limited the operation of the financial system. These included:

a) Restrictions on the composition of financial institutions' balance sheets and compulsory investment on public debt, which limited the ability of banks to channel resources to their most efficient use.

b) Specialisation and segmentation rules, which separated the various activities associated with financial intermediation, limiting the positive synergies and economies of scope that could have arisen from integrating these activities.

c) Credit ceilings, entry restrictions, interest rate ceilings and capital controls, which stifled competition and limited banks' international activities.

Some of these restrictions were designed for macroeconomic management purposes, following the balance-of-payments crisis of the late 1970s and early 1980s. Indirectly, they also greatly facilitated the financing of the public sector, the size of which increased sharply in the period. General government outlays went from an average 22 per cent of GDP in the five years before the revolution to a high of 47.9 per cent in 1983. Under the weight of a bloated public sector, the budget deficit widened sharply, averaging 10 per cent of GDP between 1981 and 1983. The low cost of absorbing banks' involuntary excess liquidity and the compulsory investment in public sector securities helped to lower the cost of financing the deficit, but adversely affected banks' profitability and crowded out private investment.[33]

This significant misallocation of credit put a heavy burden on the economy. In addition, the myriad of regulations governing the financial sector created room for arbitrage and encouraged rent-seeking behaviour. It was common for banks to operate through their non-domestic branches in order to overstep credit ceilings, while "round tripping" practices, by which a preferred borrower becomes a financial intermediary might also have taken place.[34] Finally, affected by heavy regulation, lack of competition and little exposure to innovative foreign influence, the financial system remained undeveloped and characterised by thin secondary markets and a limited choice of financial instruments. These inefficiencies are

likely to have interacted with the effects of misguided macroeconomic policies in hindering Portugal's economic performance in the early 1980s, a period characterised by balance of payments problems, high inflation and falling income per head.

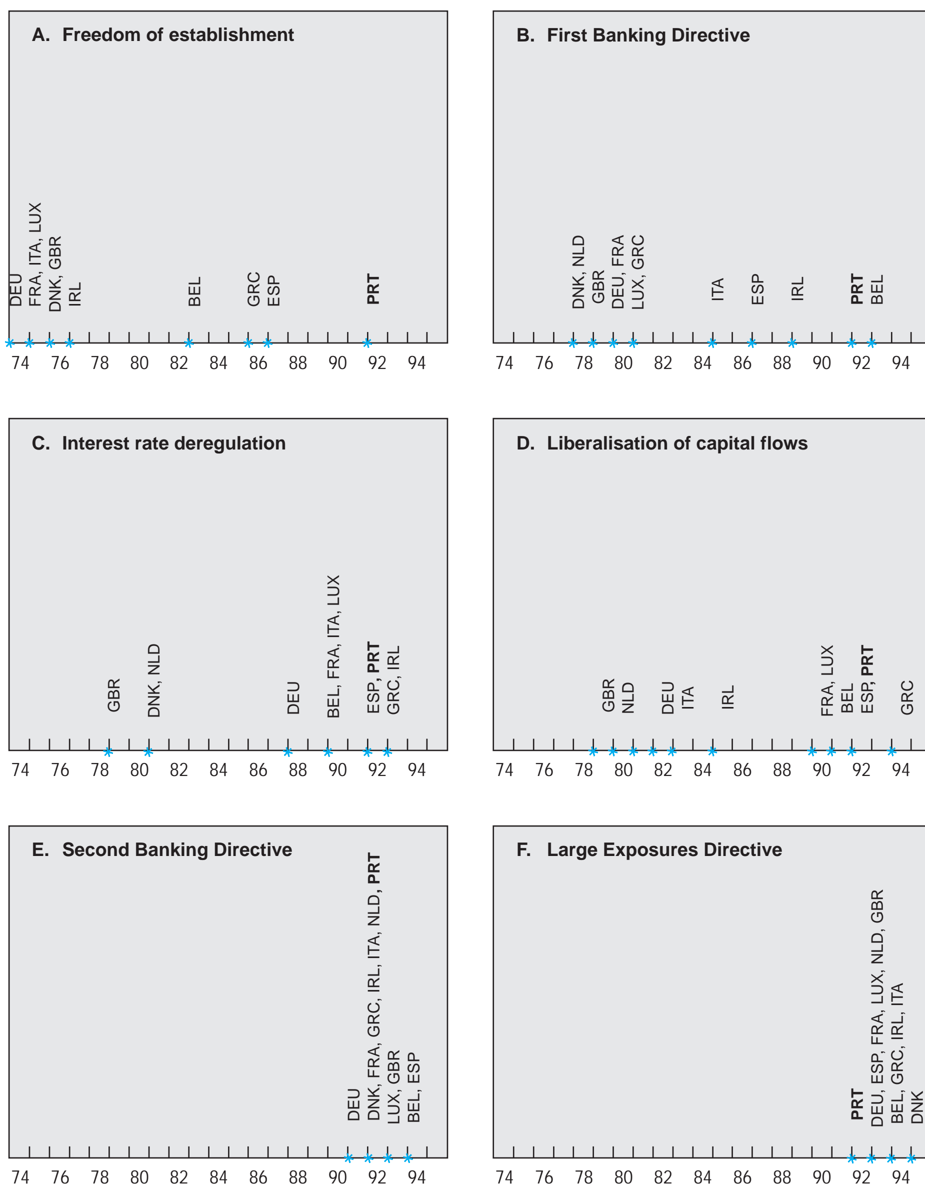
Objectives of the reforms

The liberalisation of the financial sector in Portugal was widely associated with the goal of joining the EC, a project that transcended economic objectives and for which a wide national consensus existed. Accession negotiations started at about the same time as – and served as a catalyst for – financial market reforms. By the time Portugal joined the EC in 1986, the body of relevant *acquis communautaire* was already significant: it included, for instance, the 1977 EC First Banking Co-ordination Directive,[35] which called for a considerable opening of the banking sector. Since accession, several other initiatives have been taken at the EC (or EU) level, with the objective of achieving financial integration through the creation of a single market in financial services (Figure 11). Among these, of particular relevance were the 1988 Directive on Capital Movements and the 1989 Second Banking Co-ordination Directive. Since Portugal, together with Ireland, Spain and Greece, had the least liberalised financial market in the EC in the late 1980s, the process of regulatory convergence implied, *per se*, an ambitious reform process.[36]

The main economic objective of financial reforms was to increase efficiency in financial intermediation. As in other countries that embarked on financial sector liberalisation, this goal was seen as having many dimensions. Beyond ensuring that savings were efficiently directed to investments, an efficient financial system was also expected to have in-built incentives for innovation and least-cost provision of services, while offering a large choice of financial instruments and hence allowing a better match of preferences for risk, return, liquidity and cash flow. In addition, reforms were expected to improve macroeconomic management by enhancing the conduct of monetary policy.

Reforms were also seen as necessary to enhance the international competitiveness of the Portuguese economy. At the time financial reforms started in Portugal, a process of liberalisation of financial markets had been underway for as long as two decades in many OECD countries.[37] Bank lending and/or deposit rates started to be liberalised in the 1960s in some countries. By the mid-1980s, among OECD countries, only Portugal, Japan and Iceland had significant interest rate controls or private agreements governing the setting of interest rates. Following the adoption of OECD liberalisation codes, capital-account liberalisation had also started in earnest in the 1970s through most of the OECD area.[38] Portugal was clearly a laggard in a process that was giving rise to growing internationalisation of

Figure 11. **Implementation of EU legislation**



Source: European Commission.

finance and enhanced competition in the supply of financial services at the international level. As a result, the efficiency gap between the domestic and international financial industries had increased and Portuguese enterprises were at a competitive disadvantage in relation to their foreign counterparts. Furthermore, the globalisation of financial markets had led to the growing ineffectiveness and obsolescence of most mechanisms of administrative control, since companies were finding it increasingly easy to by-pass these controls through operations involving banks' non-domestic branches.

Nature of the reforms

The reform process involved a cautious sequencing of step-by-step liberalisation, including interest rate deregulation and other changes to the regulatory framework, as well as the modernisation of monetary policy instruments and the freeing of international capital movements (Table 15).[39] A more detailed description of these measures is given in Annex 1.

There have been three distinct phases of financial sector reform in Portugal. In the first phase, spanning the second half of the 1980s, the liberalisation process was relatively slow, with the authorities preoccupied by macroeconomic imbalances and by the need to strengthen the balance sheets of publicly owned financial institutions to prepare them for privatisation and full competition. The key measure in that period was the opening of financial intermediation to private firms through the easing of entry restrictions in the banking and insurance sectors. State-owned institutions were protected from full competition however, since tight regulations and credit ceilings significantly restricted the activities of new private banks and insurers. Other measures taken in the late 1980s included the dismantling of interest rate controls and some incipient liberalisation of money and foreign exchange markets.

The pace of reforms accelerated in the second phase – in the early 1990s – with Portugal meeting the 1 January 1993 deadline for the implementation of key EU directives aimed at the creation of a single EU-wide market in financial services. In less than three years, the banking sector was fully opened to competition, most public sector financial institutions were privatised, remaining interest controls were abolished, monetary policy instruments were modernised, and external capital flows were liberalised. In the third phase, since 1993, reforms have been directed at preparing for EMU and deepening EU-wide convergence and harmonisation, including through the strengthening of prudential requirements and the liberalisation of investment services.

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Table 15. **Main financial reform measures**

	Interest rate controls	Regulatory framework	Monetary and exchange-rate policies	Liberalisation of capital movements
1983		Freedom of entry for private banks and insurance companies		
1984	Liberalisation of most deposit rates			
1985	Liberalisation of short-term lending rates		Introduction of Treasury Bills and repurchase agreements. Liberalisation of the Interbank Monetary Market (IMM). Creation of the interbank spot foreign exchange market	
1986-87		Suppression of specialisation and segmentation. Universal bank model.		Partial liberalisation of supplier's credits linked to commercial transactions and FDI
1987-88	Liberalisation of all lending rates, except housing credit		Creation of the forward foreign exchange market. The maximum maturity of operations on the IMM and on forward foreign exchange transactions was extended	Liberalisation of non-interest bearing escudo-denominated demand accounts held by non-residents
1988-89		Easing of regulatory framework of banks' shareholdings in other credit institutions and financial companies. Abolition of limits on banks' spot positions	*De facto* progressive ERM shadowing	
1989-90	End of maximum limits to all lending interest rates			Liberalisation of purchase by resident institutional investors of listed foreign securities and of spot purchase and sale of foreign currency. Clearing settlements between residents and non-residents
1990-91		New organic law for the Bank of Portugal. Securities Market Act enacted	Imposition of a single remunerated reserve requirement ratio (17%). Suspension of the compulsory credit ceiling system. Launching of a large mopping-up operation	Temporary reversal of liberalisation process. Introduction of a compulsory non-remunerated deposit on external financial borrowing.
1992	Liberalisation of all deposit interest rates		Prohibition of overdraft facilities to the public sector. The escudo joined the ERM	Compulsory deposit requirement abolished. Total liberalisation of external borrowing. Abolition of remaining capital controls.
1993		Suppression of restrictions to banks' branch network	Creation of a standing facility for the absorption and provision of liquidity	
1994		Strengthening of supervision and control of credit institutions. Deposit guarantee fund established.	The reserve requirement ratio was lowered to 2% (non-remunerated). Introduction of variable repurchase rates	
1995			Prohibition of direct purchases of government paper by the Bank of Portugal	
1996		Further liberalisation of investment services		

Source: Bank of Portugal and Ministry of Finance.

Indicators of improved performance

Financial sector reforms had their intended effect in Portugal. Before 1984, financial institutions were mostly state-owned, undercapitalised and relatively unprofitable and inefficient, while financial markets were among the thinnest in the OECD area. Today, most of the sector is in private hands, institutions are among the most profitable and solvent in Europe, and efficiency and financial depth indicators are converging rapidly towards OECD averages. The impact of the reforms can be divided into five main areas: efficiency of intermediation; securitisation and internationalisation of markets; size and structure of the financial sector; solvency and profitability of the financial system; and the conduct of monetary policy and macroeconomic performance.

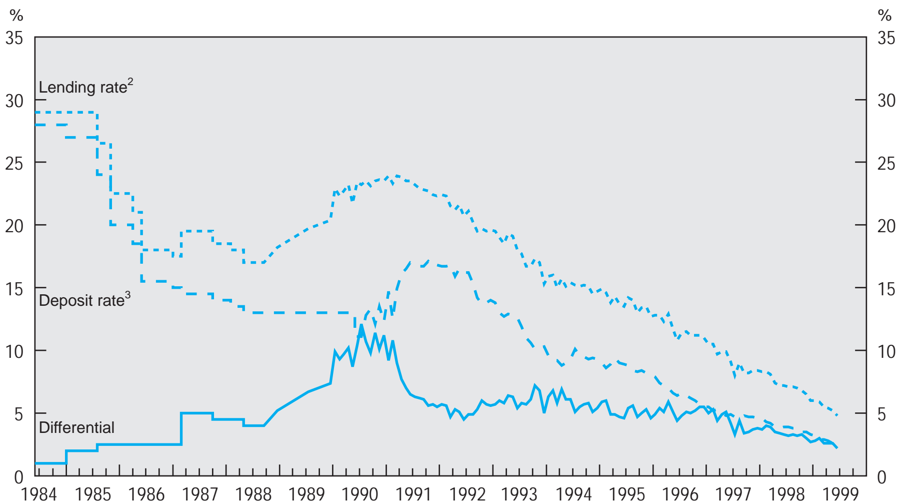
Efficiency of intermediation

Besides affecting allocative efficiency in the economy as a whole through their impact in financial intermediation, financial sector reforms have an internal efficiency component. One measure of this internal efficiency is the differential between lending and deposit rates in the banking system. The smaller this differential, the more efficient is financial intermediation, since savers receive higher returns and investors pay lower capital costs. Using this yardstick, the impact of reforms on the efficiency of the financial system was initially negative in Portugal.[40] Given the sequencing of reforms, competition remained limited in the first phase of liberalisation. This is reflected in the widening gap between banks' lending and deposit rates from 1984 to 1990, which boosted the profitability of the banking system (see below), but put a heavy burden on the rest of the economy (Figure 12).[41]

Measured by interest rate spreads, the efficiency of financial intermediation improved more clearly with the second phase of financial sector reforms. The liberalisation of branching, the elimination of interest rate controls and the replacement of direct quantitative limits on credit by open market operations led to increased competition between institutions. Also helped by the decline in inflation and the removal of restrictions on external capital inflows, the spread between banks' deposit and lending rates fell by more than 5 percentage points in the three years to December 1992, in spite of relatively high reserve requirements and stamp duties.[42] This sharp narrowing continued in the following years, bringing commercial banks' interest rate spreads closer to those of other OECD countries (Table 16).

Alternative productivity and efficiency measures also suggest an improvement in efficiency levels in the early 1990s, when the squeeze in profits created incentives for the reduction in operational expenses (Figure 13). Although these measures should be interpreted with caution, they seem to indicate that the

Figure 12. **Lending and deposit rates**[1]



1. Commercial banks.
2. Administratively fixed maximum rate for lending operations up to 180 days (until May 88); indicative lending rate on 90-day operations from the Portuguese Banking Association (from June 88 to December 89); bank's rates on loans and advances to non-financial private enterprises from 91 to 180 days (from January 90).
3. Administratively fixed minimum rate for deposits of up to 1 year (until June 90); bank's rates on time deposits from 91 to 180 days (from July 90).

Source: Bank of Portugal.

productivity of the Portuguese banking system increased steadily, with banking product (balance sheet total per employee) converging rapidly towards average OECD levels.[43] This helped to reduce staff costs – which fell steadily from 1.53 per cent of average assets in 1991 to 0.98 per cent in 1997 – making Portuguese commercial banks' operating costs among the lowest in the OECD area. Financial sector reforms also introduced incentives for financial innovation, customer differentiation and the diversification in the supply of financial services. The modernisation of the financial system as a whole is evidenced by the large increase in the availability of automatic teller machines (ATMs) and other means of electronic payments, including electronic fund transfer at the point of sale (EFTPOS). By lowering the processing cost associated with financial transactions, electronic means of payments are also a sign of efficiency of financial intermediation. By 1997, Portugal's use of electronic means of payments was above the EU average (Figure 14).

Table 16. **Interest rate differentials**

Bank lending rates less market rates

	1980-84	1985-89	1990-94	1995	1996	1997	1998
United States: Prime rate	1.5	1.5	2.4	3.3	3.3	3.4	–
Mortgage rate	2.1	2.1	2.1	2.6	2.8	2.7	–
Japan[1]	1.0	1.0	1.8	1.4	1.3	1.3	–
Germany[2]	3.8	4.0	4.3	6.4	6.7	5.8	–
France[3]	–3.0	0.8	0.6	1.5	2.8	2.9	–
Italy[4]	1.7	2.3	2.2	2.1	3.2	2.9	–
United Kingdom[5]	0.1	0.8	1.2	1.9	1.3	1.1	–
Canada[3]	1.7	1.3	1.2	1.6	1.9	1.7	–
Australia[6]	0.5	0.2	3.4	2.8	2.6	1.8	–
Belgium[7]	2.8	2.4	3.6	3.7	4.0	3.6	–
Finland[8]	–3.6	–2.1	–0.1	2.9	3.5	3.0	–
Netherlands[9]	2.2	1.7	1.0	3.2	3.4	2.8	–
Portugal[10]	**–**	**4.5**[11]	**4.7**	**4.0**	**4.4**	**3.4**	**2.9**
Spain[12]	0.7	2.6	2.8	2.0	2.1	1.9	–

1. Prime rate less 60-day financial bill rate.
2. Interest rate on short-term bank credit less 3-month euro deposit rate.
3. Prime rate less 3-month interbank rate.
4. Overdrafts with commercial banks less 3-month interbank rate.
5. Building society mortgage rate less 3-month euro deposit
6. Housing loans to individuals (saving banks) less 3-month interbank rate.
7. Overdrafts with commercial banks less 3-month tender rate on treasury certificates.
8. Commercial banks' lending rate less 3-month interbank rate.
9. Mortgage loan rate less 3-month interbank rate.
10. Banks' rates on loans and advances to non-financial enterprises from 91 to 180 days less 3-month interbank rate.
11. 1988-89.
12. Credit rate less 3-month interbank rate.

Source: OECD Secretariat.

Securitisation and internationalisation of markets

The importance of financial intermediation increased sharply in most OECD countries following liberalisation. In Portugal, indicators such as domestic credit and credit institutions' assets as a percentage of GDP, present solid evidence of a steady increase in the depth of financial markets. By 1997, domestic credit had reached over 100 per cent of GDP and total assets of Portuguese credit institutions amounted to 220 per cent of GDP, higher than in Spain or Italy, and only slightly below the EU average (Figure 15). Financial market reforms have also led to the increased use of securities in the intermediation of finance across the OECD area, a phenomenon known as "securitisation".[44] This process has also been evident in Portugal, even though banks still retain the bulk of financial intermediation, especially lending (Table 17).[45]

Since the early 1990s, investment and pension funds have flourished in Portugal, boosted by deregulation, increased real incomes and the overall

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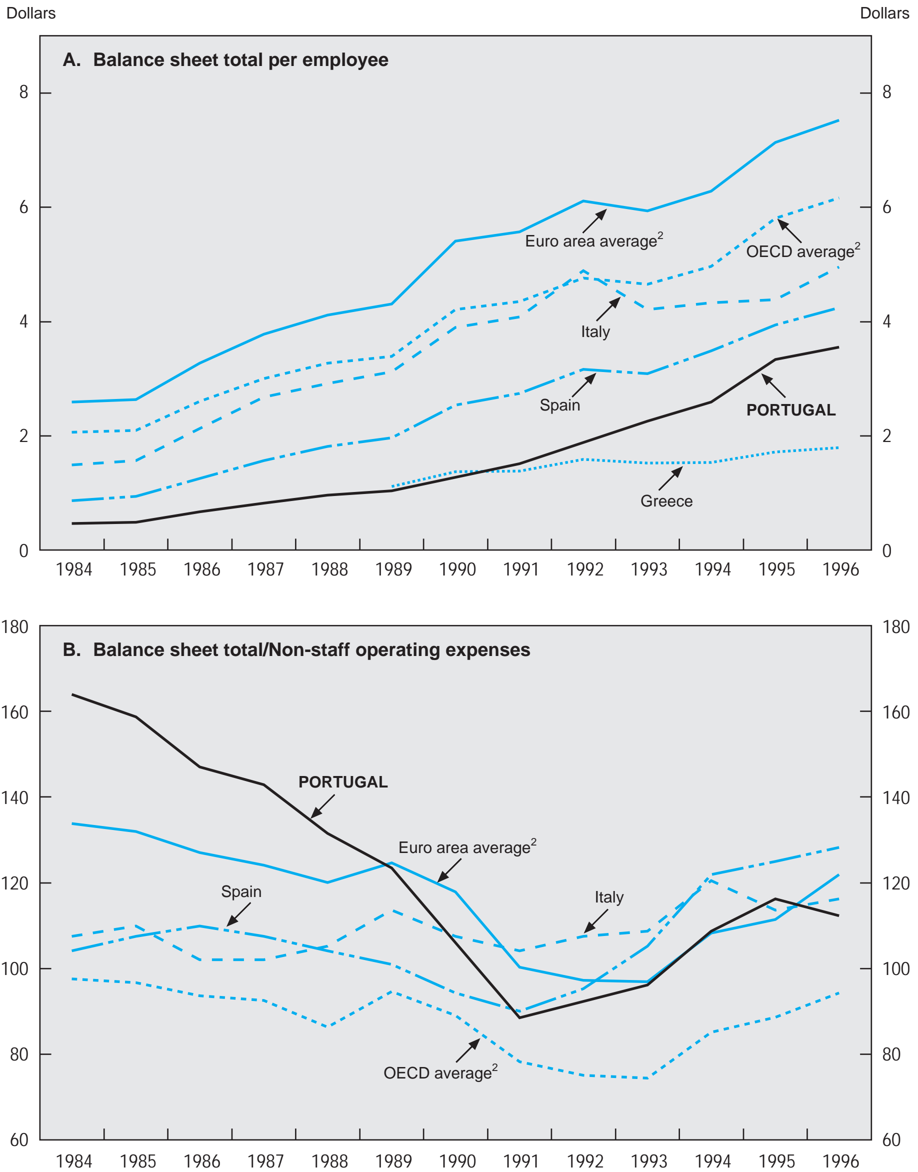
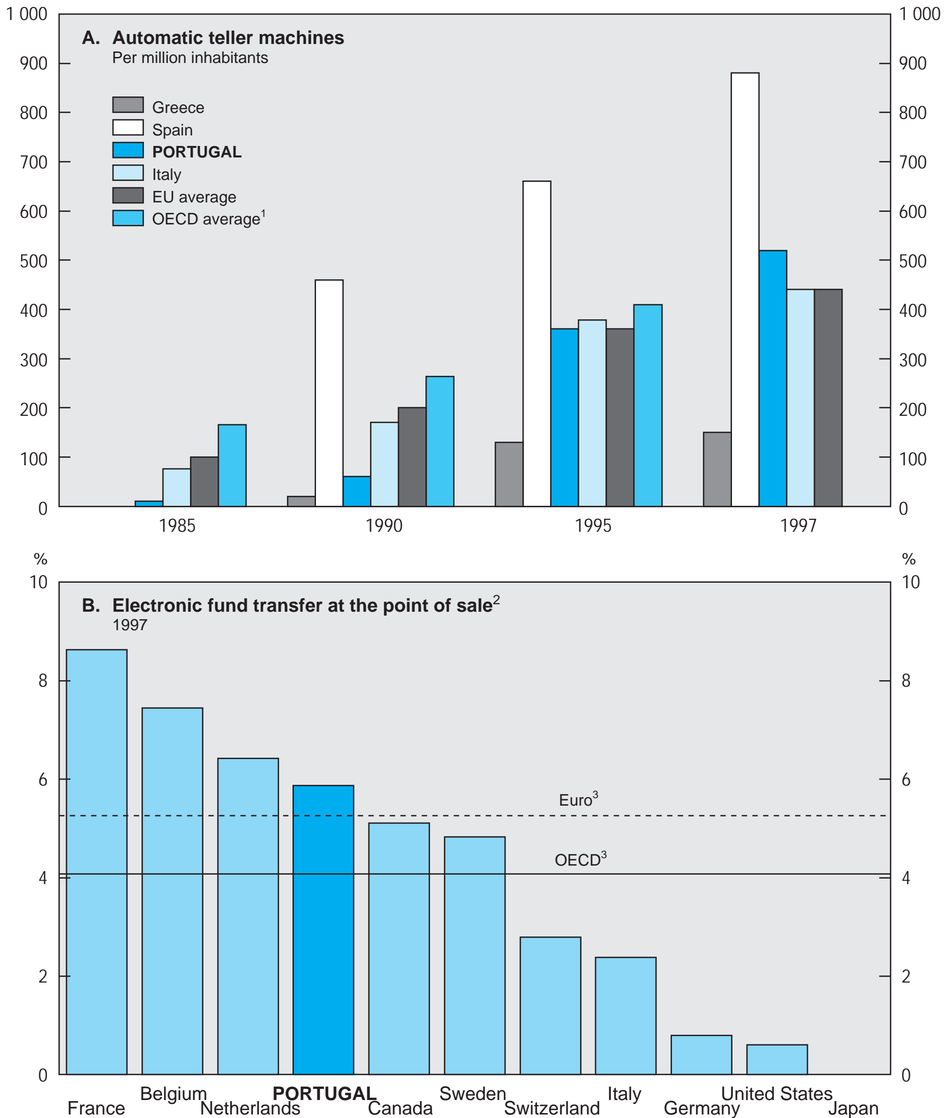
Figure 13. **Productivity and efficiency indicators**[1]



1. Commercial banks.
2. Unweighted average of countries for which data are available.

Source: OECD, *Bank Profitability*, 1998.

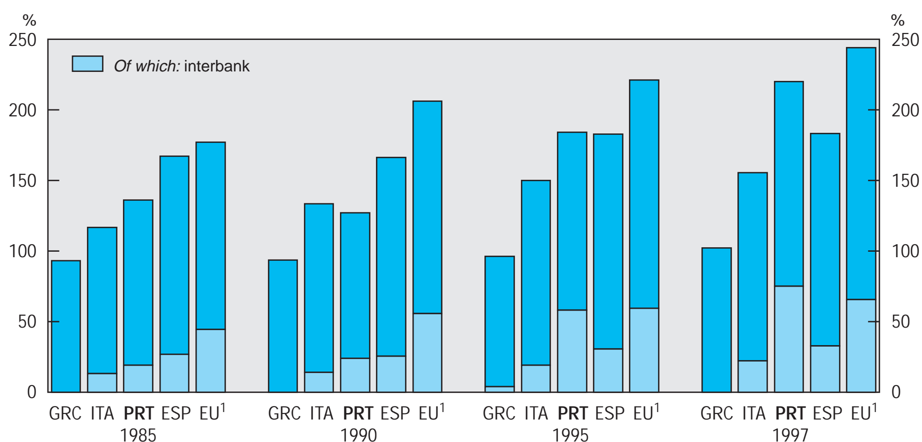
Figure 14. **Electronic means of payment**



1. Estimates.
2. Value of transactions as a percentage of GDP.
3. Unweighted average of countries for which data are available.

Source: BIS, Payment systems in the group of ten countries (December 1998); Bank of Portugal, OECD, *Bank Profitability,* 1998.

Figure 15. **Assets of credit institutions**
As a percentage of GDP



1. EU weighted average by GDP, interbank data exclude Denmark, Greece and the United Kingdom.
Source: ECB.

decline in interest rates. Investment fund assets reached the equivalent of 25 per cent of GDP in 1997, up from 5 per cent in 1990, only slightly below the EU average (Figure 16).[46] The insurance industry has also developed rapidly after the liberalisation of the sector in the late 1980s and early 1990s.[47] By 1997, the volume of insurance premia had reached 5 per cent of GDP, or almost two-thirds of the EU average (Figure 17). Convergence was much faster in the life insurance segment, which had started from a much lower base. The growth of investment and pension funds and of the insurance industry has helped the development of the securities markets: as a result of a different investor base compared with commercial banks, these funds tend to have a large proportion of their portfolio invested in long-term bonds and shares.[48] In 1998, non-bank financial institutions, including insurance companies and pension funds, acquired the equivalent of more than 6 per cent of GDP worth of medium and long-term securities and represented over half of the financial sector's net acquisition of shares.

Fuelled by strong inflows of foreign capital and the development of a base of domestic institutional investors, market capitalisation and turnover boomed in Portugal's capital markets (Table 18). Trading in shares received an additional boost from the privatisation programme, which between 1989 and 1999 transferred in average 2 per cent of GDP a year to the private sector. With

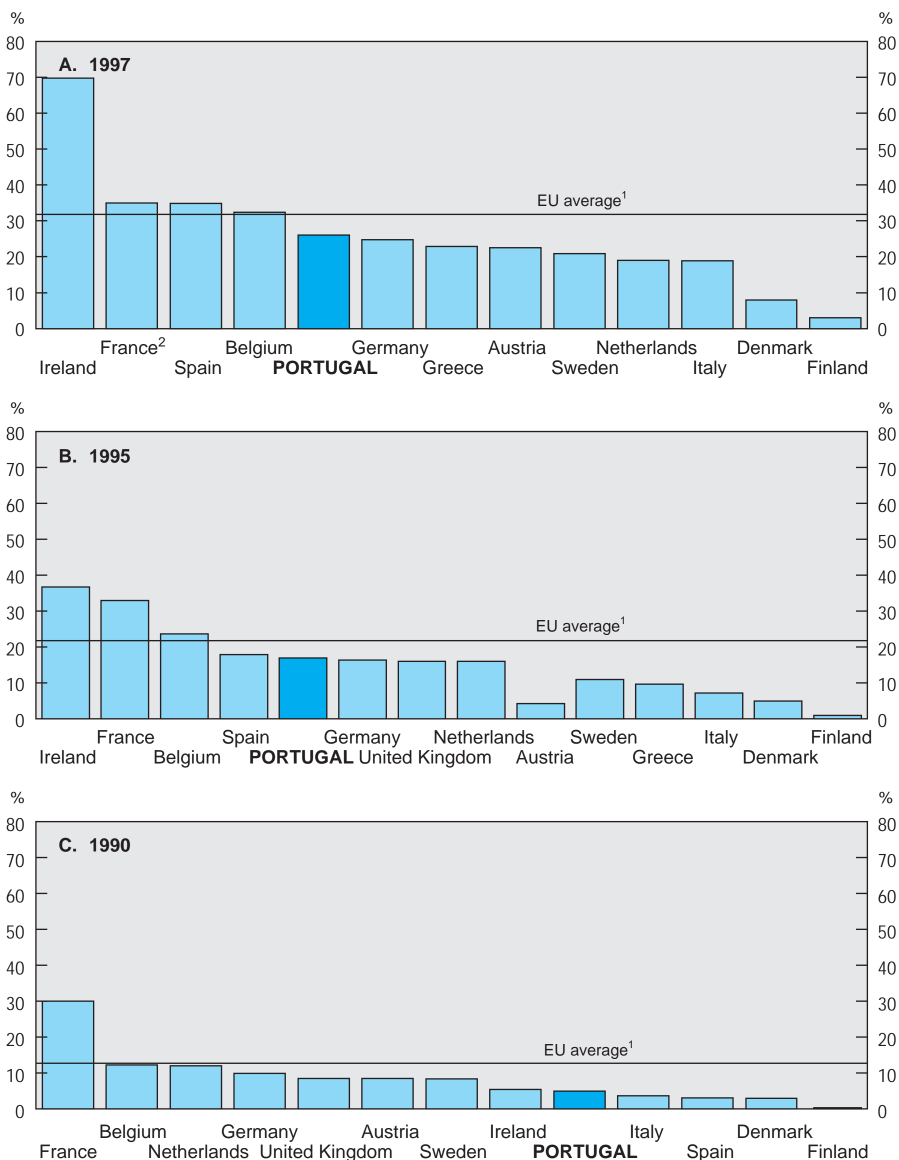
Table 17. **Financial transactions of the financial sector**

1998, billion escudos

	Central Bank		Banks		Non-bank financial institutions		Insurance companies and pension funds		Total financial sector	
	Uses	Resources	Uses	Resources	Uses	Resources	Uses	Resources	Uses	Resources
Financial transactions										
Financial saving	–106.5	–	550.7	–	49.5	–	96.4	–	590.2	–
(% of GDP)	(–0.5)	–	(2.8)	–	(0.3)	–	(0.5)	–	(3.0)	–
Net financial assets acquired	117.6	–	4 403.2	–	1 249.4	–	890.4	–	5 957.1	–
Net financial liabilities incurred	–	224.1	–	3 852.5	–	1 200.0	–	794.0	–	5 366.9
Monetary gold and SDRs	203.8	–	–	–	–	–	–	–	203.8	–
Currencies and deposits	–688.1	144.4	51.6	3 436.2	98.5	–	12.8	–	–655.1	3 450.4
Securities other than shares	588.7	107.0	–513.1	–89.2	604.5	101.4	639.2	0.2	1 191.4	–8.6
Loans	2.4	–	4 458.3	341.0	494.4	279.1	48.9	–52.6	4 529.5	93.1
Shares and other equity	17.2	–	309.0	173.4	130.9	741.4	198.9	3.4	683.7	946.0
Technical reserves	–	–	0.3	–13.8	0.6	–	16.2	824.2	16.2	809.5

Source: Bank of Portugal.

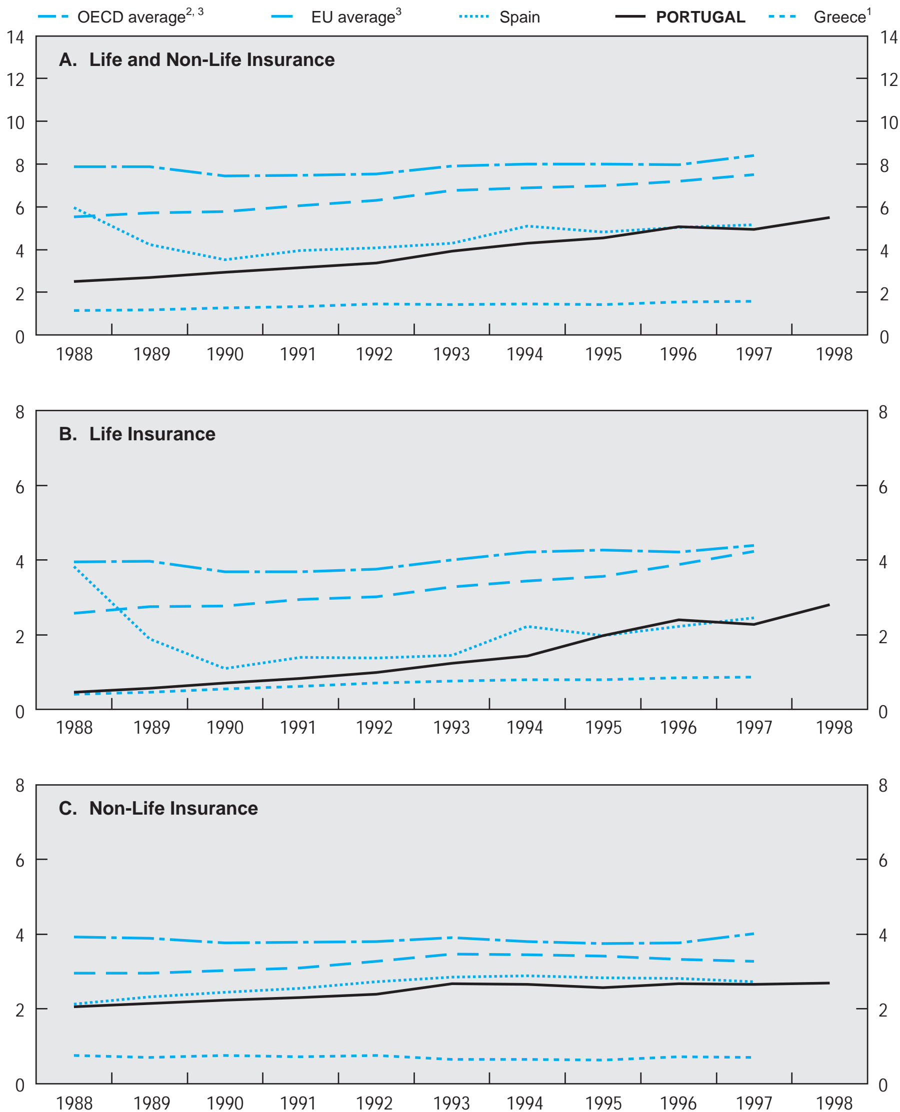
Figure 16. **Investment funds' assets**
As a percentage of GDP



1. Weighted by GDP.
2. 1996.

Source: ECB.

Figure 17. **Insurance penetration indicators**
Percentage of GDP



1. Net written premiums basis until 1991.
2. Excludes: Czech Republic before 1993, Hungary before 1991, Korea before 1994, Poland before 1993.
3. Weighted by GDP.

Source: Portuguese Insurance Institute; OECD, *Insurance Statistics.*

Table 18. **Portuguese capital market indicators**

Percentage of GDP

	1992	1993	1994	1995	1996	1997	1998
Primary market issues							
Shares	0.9	0.7	1.2	2.8	1.2	0.9	3.9
Bonds	2.9	3.3	3.5	6.6	7.9	8.5	7.5
Commercial paper	0.0	3.1	8.9	11.3	12.4	14.9	14.4
Public debt	1.7	7.0	4.6	8.0	7.6	7.9	6.3
Spot market							
Market capitalisation	38.3	49.9	51.7	55.6	63.4	80.5	101.2
Turnover							
Stock exchange	19.4	32.6	33.7	20.6	21.5	36.1	55.3
of which: Shares	3.7	5.8	6.0	2.3	6.6	22.9	48.7
Bonds	13.5	25.6	26.8	13.5	13.4	12.8	6.5
MEOG – Bonds	0.0	0.0	12.4	29.7	60.9	68.5	112.5
Over the counter	13.8	10.0	8.3	8.7	7.5	10.1	6.4
Future market							
Trading values	0.0	0.0	0.0	0.0	15.9	72.0	70.0
of which: PSI-20	0.0	0.0	0.0	0.0	0.2	4.4	12.9
0T-10	0.0	0.0	0.0	0.0	9.0	16.3	14.2
Lisbor 3 months	0.0	0.0	0.0	0.0	6.7	50.7	40.5
Securities investment funds							
Net asset value	9.1	12.3	14.1	13.2	15.8	22.1	25.0

Source: CMVM.

privatised companies accounting for about half of trading activity, share turnover on the Portuguese stock exchange reached 48.7 per cent of GDP in 1998.[49] The Lisbon stock exchange remains one of the smallest in Europe however, with less than 1 per cent of total EU capitalisation in 1997 (Portugal's GDP accounts for 2 per cent of EU GDP) (Table 19). The bond market also increased rapidly: the creation of the special wholesale bond market (MEOG) in June 1994 boosted trading and helped increase liquidity, mainly for public debt.[50] The nominal value of bonds outstanding reached 67 per cent of GDP in 1997, only slightly below the EU average (Figure 18). More importantly, an increasing share of these bonds have been issued by the non-government sector (including state-owned enterprises) – for which bonds outstanding jumped from 1 to 27 per cent of GDP between 1985 and 1997. Most of these have been issued by commercial banks. Still, the issuance of bonds by non-government non-financial enterprises reached 7 per cent of GDP in 1997, one of the highest levels in the EU. Finally, the derivatives markets remain thin, owing to the absence until recently of a futures exchange – only in June 1996 was the Porto Futures Exchange created. Liquidity has been increasing rapidly however, especially for the 3-month Lisbor contract,

Table 19. **European Union stock exchanges**

1997

	Volume billion ECU	Number of stocks	Capitalisation	
			Billion ECU	% GDP
Amsterdam	249.3	350	74.7	186.8
Athens	18.8	220	4.0	30.0
Brussels	30.1	263	43.8	164.1
Copenhagen	41.5	249	13.4	72.0
Dublin[1]	15.0	87	6.1	75.5
Frankfurt[1]	947.0	2 696	136.8	59.5
Helsinki	32.2	126	8.6	65.0
Lisbon	**18.4**	**148**	**5.6**[2]	**50.0**[2]
London	1 777.4	2 991	n.a.	n.a.
Luxembourg	0.9	284	0.3	16.8
Madrid	120.1	388	30.1	51.4
Milan[1]	181.0	239	135.2	107.3
Paris	368.1	862	59.6	38.9[3]
Stockholm	156.0	261	31.1	124.0
Vienna	11.2	136	4.1	18.0

1. Includes other national stock exchanges.
2. Nominal values.
3. 1996.

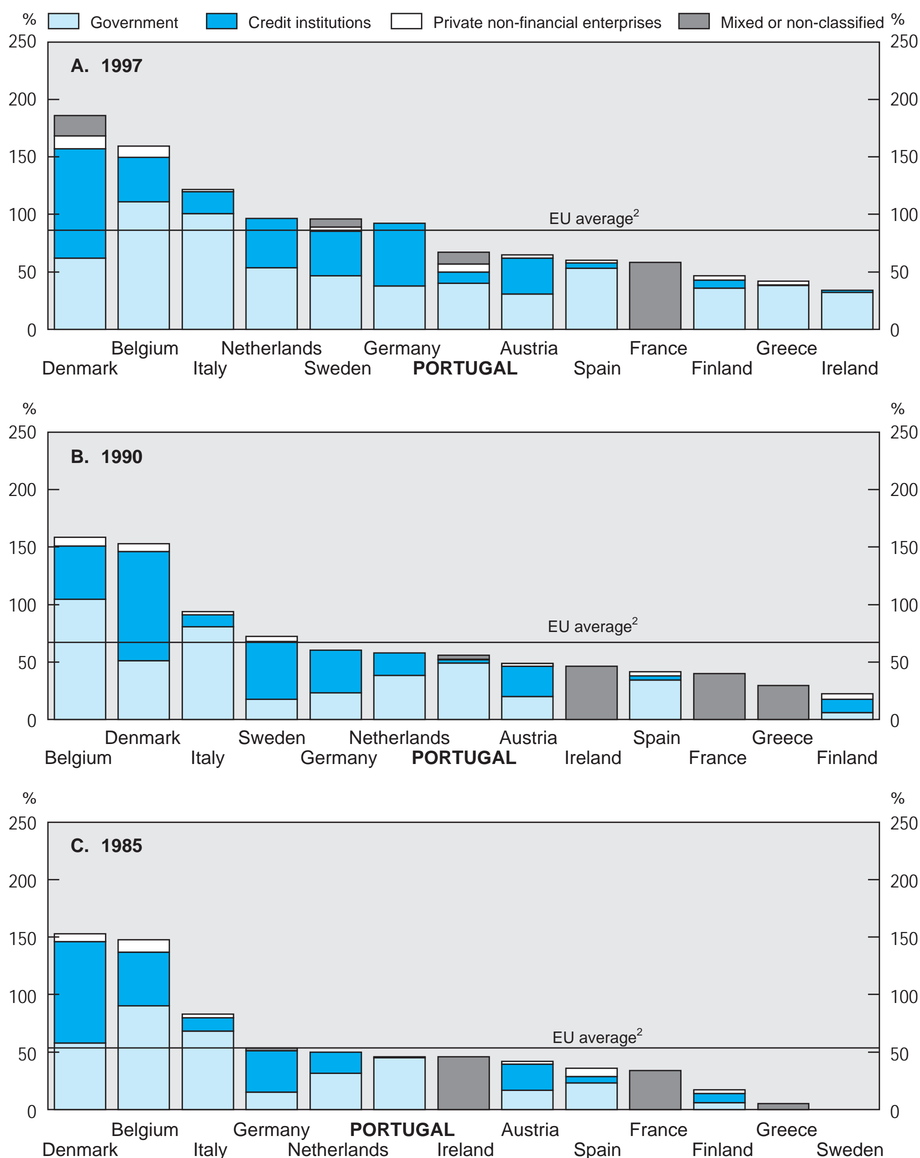
n.a. Not available.

Source: European Stock Exchange Statistics, ECB.

which accounted for about 60 per cent of the futures market total turnover of over 14 billion escudos in 1997 – or 70 per cent of GDP.

Another trend observed in most OECD countries and deriving in large part from financial deregulation has been the increased internationalisation of financial markets. The spectacular growth in cross-border transactions was a consequence of the removal of capital controls as well as of the reduction in transaction costs deriving from increased competition in financial markets. In the case of Portugal, the increasing internationalisation of markets has been evident in the increase of foreign exchange market turnover, which more than tripled in dollar terms since mid-1992. Swap operations by financial institutions, which recorded the largest increase, accounted for about half of daily average turnover in 1998. This has been mirrored by a large jump in the position of Portuguese institutions – both financial and non-financial – *vis-à-vis* foreign banks. Both assets and liabilities have increased, suggesting that capital flows augmented in both directions. Capital outflows have been reflected in the growing number of non-resident issuers in the country's primary markets – the "navigator" (*caravela*) bond market has boomed, especially since 1994, when the requirement for prior government authorisation was abolished, opening the market for borrowers other than

Figure 18. **Bonds outstanding**[1]
As a percentage of GDP

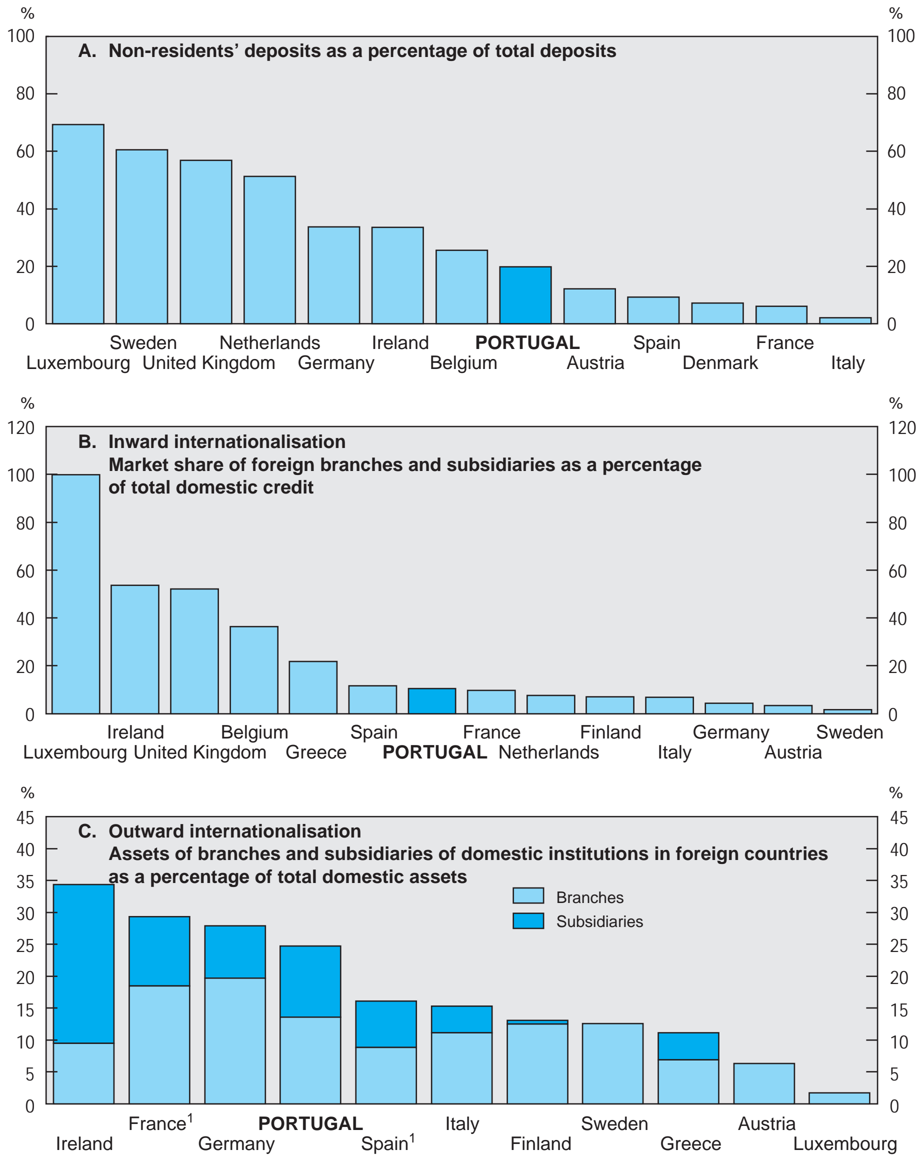


1. Nominal value.
2. Unweighted.

Source: ECB.

Figure 19. **Indicators of internationalisation in the banking system**

1997



1. 1996.

Source: ECB.

supranational and sovereign issuers. In 1997, 530 billion escudos worth of "navigator" bonds, equivalent to 3 per cent of GDP, were issued – four-fifths of which by non-sovereign borrowers. On the inflow side, the acquisition by non-residents of Portuguese government bonds was the driving force behind the large increase in capital raised by Portugal on international financial markets in the first years of liberalisation, although syndicated credits have also boomed in more recent years. Indicators of the internationalisation of the Portuguese banking system, both inward and outward, are now close to the EU average (Figure 19).

Size and structure of the financial sector

By removing constraints on the supply of financial services, deregulation has led to an initial jump in the size of the financial sector in most OECD countries.[51] This has been especially noticeable in variables such as the share of investment in financial services in gross capital formation and the share of financial sector employment in total employment. In Portugal as well, financial liberalisation, combined with high profitability, was followed by a jump in investment in the sector (Table 20). Including the insurance industry, investment in financial services almost tripled as a share of total gross capital formation during the second phase of reforms. In the early 1990s, the sector accounted for 4 per cent of total gross capital formation – one of the highest levels in the OECD – before falling back towards pre-reform levels in more recent years. Measured by its importance as an employer, the Portuguese financial sector was not significantly affected by liberalisation, however. Employment in the sector remained relatively stable in the past two decades – averaging 2.5 per cent of total employment, as banking moved from an over-manned system to a leaner and more productive one after reforms (see section below) (Table 21).

In most countries, reforms have led to an initial increase in the number of banks, followed by a process of consolidation, as less competitive firms were driven out of the market. This has also been evident in Portugal, even though the consolidation process has so far been felt mostly in terms of concentration ratios rather than on the number of universal banks.[52] In 1983, when entry in the banking system started to be liberalised, there were only three private banks operating in the country.[53] By the end of the first phase of financial sector reforms in 1989, they had increased to sixteen, ten of which were subsidiaries of foreign banks. After full liberalisation in the early 1990s, the number of universal banks continued to increase: not only there were new entrants, but also many of the existing investment companies acquired the status of universal banks (Figure 20). The number of branches also jumped sharply in the early 1990s, as competition in the retail end of the market increased – by 1996, bank branch density in Portugal was close to the OECD average (Figure 21, Panel A).[54] The number of non-bank financial institutions also boomed after the first phase of financial sector reforms, when

Table 20. **Investment in financial services**[1]

Per cent of gross capital formation

	1960-69	1970-74	1975-79	1980-84	1985-89	1990-93	1994-96
United States	1.6	2.2	3.1	5.1	7.1	7.4	7.5
Germany	1.4	1.8	1.9	2.1	2.2	2.7	2.9[4]
France	–	1.5	1.5	1.7	2.3	1.7	0.8
United Kingdom	–	5.0	5.8	9.5	9.3	5.1	12.5
Belgium[2]	–	–	2.2	2.8	3.5	2.2	1.6
Denmark[2]	1.9	2.0	2.0	2.3	2.2	2.3	–
Finland	–	–	1.7	1.8	1.4	0.6	–0.1
Luxembourg	–	2.5	3.4	6.5	13.1	15.7	–
Norway[2]	0.9	1.1	1.1	2.0	2.9	2.9	–
Portugal	**–**	**–**	**–**	**1.5**	**2.7**	**4.0**	**2.4**[4]
Sweden	–	–	–	0.7	1.1	0.9	1.3[4]
Average[3]	–	–	–	4.7	5.8	5.4	–

1. Financial institutions and insurance.
2. Financial institutions only.
3. Weighted average of countries for which data are available.
4. 1994-1995.

Source: OECD, *National Accounts.*

Table 21. **Employment in financial services**[1]

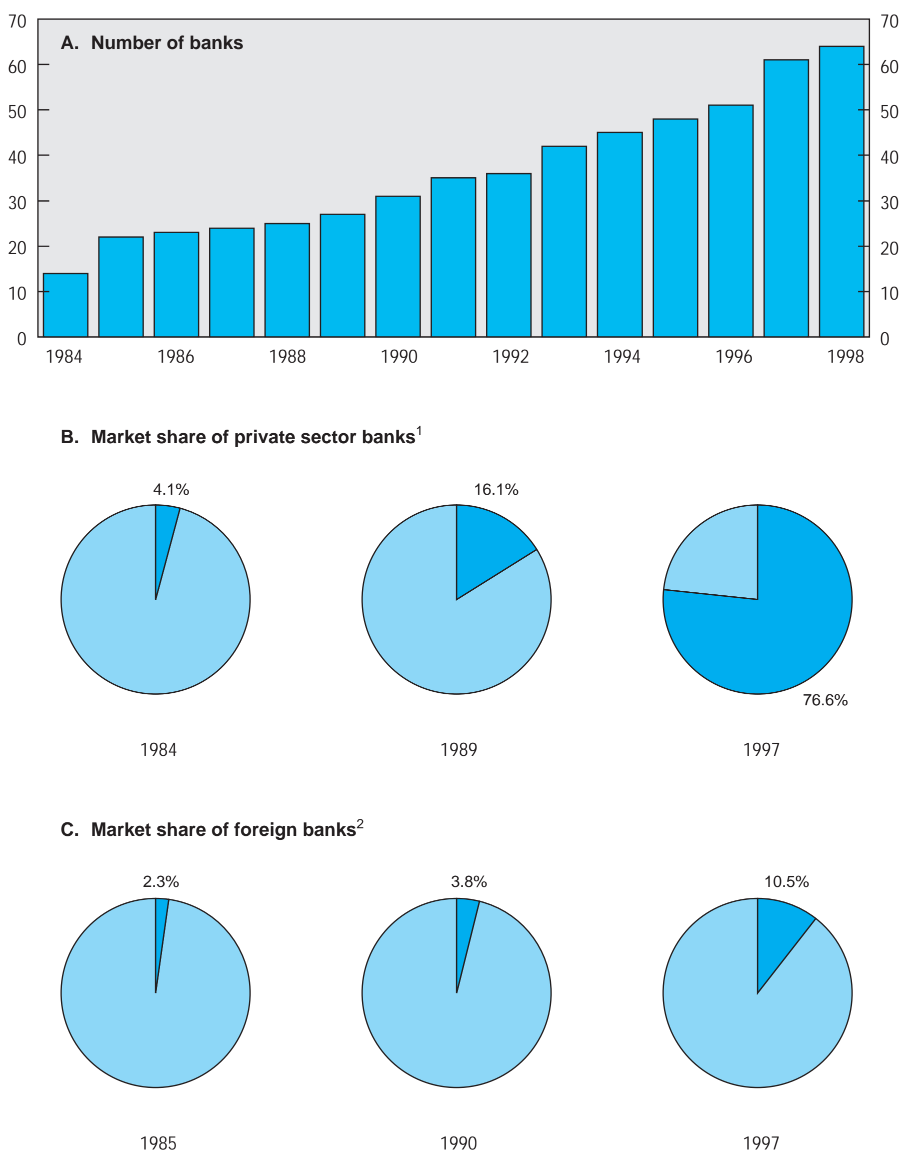
Per cent of total employment

	1960-69	1970-74	1975-79	1980-84	1985-89	1990-93	1994-96
United States	3.7	4.1	4.4	4.9	5.1	5.0	4.8
Germany	2.3	2.9	3.2	3.3	3.4	3.6	–
France	–	2.5	3.0	3.2	3.3	3.2	3.0
Canada	–	–	–	4.3	4.3	4.4	4.3
Australia	–	–	–	4.7	5.1	4.9	4.4
Austria	–	2.6	3.0	3.5	3.8	3.9	3.9
Belgium	–	3.4	3.6	4.0	4.5	4.4	4.4
Denmark	2.7	3.1	3.6	4.0	4.5	4.6	–
Finland	–	–	2.8	2.9	3.3	3.1	2.8
Iceland	–	3.2	3.5	3.9	4.5	4.8	4.4
Luxembourg	–	4.3	5.2	6.7	8.7	10.0	–
Mexico	–	–	–	–	1.0	0.9	0.8
Netherlands	–	–	–	1.0	4.0	3.9	3.8[2]
New Zealand	–	–	–	2.8	3.4	3.8	–
Norway	2.0	2.4	2.6	2.8	3.3	3.2	–
Portugal	–	–	**2.3**	**2.6**	**2.6**	**2.5**	**2.5**[2]
Spain	–	–	–	–	3.5	3.3	3.3[2]
Sweden	–	–	–	1.9	2.2	2.3	2.5[2]
Average[3]	–	–	3.5	3.8	4.1	4.1	3.9

1. Including insurance.
2. Weighted average of countries for which data are available.
2. 1994-1995.

Source: OECD, *National Accounts.*

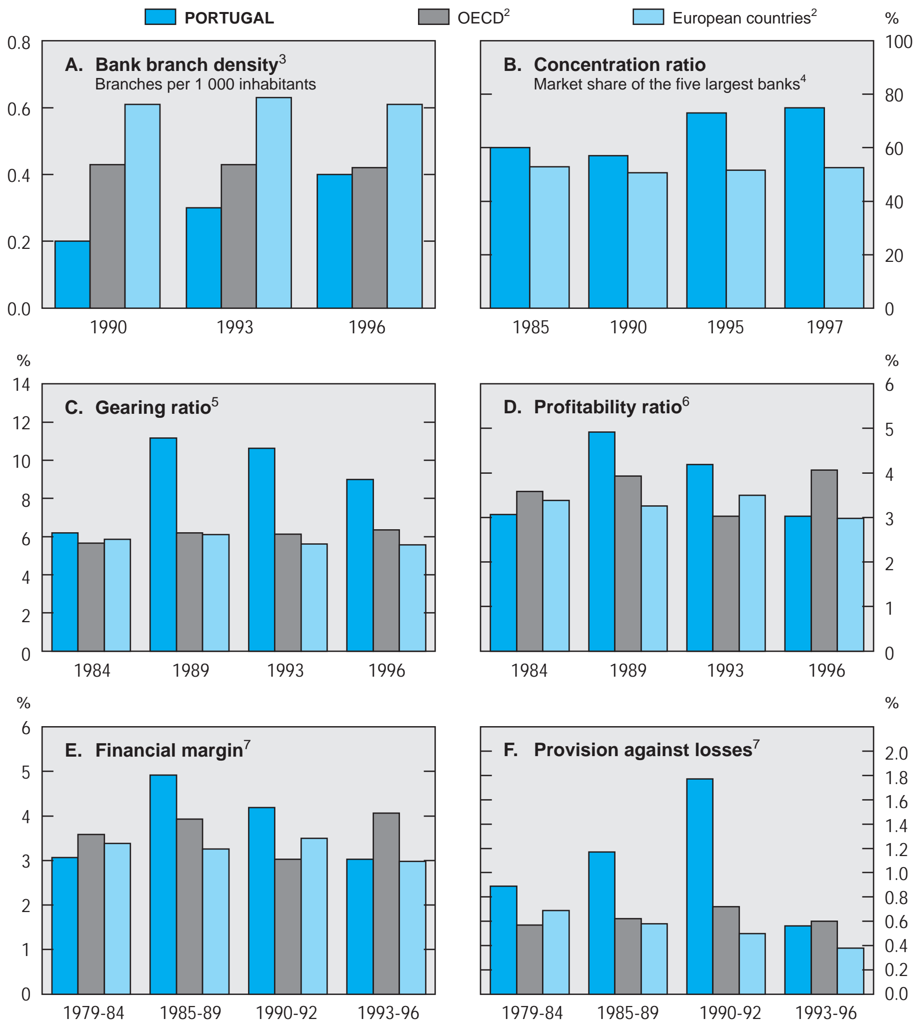
Figure 20. **The structure of the banking system**



1. In terms of credit outstanding.
2. As a percentage of total domestic assets, includes both branches and subsidiaries.

Source: Bank of Portugal; ECB.

Figure 21. **Structure and performance of the financial system**[1]



1. Country details are presented in Annex Figures A1 to A6.
2. Unweighted average. European average refers to EU countries excepts for panel A where it refers to euro area countries.
3. Commercial banks, except for Denmark, Iceland and Switzerland. European average refers to euro countries only.
4. As a percentage of total loans.
5. Commercial bank's capital and reserves as a percentage of balance sheet total.
6. Commercial bank's gross income as a percentage of balance sheet total.
7. As a percentage of balance sheet total; for commercial banks.

Source: OECD, *Bank Profitability,* 1998; ECB.

entry into non-bank financial intermediation was opened to the private sector.[55] Since the early 1990s however, a large number of non-bank credit institutions were incorporated into larger groups, often led by a commercial bank. This process also occurred in other EU countries and was linked to the implementation of the EU Second Banking Directive – enshrining the concept of universal banking and leading to the elimination of most specialisation and segmentation restrictions.[56]

Liberalisation and privatisation led to significant changes in the structure of the banking system. Today, only one banking group remains in the public sector: the "Caixa Geral de Depósito*s*" (CGD) group, which accounts for about a quarter of outstanding credits in the system. The share of foreign banks has also increased, especially in recent years, as foreign institutions have established operations in the Madeira offshore centre. By 1997, the market share of foreign banks (in terms of total assets) had reached over 10 per cent. Until the early 1990s, the large increase in the number of institutions led to only a minor downward trend in concentration ratios. First, branching restrictions meant that the majority of new entrants did not have retail operations, but rather operated exclusively on capital markets or concentrated their activities on investment banking. Second, the existence of credit ceilings at the bank level also affected the determination of market shares in the loan markets. Since 1994, a process of consolidation, including mergers and acquisitions, has been underway, and concentration ratios started to increase. The five largest financial groups that dominate the industry saw their market share increase from 69 to 77 per cent of total assets in the banking system in the four years to 1998.[57] This level of concentration is common for smaller European countries, which have also experienced a similar increase in concentration ratios in the 1990s (Figure 21, Panel B).

Solvency and profitability of the financial system

In the mid 1980s, Portuguese banks – most of them state-owned – had gearing and profitability ratios that were close to the OECD average (Figure 21, Panels C and D).[58] These banks were undercapitalised and inefficient, however. While adequate gearing ratios were merely a reflection of high (involuntary) liquidity, profitability was artificially boosted by credit ceilings, which kept lending rates artificially high. In fact, high levels of interest income served to offset relatively high staff costs, above-average levels of non-performing loans – deriving from political interference in management and compulsory investment ratios – and a system of deficit financing which worked as an implicit tax on banks' balance sheet.[59]

Although not an explicit policy objective, the strengthening of state-owned banks' balance sheets before privatisation was an indirect consequence of

the sequencing of liberalisation. Entry restrictions and credit ceilings limited competition, allowing banks to enjoy oligopolistic rents.[60] As a result, financial margins increased sharply, boosting net income (Figure 21, Panel E). Income was further boosted by the move towards a system of remunerated excess liquidity. With profitability soaring, banks were encouraged to use increased profits to improve their prudential ratios – leading to higher system-wide gearing ratios and bigger provisions against losses (Figure 21, Panel F). This improvement was particularly noticeable for state-owned banks, which converged steadily towards their more profitable and solvable private sector counterparts. By 1989, Portuguese commercial banks had the highest gearing ratios in the OECD area, while profitability was also above average.

With the second phase of reforms, competition in the banking sector started to increase significantly, as entry restrictions were eliminated and most other direct controls abolished. As a result, interest rate spreads narrowed sharply. Although positive for the economy as a whole, this hit banks' balance sheets strongly. By the mid-1990s, financial margins had fallen to pre-reform levels and were about average for the EU. This was similar to what occurred in most other OECD countries going through a process of financial sector liberalisation. In many countries however, this was in part offset by an increase in non-interest income, which was boosted by two main factors. First, increased competition led to the reduction of cross-subsidisation, boosting fee income – since financial intermediation profits had been used to keep fees low. Second, the deepening of capital markets increased income originating from financial operations, mostly securities and foreign exchange. In Portugal this was not initially the case. Non-interest income declined as a percentage of total balance sheet in the early 1990s, before recovering after 1995. This was mostly a result of the behaviour of fee income, which, contrary to the experience of many other countries, did not increase in the early phases of liberalisation – perhaps as a result of the initial reluctance of the still prominent public sector banks in raising fees.[61] Since 1995, however, fee income has recovered, and combined with large capital gains on banks' holdings of shares and bonds, has significantly boosted total non-interest income (Table 22, Figure 22). The effect of the fall in interest income predominated, however. Gross income as a percentage of balance sheet total dropped sharply between 1991 and 1995 and fell further, though at a slower pace, in the next three years.

Nevertheless, profitability has recovered in more recent years: return on equity (ROE) started to show a marked improvement in 1995, reaching pre-reform levels by 1997. Trends in operating costs played a large role in this turnaround. During the second phase of reforms, operating costs (as a percentage of balance sheet total) had increased, pushed by personnel costs – the number of employees had increased by 8.4 per cent between 1989 and 1992, as the number

Table 22. **Commercial banks' income statement**

Percentage of average total assets

	1991[1]	1993	1995	1997	1998[2]
Net interest income	5.0	3.4	2.4	2.0	1.8
Non-interest income (net)	1.2	1.1	0.9	1.1	1.2
Securities	–	0.1	0.1	0.1	0.2
Fees (net)	–	0.4	0.3	0.4	0.4
Net profit on financial operations	–	0.4	0.3	0.4	0.4
Other	–	0.1	0.2	0.2	0.2
Gross income	6.1	4.4	3.3	3.2	3.0
Operating expenses	2.8	2.1	1.8	1.7	1.4
Staff costs	1.6	1.4	1.2	1.1	0.9
Other	–	0.7	0.7	0.6	0.6
Net income	3.4	2.3	1.4	1.5	1.6
One-off income	–	0.2	0.1	0.1	0.1
Reimbursements	–	0.4	0.3	0.2	0.2
Provisions (net)	1.8	1.1	0.6	0.5	0.6
Profits before tax	1.6	1.0	0.7	0.9	0.8
Income tax	0.4	0.2	0.2	0.2	0.2
Profits after tax	1.2	0.8	0.6	0.7	0.6
Assets (billions of escudos)	14 952.7	20 972.2	27 930.4	36 709.7	44 297.4

1. As a percentage of balance sheet total.
2. December only.
Source: Bank of Portugal; OECD.

of branches jumped sharply (Figure 23).[62] After 1992 however, operating costs started to drop, pulled down by a decline in staff and property cost. Provisions also declined sharply, as the share of bad loans fell.

In contrast to its effects on profitability, the second phase of financial sector liberalisation did not have a major impact on the gearing ratios of Portuguese commercial banks, which have remained comfortably above OECD averages and EU-wide prudential requirements (Box 2). High gearing ratios may have derived from prudent management and efficient supervision, as well as from the generally benign macroeconomic climate prevailing in the 1990s. Since the early 1990s, ratios have declined slightly however, moving towards the OECD average, a process which is consistent with the increase in banking activity at rates faster than the growth of equity in the system. Contributing to this movement have been a fall in net provisions and a decline in the newer banks' gearing ratios, which at the time of entry were considerably above the system's average.

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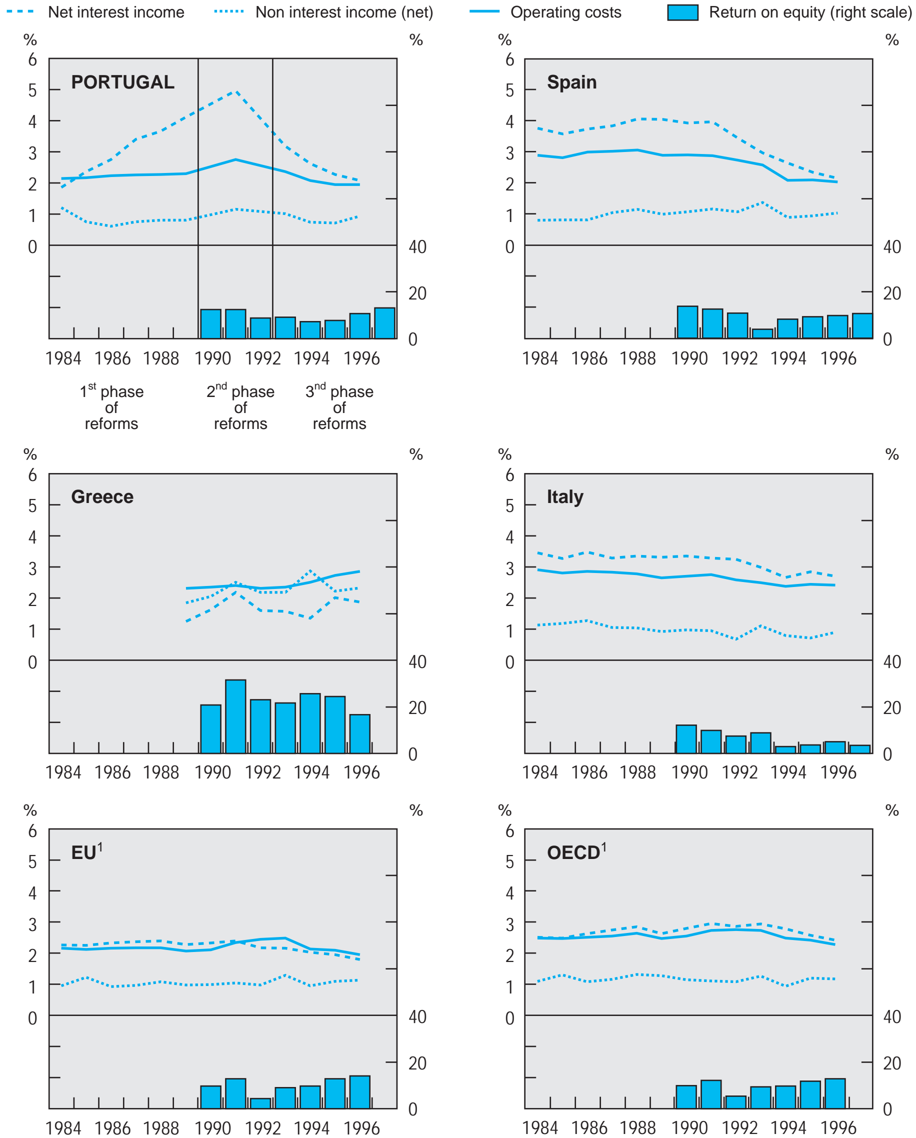
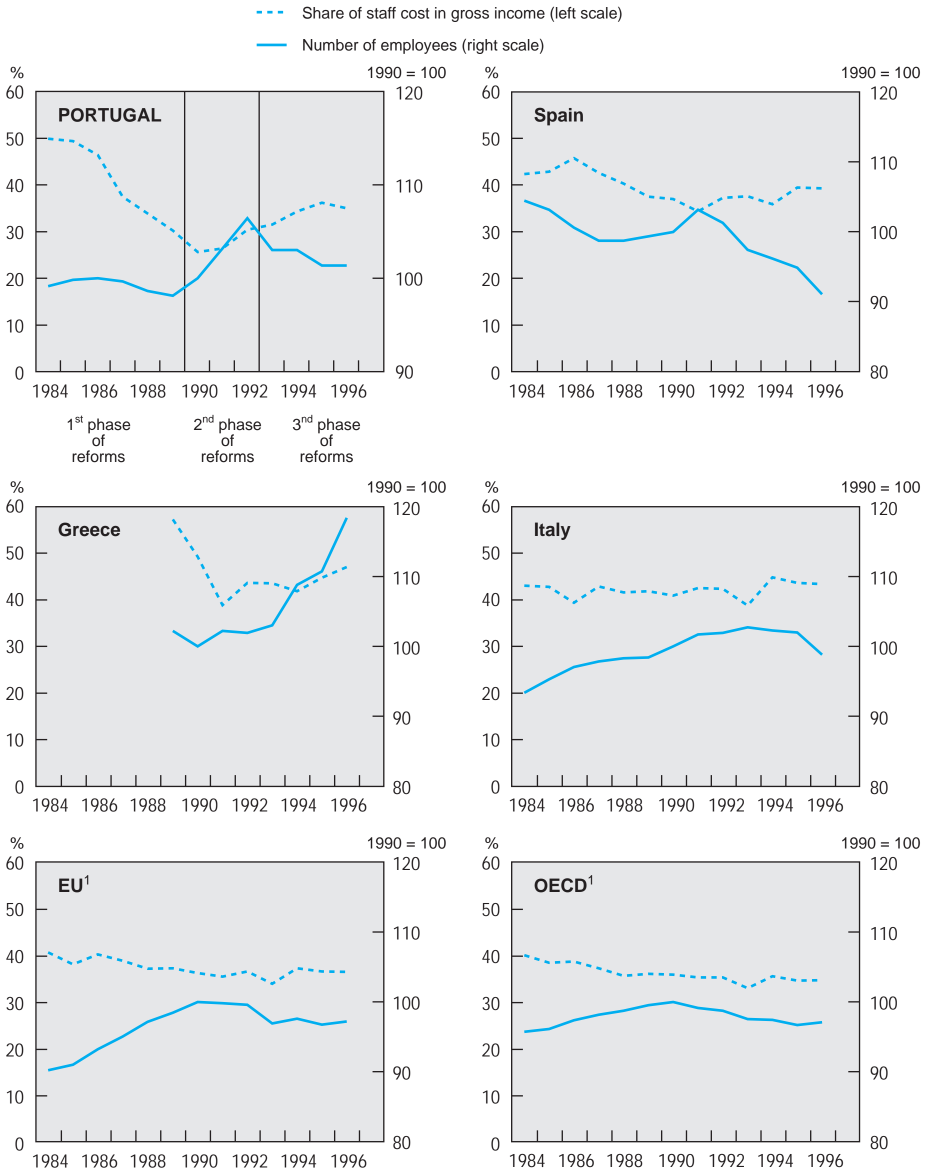
Figure 22. **Income, operating costs and return on equity**
As a percentage of balance sheet



1. Unweighted average.
Source: OECD, *Bank Profitability,* 1998.

Figure 23. **Number of employees and staff cost**



1. Unweighted average.
Source: OECD, *Bank Profitability,* 1998.

Box 2. Prudential regulation and supervision issues

Deregulation led to the relaxation of restrictions on the operation of financial institutions and to significant structural changes in the industry. This in turn changed the size and nature of possible systemic risks, so that the upgrading and modernisation of prudential supervision became a necessary complement to the liberalisation of the financial industry world-wide.[1] Major challenges to supervisory authorities world-wide have derived from the following trends:

a) The liberalisation of capital movements has led to increased cross-border financial flows as well as to enhanced links between markets and financial institutions world-wide, increasing the need for international co-operation between supervisory authorities.

b) Securitisation and the increased use of more innovative and complex financial instruments (including financial derivatives) have led to changes in the structure of banks' balance sheets and might also have affected asset quality. This, together with the fact that many derivatives transactions take place off banks' balance sheets, caused difficulties for supervisors and managers to properly assess institutions' risk exposures.[2] This created the need for capital standards to be revised.

c) Finally, as specialisation and segmentation rules were liberalised, financial conglomerates were formed, exposing banks to risks connected with their connected corporate units' activities. As a result, the compartmentalised model that separated the supervision of banks, insurance companies and securities exchanges had to be reconsidered in many countries.

In Portugal, some of these concerns have been at least partially addressed by EU-wide legislation. Several EU directives – including the Second Consolidated Supervision Directive – have provided for enhanced co-operation between national authorities and significantly harmonised capital standards within the EU, including through the application of a minimum 8 per cent solvency ratio with respect to credit risk.[3] This significantly limited – although it did not completely eliminate – the possibility of "regulatory arbitrage" within the EU. At the broader international level, the agreements under the Basle Committee on Banking Supervision provide for a measure of co-operation and common standards.[4]

Concerns about the inadequacies deriving from the compartmentalisation of supervision have not yet been fully addressed by EU legislation, which is generally mute on the issue, with the exception of the required consolidated supervision for banking groups that include securities firms. Opinions differ on the benefits of a single financial sector supervisory model and there are no EU-wide requirements in that regard. Still, in many countries the various agencies with supervisory roles were either merged or linked through institutional arrangements. This has not been the case in Portugal, where the banking system is supervised by the Bank of Portugal, the insurance industry by the Insurance Institute of Portugal ("Instituto de Seguros de Portugal", ISP) and the securities market – including mutual funds – by the Securities and Exchange Commission ("Comissão do Mercado de Valores Mobiliários", CMVM).

(continued on next page)

(continued)

Co-ordination and systems for the exchange of information between the three supervisors are in place, however.

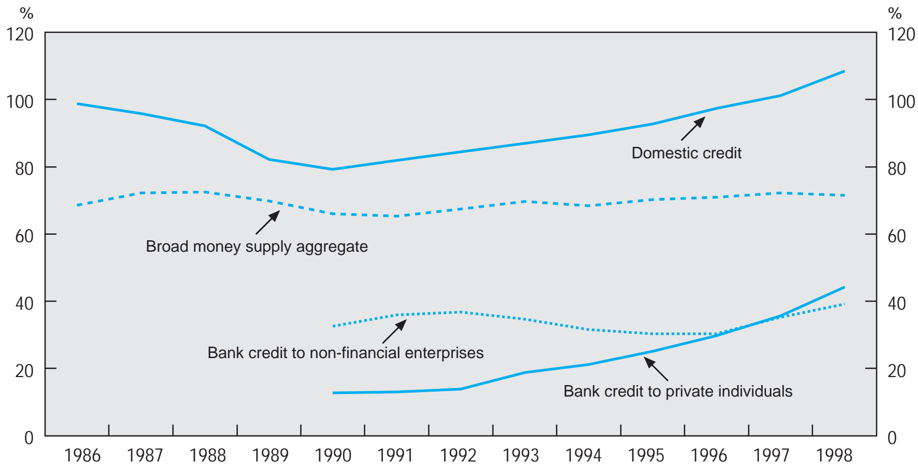
1. See Borio and Filosa (1995).
2. This is one of the main reasons why supervisory authorities allow banks to assess market risk on the basis of VAR models.
3. Other relevant EU directives include the Capital Adequacy, Solvency Ratio and Own Funds Directive.
4. Under the Core Principles advocated by the Basle Committee, which determines the amount of capital banks must hold, bank loans are grouped in classes. These range from zero capital for government loans to 8 per cent for normal commercial lending. This approach has been criticised in part for not taking into account other risks such as those arising from the portfolio of assets traded by the bank. Revisions to present arrangements – including both EU-wide and Basle agreements – are under study.

The conduct of monetary policy and macroeconomic performance

The conduct of monetary policy has benefited from the modernisation of policy instruments carried out as part of financial sector reforms. Largely as a result, monetary policy over the past few years has been broadly successful in steering the economy and contributing to the smooth transition to EMU. The effect of financial market reforms on macroeconomic variables is more difficult to isolate, especially since, in the case of Portugal, the latter part of reforms coincided with the entry of the escudo into the Exchange Rate Mechanism (ERM) and the preparations for EMU, which entailed the implementation of a programme of fiscal adjustment and cautious disinflationary monetary policy. To the extent that the deregulation of financial markets was an essential part of the process of intra-EU financial integration, it has probably played a significant role in the successful Portuguese macroeconomic performance for most of the 1990s – a period marked by relatively high output growth, declining inflation and the absence of major external imbalances.

Financial deregulation has led to extensive changes in the macroeconomic environment in many countries, although macroeconomic policy outcomes – beyond the increase in the overall efficiency of the economy – were generally not an explicit objective of financial sector reform processes.[63] Often, the most significant macroeconomic impact of reforms was felt on the behaviour of credit growth and saving ratios.[64] In Portugal, the combination of rising real interest rates and remaining credit guidelines in the late 1980s led to declining financial intermediation activity, as measured by the share of domestic credit to GDP. Intermediation only started to increase in the second phase of reforms, when credit

Figure 24. **Money and credit aggregates**
As a percentage of GDP



Source: Bank of Portugal; OECD, *Main Economic Indicators*.

ceilings were abolished and interest rate controls eliminated (Figure 24). The behaviour of Portugal's gross national saving mirrored to a large extent that of credit aggregates – increasing slightly in the second half of the 1980s and declining in the 1990s (Figure 25). This suggests that the effects of higher real interest rates on savings predominated in the first phase of liberalisation, before being offset by increased access to credit towards the second phase of the reform process.

There were significant differences in the behaviour of the various components of domestic credit and saving, however. Most of the increase in the availability of credit in the 1990s has consisted of bank credit to the household sector, which increased from 14.2 per cent of GDP in 1990 to 45 per cent in 1998. On the demand side, besides the effect of the drop in interest rates, consumer credit was boosted by the abolition of stamp duties in 1995 and mortgage credit by a favourable subsidy regime. Household indebtedness increased steadily between 1990 and 1998 – to about 66 per cent of total disposable income, a level which is about average for the OECD – while household savings declined by 6 percentage points of GDP.[65] Contrary to household credit, bank credit to non-financial private enterprises did not increase significantly soon after financial market liberalisation. This was in part a result of macroeconomic developments in 1992 and 1993, when

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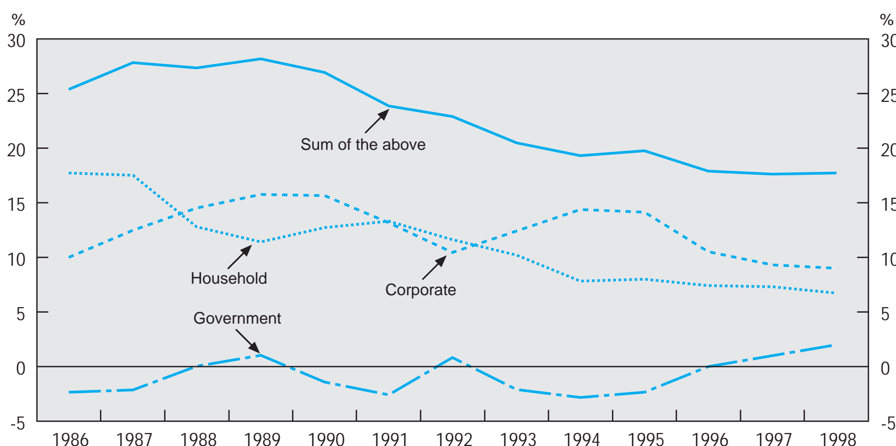
Figure 25. **Saving ratios**[1]
Per cent of GDP



1. Non-adjusted for inflation. Estimates for 1996 to 1998.
Source: Bank of Portugal; OECD, *National Accounts*.

ERM-wide turmoil led to exchange rate devaluation and monetary policy tightening. At that time, a jump in non-performing corporate loans led to significant credit retrenchment, which only started to be reversed in 1995. Domestic bank credit to the corporate sector only reached pre-ERM crisis levels in 1997. More recently, this ratio has been increasing rapidly – by 1998 banking credit to the corporate sector had reached 45 per cent of GDP. Total indebtedness of the corporate sector has also increased sharply, reaching 65 per cent of GDP in December 1998. The behaviour of corporate saving was the mirror image of developments in corporate indebtedness – it increased between 1992 and 1994, before falling from 1995 to 1998.

Reasons for the success of reforms

The reform process was a remarkable success. The main objectives of liberalisation were met, including enhanced efficiency of financial intermediation and improved macroeconomic management. Importantly, this was achieved without the concomitant financial instability experienced by many other OECD countries that liberalised the sector. The approach followed by the Portuguese authorities seems to have been the main reason behind this success, with prudent

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macroeconomic policies, adequate supervision and careful sequencing all playing a role in the reform strategy.

The collective experience of OECD countries has shown that deregulation has led to increased competition in the financial services industry.[66] Competition, in turn, has helped raise efficiency of financial intermediation by spurring reductions in both financial margins and operating costs. Furthermore, removal of regulatory restrictions has given financial firms more freedom to adopt the most efficient practices available and to develop new products and services. This has also been the case in Portugal, where reforms have had significant effects on the efficiency of financial intermediation, the deepening and internationalisation of markets, the structure of the financial sector and the soundness and profitability of the system. Moreover, by enhancing the conduct of monetary policy, they have contributed to improved macroeconomic performance and to a successful transition to EMU.

In spite of its positive effects on the efficiency of financial intermediation, financial market liberalisation has led to significant micro and macroeconomic problems in some OECD countries. A prominent feature of the post-liberalisation period has been the emergence of a number of cases of failure of institutions in the financial sector; with significant costs to the economy as a whole and to the public treasury in particular. In most cases, this derived from the failure of macroeconomic policy to counteract the explosive expansion of credit and of supervision authorities to prevent the increase in risk-taking by banks.[67] The boom-bust cycle associated with the deterioration of credit quality and bank failures that followed financial market liberalisation in many OECD countries, did not occur in Portugal. This was in part a result of the macroeconomic context at the time of reforms. The end of the second phase of reforms, when most liberalisation measures took place, coincided with the ERM crisis of 1993, an escudo devaluation and a steep recession in Portugal. As a result, the incipient boom in private credit was quickly reversed. Also playing a significant role in preventing a boom-bust cycle were the prudent macroeconomic policies pursued throughout the 1990s, in particular monetary policy. On two occasions, financial market reform measures led to the release of "structural" excess liquidity, which was promptly "mopped up" by the issuance of public-debt securities, worth approximately 12 per cent of GDP each time. In 1991, this was related to the move to indirect monetary control and in 1994, to the reduction in reserve requirements. These operations were crucial in controlling the growth of broader monetary aggregates, reducing credit growth and preventing a sharp drop in saving ratios, occurrences that preceded the onset of financial crises in many countries.

Adequate supervision has also played an important role in preventing bank failures, as financial reforms coincided with the gradual strengthening of prudential requirements in the context of EU-wide harmonisation efforts and with

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increased autonomy and supervisory powers given to the Bank of Portugal. Finally, the sequencing of reforms in Portugal also seems to have been adequate. Initial steps were taken in the context of a steady fiscal adjustment, which brought the general government budget deficit down from 10.2 per cent of GDP in 1983 to 2.5 per cent in 1989. Given that most of the financial system was geared towards financing this deficit, fiscal consolidation was a necessary pre-condition for reforms. Moreover, interest rate deregulation preceded changes to monetary policy, which in turn were implemented before the liberalisation of capital movements. This had two main consequences. First, the banking system was strengthened before the advent of full competition, with both profitability and solvency boosted before the abolition of credit ceilings. Second, selective controls on capital inflows prevented an explosion of external borrowing and enhanced the effectiveness of monetary policy at a time when the move to indirect monetary control could have led to an uncontrolled expansion of domestic credit. Also important was the pace and sequencing of changes in monetary policy. The liberalisation of money markets and the introduction of treasury paper were implemented in steps, starting with short-term maturities, which facilitated the fine-tuning of monetary conditions and the gradual build-up of the monetary policy framework. This gradual approach had some costs, however. The relatively slow pace of liberalisation increased the burden on the rest of the economy, as real interest rates and financial margins were kept high. This, combined with the persistence of credit ceilings, led to a decline in the size and efficiency of financial intermediation in the late 1980s and early 1990s. Despite their cost in terms of efficiency losses, these measures were useful in that they helped to limit the risks of a financial crisis occurring.

EMU and other key challenges facing the Portuguese financial system[68]

The advent of the third stage of Economic and Monetary Union in January 1999 represents a further step in the integration of European financial systems. As such, it can be seen as part of a process that started with the liberalisation measures of the 1960s and 1970s and included the implementation of several EU directives aimed at the creation of a single market for financial services. In terms of its effects on financial markets, the introduction of the euro is significant to the extent that it eliminates national currencies and the related foreign exchange risk.[69] Overall, the further integration and deepening of financial systems implied by the introduction of the euro is likely to foster competition and lead to increased efficiency of financial intermediation, with higher returns provided to savers and lower capital costs available to investors. On the other hand, EMU presents the financial system with important challenges. The single currency has implied some start-up costs and is likely to lead to an acceleration of pre-existing

trends in the industry, such as technological change, securitisation and increased competition. As a result, the profitability of financial institutions will be put under further pressure and banking industry excess capacity will need to be reduced faster.[70]

EMU start-up costs, technological change and securitisation

The introduction of the euro has implied start-up costs for the financial system, such as those related to the need to train staff and to adapt the information technology in particular. These are in addition to costs related to the Year 2000 (Y2K) problem, which has also led to significant expenditures. Although euro-related costs are likely to be spread over a few years – at least until the introduction of euro bank notes in 2001/02 – provisions have, to a large extent, already been made by banks in their 1997 and 1998 balance sheets.[71] As efforts to incorporate new technology are relatively more recent in Portugal, its banks tend to have more up-to-date operational systems than those of other EMU countries. As a result, the cost of the introduction of the euro – as far as information technology is concerned – should be relatively lower in Portugal.

The single currency is also expected to be a catalyst for accelerating technological changes that are already occurring in the financial systems of most OECD countries. ATMs, EFTPOS, the Internet and telephones will continue to expand as delivery channels and the options available will likely increase. Furthermore, some commentators have predicted that over the next decade, "smart cards" will largely replace cash in frequent, low-value transactions. Portugal's use of electronic means of payments is one of the widest in the EU. Phone banking is widespread and the use of the Internet as a service delivery channel is expanding fast. Most larger banks already allow their customers to conduct transactions such as money transmission, securities trading and foreign exchange operations through the Internet. Portugal has also been the pioneer on a wide-scale and relatively successful experiment with smart cards (Box 3). Finally, the advent of the single currency is likely to lead to the acceleration of the trend towards securitisation – the increased use of securities in the intermediation of finance – observed in most OECD countries in the past few years.[72] This may be especially the case in Portugal, where the process is still incipient and has been hampered by the relatively small size of the domestic market.

Excess capacity and consolidation

Concerning the structure of the banking system, most analysts agree that there is excess capacity in the EU. As excess capacity is in part a result of imperfect competition, the advent of a more competitive financial system is expected to increase pressures to eliminate it.[73] Recent studies could not conclude that there was excess capacity in the Portuguese banking system,

Box 3. The experience of Portugal with smart cards

Portugal has been a pioneer in the large-scale use of smart cards as electronic purses. Launched in March 1995, these anonymous multipurpose prepaid cards have gained increased acceptance by consumers, although the cost of installing terminals, borne by retailers, has limited their use. Participating merchants need an electronic purse or EFTPOS terminal so the value from the card can be either transferred automatically to their bank accounts or, in the case of portable terminals, be accumulated in the terminal's memory and later "unloaded" into their accounts at any ATM. By the end of 1998, over 400 000 cards had been issued with a total value of 1.9 billion escudos. Smart cards can be (re-) loaded at ATMs and have a maximum stored value of 63 000 escudos.

Clearing is made through a company created by a pool of credit institutions to develop and manage the cards (SIBS), while final settlement is made at the Banco de Portugal, which is also the regulatory agency in charge. Specific regulations pertaining to the use of smart cards include:

i) Only credit institutions authorised to take deposits from the public may issue multipurpose prepaid cards.
ii) Issuance requires prior authorisation from the Bank of Portugal; and
iii) The amounts loaded into the cards shall be registered in the credit institutions' books in a special account especially created for that purpose.

however. Both branch density and employment levels are lower than the EU average. Furthermore, profit-based measures of excess capacity indicate that only a small percentage of Portuguese banks have suffered from low profitability and that, contrary to some Nordic countries, these have been essentially small banks. These results suggest that pressure for consolidation may be relatively less strong in Portugal than elsewhere in the EU. Given the size of their domestic markets however, Portuguese credit institutions are small by international standards – at the end of 1995, the largest Portuguese bank (CGD) was ranked 147th among the world's credit institutions in terms of total assets. To the extent that economies of scale and scope are important in the industry, the Portuguese banking system is not expected to be alien to the EU-wide pressure for consolidation.

The recent experience of foreign banks in Portugal suggests on the other hand, that at the early stages of EMU smaller banks are still likely to remain major actors on their domestic retail market.[74] Remaining cultural differences and the advantage of geographic proximity is likely to lead to only a very gradual adjustment of institutional and individual investors' behaviour. In spite of the development of Internet and telephone banking, the development of a large branching network is still an important factor affecting competition. The remaining differences in tax and labour legislation will also limit the speed at which further bank consolidation is achieved. Most analysts think therefore, that it is unlikely

that the EU (or Portuguese) retail banking system will experience a sudden change in structure as a result of EMU. More likely, restructuring would continue as a gradual process, to a large extent through M&A, and with medium and large-size banks likely to co-exist over many years. The same is not true for wholesale banking, however, where consolidation is expected to be much faster.

Pressures on profitability

The single currency should serve to partially insulate economies – and banks – from global financial turbulence. On the other hand, by increasing competition, it should also have a significant short-run negative impact on bank profitability. Even though the cost of the technical (operational) changes involved in the change-over from national currencies is not negligible, it is the change in market conditions brought about by the single currency that is likely to be the main factor in increasing pressure on banks' balance sheets. For instance:

a) Increased competition in an integrated, deeper and more liquid market may lead to a decline in *financial margins*, even though net lending is likely to increase.

b) Commissions from *foreign exchange operations*, including hedging, are likely to fall. This includes not only fees from exchanging EMU currencies against each other, but also from exchanging the euro against other currencies, an activity that it is likely to witness an increase in competition and a fall in margins.[75]

c) Profits from *money market trading* are also likely to decline, as arbitrage opportunities within the euro area disappear and increased competition leads to narrowing margins in arbitrage with other non-euro markets. The disappearance of market power in the setting of "domestic" interest rates is also likely to lead to lower net income from this source.

d) Banks' *share of financial intermediation* is expected to fall. Deeper and more liquid securities markets will increase trading volumes and related fees, but may lead to further dis-intermediation.

e) *Capital gains and "float" profits* may continue to shrink, especially in previously high-inflation countries like Portugal, where convergence has implied both lower inflation and a decline in interest rates.[76]

Portuguese banks are likely to face many of these pressures. Higher-than-average profitability in the past few years has been in large part a result of capital gains and lower operating costs. With interest rate convergence complete, windfall gains from holdings of bonds are likely to fall towards the EU average. On the other hand, the Portuguese bank lending market, where domestic retail banks have the advantage of proximity, has expanded at rates much faster than in other EU countries, so profits from lending activities may remain relatively high in the next few years. Concerning costs, Portuguese banks seem to have an important

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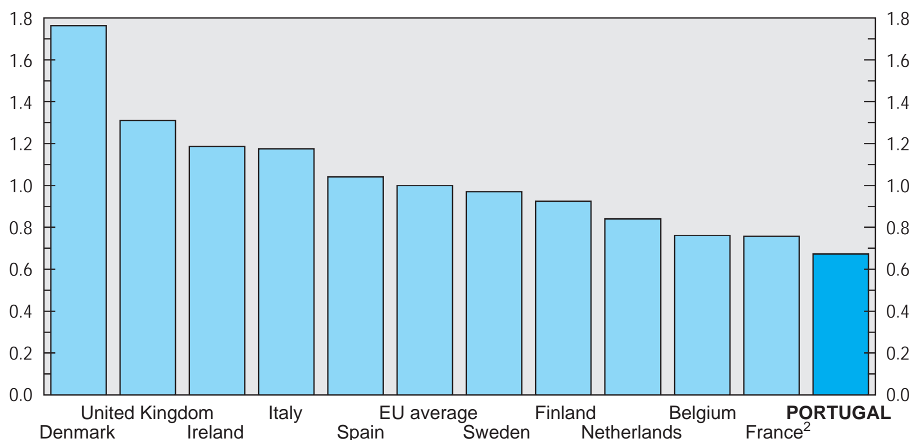
Figure 26. **Unit labour cost in banking**[1]
1996



1. Calculated as average wages in banking adjusted for balance sheet total per employee.
2. 1995.

Source: OECD Secretariat's calculations based on ECB and OECD data.

competitive advantage over their EU counterparts, as operational costs are one of the lowest in the EU. This is mostly a result of lower staff costs – even though labour productivity is below the EU average, this is more than offset by lower wage levels (Figure 26).[77] Although productivity and wage levels are expected to converge, this advantage may prove valuable at the initial stages of EMU. Finally, Portuguese banks' exposure to emerging markets is generally lower than elsewhere in the EU, even though some individual banks have recently invested significantly in Brazil.

Policy issues

Although the reform of the financial system has been broadly successful and the sector is now in relatively good shape, there are a few policy issues, some related to the challenges discussed above, which will need to be tackled by the authorities in the period ahead. Careful monitoring of the potential regulatory and monetary impact of structural changes in the sector is called for. Moreover, international co-ordination and co-operation in supervisory and regulatory activities

Box 4. Recommendations concerning the financial sector

In the light of the challenges facing financial markets, the authorities should consider a number of policy actions, including:

Prudential regulations and supervision issues

Improve co-ordination between financial sector regulatory and supervisory agencies. Formal links between the three agencies (CMVM, Bank of Portugal and the Insurance Institute) should be reinforced.

Adapt regulatory and other legal frameworks to keep pace with technological change in financial markets. At the international level, disclosure requirements need to be tightened and contract enforcement mechanisms reinforced, especially those related to Internet transactions. In addition, national authorities should introduce education and awareness programmes to prepare consumers for a rapidly changing market.

Introduce a more market-based assessment of risk for prudential purposes. Present prudential arrangements are under revision, both at the EU and multilateral (Basle Committee) level. Portuguese authorities should implement revised guidelines once they are adopted.

Create an appropriate legal framework for the development of mortgage-backed securities. This "securitisation" of mortgages would facilitate banks' liquidity management, while allowing for the removal of some mortgages from banks' balance sheets. Banks would then have the option of limiting (or eliminating) their exposure to credit risk in mortgage lending.

The restructuring of the banking industry

Ensure that the ownership structure of financial institutions is conducive to competition. Further privatisation in the banking system should be considered over the longer term.

Make pension rights of banking sector employees portable. Easing transferability rules of the separate banking sector pension scheme would further enhance labour market flexibility and facilitate the restructuring of the banking system.

Monitor private arrangements to ensure they do not limit competition. Private arrangements especially those that prevent hostile take-overs, should be closely monitored to ensure they do not constitute barriers to entry.

should be stepped-up, both at the EU level and within a wider multilateral context. Specific policy recommendations are listed in Box 4.

Prudential regulation and supervision issues

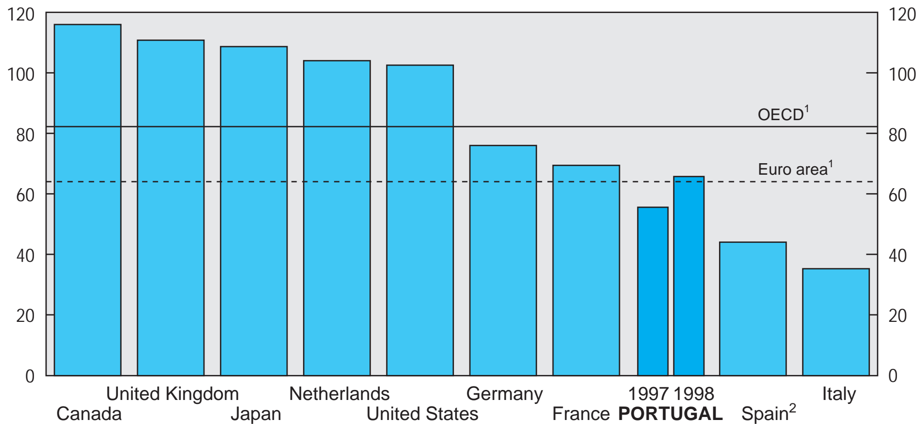
In a highly competitive environment expected to arise from EMU, pressure on banks' profit margins may lead them to take more risks. The enhancement of financial stability remains the responsibility of national supervisory authorities.

Furthermore, bank failures may lead to systemic problems, the cost of which will ultimately rest with national fiscal authorities, thus weakening market discipline and raising moral hazard issues. In that regard, a more structured co-ordination between the three financial sector supervisory authorities – the Bank of Portugal, the Insurance Institute and the Securities and Exchange Commission for banks, insurance and securities markets, respectively – would be appropriate, since it would allow a better monitoring of the system. Although there is an institutional link between the three agencies, in practice, problems of co-ordination sometimes occur. The authorities recognise the problem and are studying changes to the regulatory model to reinforce links between the three agencies.

Recent technological changes may also have policy implications for regulatory and supervision authorities. Whereas the increasing reliance on electronic transactions does not appear to be of major policy significance, the widespread use of smart cards and the Internet may raise some policy issues: *a)* in relation to the Central Bank's monopoly on seignorage; *b)* as to whether non-bank issuers should be subject to a disclosure regime; and *c)* as to whether increasing flows outside the banking system might have implications for monetary policy and supervision.[78] In the case of the Internet, there is an added complication arising from legal and technical issues related to digital signatures as well as from the issue of national jurisdiction. This means that consumers will need to be well informed about the financial standing of the institutions they are dealing with and the legal status of the transactions they are involved in. To that effect, education and awareness programmes would help consumers deal with a rapidly changing and increasingly sophisticated financial market. Also, given that at least two jurisdictions will be involved in any cross-border transactions, it will be important that the rights and obligations of each party are clear and contract enforcement mechanisms be in place.

The issue of supervision has been brought to focus as a result of the sharp growth of credit aggregates in the past two years (see section on credit aggregates in Chapter II). Domestic credit expanded by 17.1 per cent (year-on-year) in December 1998, in spite of a sharp decline in net credit to the general government. In the same period, credit to non-financial enterprises and households surged by 22.9 and 31.3 per cent respectively. This compares with inflation (national CPI) of 3.2 per cent and money supply (broad aggregate) growth of 7.3 per cent. It still too early to assert whether these figures presage the emergence of an uncontrolled boom – and hence, of a possible bust. Mortgage lending has been quite prudent up to now, as most loans have appropriate levels of collateral. Also, the fast expansion of household credit at the end of last year may have been in part linked to an anticipation effect, since the eligibility requirements for mortgage subsidies were tightened in early 1999. Finally, there are few clear signs of the appearance of asset price bubbles, default rates are low and the level of household indebtedness is close to euro area average levels (Figure 27).

Figure 27. **Household indebtedness**
As a percentage of disposable income, 1997



1. Unweighted average of countries for which data are available.
2. Estimate.
Source: OECD Secretariat.

Still, this fast expansion of domestic credit, if unabated, would raise prudential issues, especially since most mortgages carry variable interest rates. This could lead to a sharp increase in defaults in a hypothetical situation that would combine an upward movement in interest rates with a cyclical downturn in the Portuguese economy.

The authorities have been closely monitoring domestic credit. In mid-1999, the Bank of Portugal required credit institutions to increase provisions on consumer credit from 1 to 1.5 per cent of the amount of outstanding loans. Moral suasion was also stepped up to discourage bank lending. There are limits to this course of action however, since an increasing differential between Portuguese and other EU countries' required provisions rates could put domestic banks at a competitive disadvantage. Furthermore, EMU has implied a sharing of monetary authority, making it unlikely that interest rates will be high enough to check the growth of Portuguese credit aggregates in the near future. An alternative course of action would be to step up and improve supervision. This may come in the context of the proposed new Basle Committee rules concerning prudential arrangements, which if adopted will lead to the world-wide introduction of a

market-based assessment of risk for prudential purposes, discouraging certain types of riskier lending. Also, mortgage-backed securities are almost non-existent in Portugal, as their development has been hampered by the absence of an appropriate legal framework. The completion of this framework would be appropriate. In some OECD countries like the US, banks can eliminate their credit risk exposure to mortgage default by selling a pool of mortgages to specialised agencies which convert them into securities traded in the secondary market. In other countries, even though mortgage-backed securities exist, banks retain a credit risk exposure to mortgage default.[79] Finally, if the expansion of credit threatens to create serious macroeconomic imbalances, the burden of ensuring an appropriate macroeconomic stance will fall more heavily on fiscal policy, through lower public sector borrowing requirements and a faster reduction in public debt.

The process of restructuring in the banking industry

The key policy issues related to the restructuring of the banking industry are to ensure that it happens in an orderly way, that it does not increase systemic risks and that it enhances – rather than distorts – competition in the industry. Besides the need to upgrade the supervisory framework and to ensure sound and efficient payment and settlement systems, market participants need to be provided with the means and incentives to exert discipline. As noted by the Bank of International Settlements (BIS *Annual Report*, 1996), policies which are conducive to these goals include: adapting the structure of ownership of institutions, favouring those forms that are more sensitive to the operation of market forces; and lessening the obstacles to the adjustment of capital and labour, notably by easing regulatory constraints on the take-over mechanism and increasing the flexibility of the labour market.

Concerning the structure of ownership of credit institutions, the state is directly involved in the banking sector of most OECD countries, either through direct ownership or through the provision of state guarantees to certain institutions. Most of these institutions serve objectives related to the stability of the banking system or promote broader social or economic goals, such as directing credit towards favoured sectors, promoting new or small enterprises and providing services to small communities. Often however, state-owned institutions distort competition. First, explicit or implicit state guarantees put them at a comparative advantage in relation to private sector banks. Second, the pursuit of public goals instead of private ones (*i.e.* returns on investment) facilitate the cross-subsidisation of activities.[80] Although privatisation would be desirable in most cases, other options are available to minimise the effect of state-ownership on competition. Changing ownership structures, normally through an association with a strategic partner, would make public sector financial groups more responsive to the operation of market forces. Furthermore, management-level

changes, including through the introduction of activity-related profit objectives, would limit cross-subsidisation and ensure that fee structures better reflect underlying costs.

In Portugal, there remains a large state-owned financial group, accounting for about a quarter of banking assets, which has always been in public hands and has no special privileges. The group, one of the most profitable in the industry, has not recently received state aids, which have been a major source of distortions in other EU countries. However, it benefits from an implicit state guarantee. This financial group does not seem to introduce market distortions and has been operating well to date. Nevertheless, the experience of other OECD countries shows that such institutions, when fully subject to market forces, lead to greater efficiency over the longer term.

Concerning obstacles to the adjustment of labour, differences in social security legislation, such as pensions and unemployment benefits, hamper EU-wide mobility and create inefficiencies. In Portugal, even though the flexibility of the labour market is relatively high compared with many European countries, the segmentation of pensions, with bank employees having a separate and non-transferrable pension system, represents an impediment to the movement of labour between sectors. The elimination of this barrier, through the easing of transferability rules, would thus further enhance labour market flexibility and facilitate the restructuring of the banking system.

As regards capital, most barriers to adjustment have been eliminated within the EU with the liberalisation of capital movements and entry regulations. Some barriers indirectly affecting the adjustment of capital remain however, including some co-operative arrangements between banks, which in practice may represent a barrier to entry.[81] In the case of Portugal, these arrangements do not at present seem to raise serious competition concerns. On the other hand, competition authorities should establish mechanisms for guaranteeing access by eliminating regulatory constraints and other private arrangements that may limit competition, especially those that prevent the take-over mechanism from working. For instance, a significant barrier to entry into the Portuguese banking system has derived from domestic banks' recent actions to prevent hostile take-overs by changing internal statutes governing the distribution of voting power among shareholders – a measure that seems to be in large part directed at foreign institutions. In the past, the existence of restrictions to foreign entry had a negative effect on the efficiency of financial intermediation in Portugal. This was especially the case of barriers to foreign participation in the financial sector's privatisation process in the late 1980s and early 1990s – generally limited to 25 per cent of an institution's equity. These restrictions are likely to have led to inefficiencies and direct losses in terms of privatisation proceeds, while delaying the privatisation process in order to match the capacity of the country's stock

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market. Even though official restrictions have now been abolished, private arrangements like the one mentioned above can have the same effect as a barrier to foreign entry. The legality of these arrangements is under revision. To the extent that they limit competition and slow down the efficiency-enhancing consolidation of the financial system, they merit careful examination by regulatory and competition authorities.

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IV. Structural policy developments

This chapter examines recent progress in structural reform, with a focus on the labour market, increased product market competition and measures related to the health care system. The unemployment rate in Portugal – 5 per cent in 1998 – is not very high by comparison with most other OECD countries, especially in Europe. And the participation rate – nearly 68 per cent over the past three years – is close to the OECD average and above the European rate.[82] But young people without adequate qualifications are at risk in the labour market, as are persons having lost their employment in traditional activities. Furthermore, long-duration unemployment is not negligible. The structural changes already introduced over the past ten years or more will doubtless be intensified, necessitating high labour mobility – between sectors and between types of job – so as to reduce the cost of adjustment. This is made all the more necessary by Portugal's entry into the EMU, which has narrowed the range of macroeconomic policy instruments that can be used, making any adjustment more dependent on adaptability of the economy and of the labour market in particular.[83]

In this perspective, the authorities have for some years been taking measures which directly target the labour market. Initiatives have also been taken on other fronts, since they too may help to promote output and employment growth, as stressed in the *OECD Jobs Strategy*, 1994. Improvement of infrastructures, creation of a climate favourable to entrepreneurship and diffusion of technological know-how are cases in point. Privatisation has continued and resolute action has been taken to open up public-sector strongholds and increase product-market competition. The two previous *OECD Economic Surveys of Portugal* reviewed progress made and put forward recommendations. The paragraphs that follow discuss the recent reforms and the problems still outstanding. The chapter concludes with a look at the reform of the health care system, which was analysed in detail in the 1998 *Economic Survey*.

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Employment measures

The OECD conducted a detailed review of the Portuguese labour market in the 1996 *Economic Survey*, within the analytical framework set out in its *Jobs Strategy*. A number of fronts on which measures needed to be taken to improve labour market performance were identified, and specific recommendations were made. Subsequently the Social Pact of December 1996, signed by the Portuguese government and the social partners, established as a target a trend increase in employment. In return for nominal wage restraint, the government undertook to implement structural reforms designed to enhance labour market performance as well as to improve the safety net. In April 1998 an *Employment Action Plan* was produced, consistent with the strategy adopted at the European level by the EU countries. The Plan defines the priorities for government action within the policy settings already established and makes specific commitments, the long-term aim being to raise the rate of employment. Most of the points made in the *OECD Jobs Strategy* are covered in the Action Plan. But it will be necessary to bring the present programmes to completion with careful monitoring, rationalise government action and broaden the scope of reforms (Table 23).

Improving labour force skills and competencies

Development of skills and competencies is a priority for a country like Portugal, which at the start of this decade was still suffering from a very low level of educational attainment of the population as a whole. Progress on this front can increase the mobility of those with employment, facilitate the re-employment of those who lose their jobs and help youth labour market entry. This is necessary in order to promote equality of opportunity in all regions and for all income categories and to reduce the vulnerability of the groups most at risk (youth and long-term unemployed, in particular). The rate of youth unemployment was nearly 15 per cent in 1997. Indeed, this was below the EU average of 20 per cent, but relative to the overall unemployment rate of 7 per cent in Portugal at that time (12 per cent for the EU) it was not negligible. The situation in Portugal improved in 1998 (the youth rate falling to 10 per cent), but this was probably due in part to short-lived factors – such as Expo 98 – which were particularly favourable to youth employment. Young people continue to account for about one-third of total unemployment; with the disappearance of those temporary factors, additional policy measures targeted at young people, such as those included in the National Action Plan, are needed to prevent a reversal of the recent positive trend. The length of compulsory schooling was extended to nine years a few years ago, but the drop-out rate is still significant – although declining – and many youngsters who do stay to the end, leave school without any qualifications. Progress has been made in providing them with training opportunities at the end of the schooling cycle; in 1998, the availability of training covered 60 per cent of needs. However,

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Table 23. **Implementing the OECD Jobs Strategy: an overview**

Jobs Strategy Proposals[1]	Action taken	OECD Assessment and Recommendations
I. Improve labour-force skills and competencies		
– Raise compulsory schooling age and increase training opportunities to ensure that all school leavers have some qualification	Special training programmes for the young. Development of 9 years of schooling + 1 (of schooling and training)	Continue with implementation
– Raise the quality of formal education, including vocational and technical programmes	Broader access to pre-school education. Revision of school curriculum. Development of information technology in schooling and professional training	Implement proposals of 1998 Employment Action Plan; monitor results; evaluate and rationalise schemes in operation
II. Make active labour-market policies more efficient		
– Improve effectiveness of reinsertion programmes	Earlier intervention of Public Employment services	
– Tailor programmes more closely to the needs of targeted groups	Individual follow-up of unemployed introduced	Continue to implement 1998 Employment Action Plan; monitor results; evaluate and rationalise ALMP measures
– Monitor programmes more systematically	Performance indicators introduced	
III. Increase labour-market flexibility and labour mobility		
– Establish legal framework for workers with no formal contracts	Drafted legislation to reduce disguised self-employment	Implement drafted legislation
– Modernise legislation on temporary contracts and part-time work	Drafted legislation, more flexibility introduced in public administration	Should serve as example for labour markets at large
– Ease employment protection legislation and apply it uniformly	Stricter application of labour norms with stronger sanctions	Implement drafted legislation on sanctions
– Increase the age-differentiation of minimum wages	No action	Remove obstacles to the hiring of young persons
– Phase out housing market restrictions	No action	Design global plan to derestrict the housing market
IV. Review the tax and transfer system		
– Improve tax administration	Faster tax collection; action against tax evasion	Keep up momentum to improve tax collection
– Restructure tax and contribution rates	No action	Restructure tax and contribution rates
– Harmonise self-employed and wage earners' social security contributions	Full harmonisation to be achieved by 2000	Continue with implementation
V. Improve the infrastructure and the climate for entrepreneurship and innovation		
– Improve infrastructure	Completion of large projects; new projects starting (with EU financing)	Consolidate progress in improved co-ordination and implementation
– Stimulate research and development	Steps taken in high school, university and to promote technology diffusion in business sector, including SMEs	Implement proposals of 1998 Employment Action Plan and monitor results
– Cut back red tape and shorten procedures for business start-ups	Creation of a Network of Centres for information and administration support for businesses.	Continue with implementation
VI. Increase product-market competition		
– Remove entry barriers and introduce regulatory reform	Liberalisation of electricity and telecommunications	Liberalisation of electricity should be accelerated
– Continue privatisation	Extensive sale of state-owned enterprises	Maintain tempo of privatisation as planned

1. Proposals are discussed in detail in OECD (1997), Chapter III.
Source: OECD Secretariat.

Figure 28. **Education indicators in comparison**

1. Public expenditure only for Belgium, Luxembourg, New Zealand, Norway, Poland, Switzerland and United Kingdom.
2. Percentage of the population having completed at least upper secondary education, by age group.

Source: OECD, *Education at a Glance*, 1997, 1998.

the increasing mismatch between skill demand and supply, particularly in the case of young job-seekers, suggests that the mechanisms of transition from education to labour market are still insufficient.

The problem does not seem to be lack of resources, since Portugal's education effort is comparable with the average for OECD countries (total allocated expenditure represents 5.4 per cent of GDP, for a school-age population share close to the OECD average) (Figure 28). The 1998 *Economic Survey* reported on some of the progress already made in improving labour force skills and competencies and facilitating the transition from school to working life. New measures have been taken since. As regards basic education, the Employment Action Plan aims to generalise pre-school education and modernise primary school facilities. At the secondary level, computer literacy will be developed[84] and classroom education in vocational schools will be supplemented by periods of in-firm training. Finally, employers are to increasingly participate in the design of education and training curricula, provide equipment and qualified technicians, and take in trainees.

In quantitative terms, the targets are to double the number of apprentices in five years and to increase the number of young persons receiving training (by about 10 per cent a year). One of the new instruments defined in the Employment Action Plan is a specific programme to develop youth information and educational guidance (AZIMUTE). Remedial teaching will be intensified for underachievers in their last year of compulsory schooling – or possibly at the end of secondary education – to enable them to complete the course with a recognised credential. The "9 + 1" years of schooling have been introduced; the extra year, which offers employment-training opportunities, is already being provided in a significant number of educational establishments. Finally, employment-training programmes are now being restructured so as to be tailored more closely to the needs of targeted groups. There will be a systematic monitoring of results by reference to specific indicators such as: youth unemployment by age bracket and as a share of all young persons entering the labour market each year; and the share of young persons enrolled in vocational education as opposed to those in general education.

Raising labour market flexibility and facilitating labour mobility

The persistence of long-term unemployment up to an advanced stage of the business cycle suggests that the labour market is adjusting less easily than in the past. There was a marked improvement in the situation in 1998, with long-term unemployment down to less than 40 per cent of total unemployment at year-end from nearly 50 per cent twelve months earlier.[85] To consolidate the results obtained so far and limit the risks of a reversal when the pace of economic activity slackens, specific measures are necessary. Further to the programmes already in

operation, the Employment Action Plan provides for new schemes to facilitate re-employment of the jobless. The whole approach of the Public Employment Services has been revised. The aim now is to take earlier action to assist the jobless with individual tracking until re-employment, the Employment Services undertaking to find jobs or training slots for youth (before six months of unemployment) and adults (before twelve months). Programmes for individual tracking of unemployed youth and adults have begun in designated priority zones and coverage will be progressively extended. An individualised programme with systematic interaction combining guidance, training and job entry has also been introduced for persons already experiencing long-term unemployment.[86] Implementation of these individualised schemes began in mid-1998. By the end of the first year, performance indicators will measure the progress made. The entire country is expected to be covered by the end of 2000.

The 1996 *Economic Survey of Portugal* pointed out the inadequacies of the Portuguese social security system, which called for reform measures. The first necessity was to ensure the system's financial sustainability over the long term. But there were problems of equity as well, the extent of cover differing according to population segment and type of activity. Finally, administrative capacity was insufficient, permitting large-scale evasion and discrimination against wage earners. Commitments to reform the system were written into the Social Pact of December 1996. Some of the measures prescribed were considered likely to help improve the functioning of the labour market. Proposals in this regard were presented in a White Paper published in January 1998, on the basis of which the government submitted a reform bill to Parliament. Some of the decisions already taken are pertinent to the labour market. The social security contributions – and coverage – of self-employed persons have been harmonised with those of employees, with full alignment expected by the year 2000. This measure, by diminishing the grey area created by differing treatment, should serve to reduce the distortions in resource allocation and narrow the scope for evasion. The pension system has been made more flexible in that retirement can now be postponed (with no age limit) or brought forward (with no specific inducement), an actuarial system being applied whereby pension entitlements are calculated according to years of contribution. A new family allowance (means-tested and according to the number of children) replaces several types of family transfer and should serve to reduce the opportunity cost of school attendance for low-income families. Several measures to increase basic welfare cover have been introduced, together with a number of adjustments to the system's financing in the interests of transparency.

During recent years, increasing use has been made of "atypical" work contracts – fixed-term, part-time – to suit new patterns of production. With the Social Pact of 1996, the government and the social partners undertook to modernise labour legislation and to see that labour standards were more strictly

applied in order to protect workers with atypical contracts. The regulations governing temporary and part-time work are being revised. The new arrangements aim at creating incentives for part-time work, provided that it is voluntary, reversible and offset by recruitment. Several such schemes have already been introduced in the government sector: under legislation approved in August 1998 public servants nearing retirement age are allowed to complete their careers on a part-time basis, while commensurate recruitment takes place. According to the authorities, the new schemes should make it possible to renew part of the government sector's workforce. Another arrangement allows public servants to opt for a four-day week, subject to certain conditions. Local and central government services have been merged in respect of human resource management and all public servants may apply for posts in one or other of the two areas. With the introduction of greater flexibility in the public sector and appropriate regulations, the authorities intend to make that sector a pace-setter for modernisation of the labour market.

Improving the efficiency of active labour market policies

Expenditure on labour market policies in general (2 per cent of GDP in 1997) is not very high by international standards, reflecting a lower unemployment rate than in most other countries and a more restrictive system of unemployment compensation (Table 24). The share of these resources allocated to active labour market policies has increased progressively to nearly 50 per cent.[87] One-quarter of all unemployed persons can now benefit from active measures. Of the total amount allocated to active labour market policies, 50 per cent goes to youth integration programmes, 20 per cent to measures to combat adult unemployment, and 30 per cent to training and skilling of persons in employment. The previous *OECD Survey* recommended better monitoring of the programmes in place and closer tailoring to the needs of targeted groups. The new initiatives defined in the Employment Action Plan have been designed accordingly.[88] Certain schemes are to be restructured and the weight of active measures is to be further increased, notably by providing vocational training opportunities for larger numbers of the unemployed. In addition, the system of unemployment compensation will be revised and adjusted to eliminate the work-disincentive effects it might create. For example, unemployed persons who accept part-time jobs will lose only part of their benefit. Impact studies were made while the Action Plan was being drawn up. For certain key programmes, as in the case of training schemes for large numbers of people and a few other programmes undergoing modification, evaluation studies are being made with the aid of independent experts; in most cases, however, these evaluations are internal.

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Table 24. **Expenditure on active labour market policies, 1997**

	Total expenditure on labour market policies	Expenditure on active labour market measures	Unemployment	Expenditure intensity[1]	
	Per cent of GDP		Per cent of labour force	Total labour market policies	Active labour market measures
Portugal	**2.0**	**1.0**	**6.8**	**0.29**	**0.15**
Other selected EU countries					
Germany	3.8	1.3	9.7	0.39	0.13
France[2]	3.1	1.3	12.4	0.25	0.10
Italy[2]	2.0	1.1	12.0	0.17	0.09
United Kingdom	1.5	0.4	7.1	0.21	0.06
Belgium	4.3	1.5	9.2	0.47	0.16
Denmark	5.8	1.8	6.1	0.95	0.30
Netherlands	4.9	1.5	5.2	0.94	0.29
Spain	2.4	0.5	20.8	0.12	0.02
Sweden	4.3	2.1	10.2	0.42	0.21
Average of the above (unweighted)	**3.6**	**1.3**	**10.3**	**0.44**	**0.15**

1. Expenditure as a percentage of GDP divided by the rate of unemployment.
2. 1996.
Source: OECD (1998), *Employment Outlook.*

Summing up

In some respects Portugal's labour market policies bear comparison with those of other European countries: for example, the proportion of jobless persons with access to training is relatively high. The main problem continues to be the excessive number of schemes in operation. The introduction, under the Employment Action Plan, of a system of programme evaluation on the basis of performance indicators (rather than resource use) is appropriate. But this approach needs to be taken further: results should be assessed more systematically and the schemes in place should be rationalised. As has been seen, the Action Plan has introduced new schemes that are in addition to the large number of programmes already in operation. Measures with similar targets should be merged to minimise implementation costs and limit duplication. One of the objectives of the framework law on employment policy, which was under discussion with the social partners at the beginning of 1999, is to rationalise the instruments of active labour market policy.

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The dual approach in labour market policy, at once remedial and preventive, is appropriate. Following this approach, several programmes are aimed at providing training to enable the workers most at risk to remain in employment and, if some become unemployed, to facilitate their job search in order to limit the period of joblessness and so avoid the reintegration problems that arise for the long-term unemployed. Revision of education and training curricula, and more active involvement of employers, are part of this preventive strategy, the ultimate purpose of which is to ensure adaptability of the labour force to rapidly changing needs. More generally, the strategy adopted in Portugal, as in several other OECD countries, aims increasingly to raise the rate of employment rather than to lower the rate of unemployment by way of reduced labour force participation. This approach seems the most appropriate and the most effective. The measures to make retirement age more flexible go in this direction.

One area that requires the government's undivided attention is job protection. Further action needs to be taken to make the relevant legislation less rigid and at the same time ensure that it is uniformly and strictly applied. Portuguese labour market performance is quite favourable by comparison with most other OECD countries, especially the European ones. But in recent years one of the main tools of adjustment has been real wage flexibility. In a context of lower inflation due to EMU, less use can be made of it. Initiatives serving to reduce the institutional rigidities that hamper labour market adjustment become more important. Easing of the different employment regulations could also facilitate the creation of jobs with formal and indefinite-term contracts. Other OECD country experiences show that where institutions are too rigid, one outcome may be the growth of hiring under fixed-term contracts, false self-employment (recruitment with no work contract) and even unrecorded employment. The Portuguese authorities recognise the importance of labour market flexibility; they are concerned with ensuring a stricter application of labour standards, which is appropriate, and they are also attempting to preserve work incentives. The revision of the unemployment insurance system is a move in this direction. Furthermore, in accordance with the commitments defined in the Social Pact for 1996-99, a bill has been submitted to Parliament that provides, *inter alia*, for a revision of the law concerning redundancies so as to reduce the compensation payable by the employer. The present phase of buoyant activity seems a very good time to move forward on this front.

The OECD *Jobs Strategy* stressed the importance of an integrated approach for enhancing growth of output and employment over the long term. Infrastructure development and efforts to create the right climate for entrepreneurship are part of this ongoing process. The vigorous action being taken to liberalise the economy and increase product-market competition – which will be discussed further on – may also help to improve the results of employment policy.

Improving the infrastructure and the climate for entrepreneurship

Structural funds (transfers) received from the EU have increased greatly in recent years with the two Community Support Frameworks, which encompass structural funding and cohesion funding. This has contributed significantly to economic development. The CSF funds have been used mainly to build physical infrastructures and develop human capital, the remainder going to assist the productive sector in such areas as investment, technological innovation and marketing.[89] Annual inflows averaged the equivalent of 3.2 per cent of GDP over the period 1994-97 and reached 3.4 per cent of GDP in 1998, thus having a very sizeable direct impact on the budget, balance of payments and, above all, investment and growth. The economic impact of CSF aid is particularly difficult to gauge. The funds stimulate demand by way of increased public spending that works through to aggregate expenditure and output, leading to a rise in employment and incomes. In the longer term, the supply-side effects will probably be the more significant as the increase in the capital stock generates positive externalities and increases the growth potential.[90] A further positive factor is that the CSF commits the government to long-term planning of investment projects, which makes these less vulnerable to short-term budgetary considerations. The Agenda 2000 has set transfers to Portugal for 2000-2006 amounting to € 22.8 billion spread over seven years, which represents a 2.3 per cent average annual increase in EU funding compared with Phase II of the programme (1994-1999). The Community Support Framework for 2000-2006 (CSF III) is being negotiated in the European Union. In February 1999, the Portuguese government presented the national plan for economic and social development for 2000-2006, outlining its strategy. The plan aims at overcoming within one generation the economic and social gaps between Portugal and its partners in the European Union. This is to be achieved through action on a broad front, including promoting the quality of human resources, changing the productive structure towards more dynamic and technology-intensive activities, and assuring the sustainable improvement of social protection. In addition, the authorities are finalising the Programme for Regional Development that will be the basis for the negotiations concerning the Community Support Framework (CSF III) with the European Commission.

A number of targeted programmes have been put in place over recent years to create a favourable climate for entrepreneurship and modernise the production structure. They aim to promote quality and innovation in Portuguese firms generally, and more specifically to help small and medium-sized enterprises (SMEs) to become more competitive. The Employment Action Plan continues the strategy introduced by the Social Pact of December 1996.[91] The aims are to develop an entrepreneurial culture, facilitate enterprise creation and improve the business climate, as well as to explore all options permitting job creation. In this regard, small firms and micro-businesses, which provide 60 per cent of all

jobs in Portugal, require particular attention. A start has been made on simplifying the administrative procedures that burden businesses generally, but SMEs in particular, and steps have been taken to make business information more readily available to all companies, including SMEs. A network of Business Formality Centres has been set up for this purpose.[92] To facilitate SMEs' access to funding, the legal and regulatory framework has been revised, guarantee and capitalisation facilities having been created or enhanced with the aid of financial institutions. In response to the difficulty which most Portuguese firms have in entering foreign markets because of their size and insufficient qualifications, incentives to technical innovation have been introduced for SMEs. Training programmes for small businesses have also been expanded. Although SMEs employ a large share of low-skilled labour, only about 10 per cent of them have been receiving public aid for training purposes until now. A scheme has been introduced whereby SMEs are exempted from social security contributions if they recruit persons on a temporary basis to replace employees undergoing training.

After remaining flat for several years, gross domestic expenditure on R&D increased in 1995-97. However, by international standards it is still low as a proportion of GDP – 0.7 per cent compared with 1.9 per cent for Europe as a whole and 2.2 per cent for the OECD area. Since 1995 there has also been an increase in the budget allocated to the Ministry for Science and Technology, including for 1999. The authorities recognise that human resources are a major constraint on the development of R&D and technology diffusion. For this reason, as shown in the preceding paragraphs, their strategy here is built around three concerns: improving technical education in upper secondary schools, developing postgraduate scientific research, and integrating science and technology into the business environment, including SMEs and micro-firms.

Measures to assist SMEs and micro-firms have a part to play in labour market policies. These businesses, which employ a large share of the population, are often the most dynamic in terms of job creation (even if they probably also contribute significantly to job losses). Furthermore, by providing an occupation and experience for the most disadvantaged population segments, they can generate positive externalities. Increasingly, in Portugal as elsewhere in the OECD area, public schemes that target SMEs are aiming to encourage clustering and make it easier for businesses to operate, including in cases where it is the bureaucratic procedures of the state itself that inhibit business activity.

Enhancing product market competition

Over the past decade or so significant steps have been taken to liberalise the economy, efforts focusing on two broad areas in particular. First, the authorities have undertaken a rapid and broad privatisation programme, helping to

improve efficiency and contributing to public debt reduction. Second, several reforms have been aimed at opening up critical network industries such as the electricity sector and telecommunications.

Portugal's privatisation programme, among the most ambitious in the OECD area, continued in 1998 and early 1999 essentially through a secondary offering in a number of sectors. Recent operations include the sale of shares of Portugal Telecom, EDP (electricity), BRISA (motorways) and Cimpor (cement). Total revenues from privatisation are estimated at about 4 per cent of GDP in 1998, of which two-thirds went to the state; of this amount, a little more than half was used for public debt redemption and the rest mostly for the re-capitalisation of public enterprises. Receipts for 1999 are expected to reach a similar amount. Since the late-1980s, more than 100 enterprises have been sold, with privatisation revenues averaging more than 2 per cent of GDP per year. As a result of this broad programme, the share of majority state-owned public enterprises is expected to fall to 5 per cent of GDP by the end of 1999, compared with about 20 per cent in 1988. Although a wide range of procedures has been used, including direct sales, public tender, public offer and private placements, the great majority of privatisation operations involved capital market transactions, contributing to the broadening and deepening of these markets.[93] Privatisation was complemented by deregulation and the elimination of entry restrictions.

The electricity sector started to be restructured in 1994 when the state-owned EDP was separated into six subsidiaries (one for generation, one for transmission and four for distribution). Since then, reforms have included the partial privatisation of EDP and the establishment of a regulatory agency (operational since 1997).[94] A new tariff code was published in September 1998, with separate tariffs for energy, power, use of transmission and distribution networks and global use of the system (ancillary services, environmental costs, etc.). This new tariff structure enables consumers to purchase electricity outside the public electricity system, enhancing competition in the sector. In the generation sub-sector, private firms will be allowed to participate in tendering procedures to select new capacity for the public electricity system, or they can construct new power stations in the independent sub-system. Private firms can also take advantage of the special regimes applicable to small generators (co-generation, renewable and waste sources). Customers with consumption above 9 Mwh a year, which account for 25.2 per cent of the market, can choose their supplier. In addition, the holders of binding distribution licences in the public system are authorised to purchase up to 8 per cent of their needs outside the public electricity system. As a result, a third of the electricity market was already opened by February 1999.

Electricity tariffs are still tightly controlled by regulatory authorities. Electricity distribution companies face a tariff cap which will be subject to revisions, while grid companies are regulated on the basis of costs, and generation is

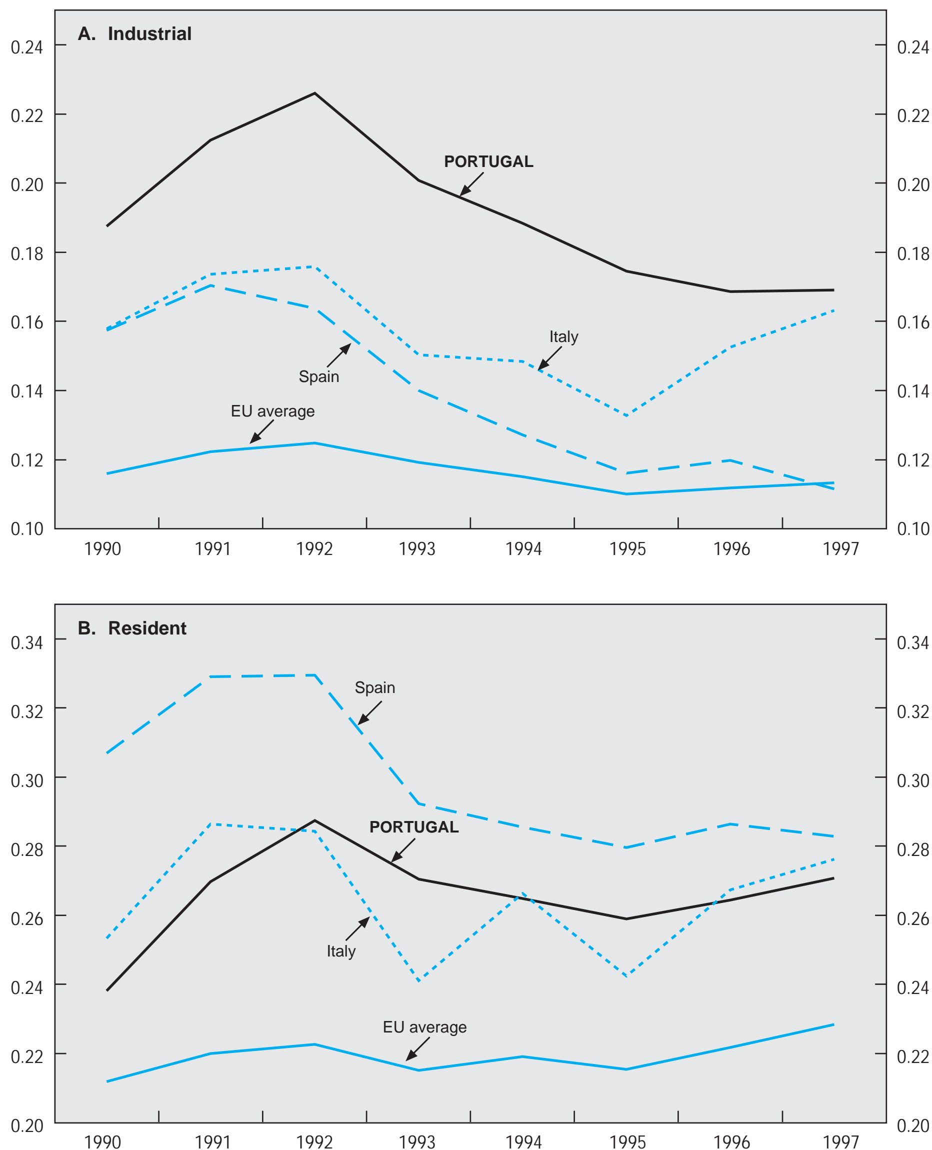
governed by long-term Power Purchase Agreements. Although cross-country electricity price comparisons are difficult due to the complexity of pricing structures, on average Portuguese prices have clearly been above the EU average in the past few years – by 16 per cent in 1995, according to OECD Secretariat estimates (Figure 29). Using a different methodology, Eurostat estimates that this differential was down to 3.4 per cent in July 1998 – 0.2 for residential consumers and 7.3 per cent for industrial users. The tariff reductions of 1999 (by 4.7 per cent for residential consumers and 7.3 per cent for industrial users) are expected to have brought Portuguese prices closer to the EU average. The liberalisation of the electricity sector is to continue over the next few years, in line with EU directives.

The telecommunications sector has also been gradually opened in the past few years. A regulatory framework was established in 1989 and Portugal Telecom has been privatised – with the government holding only 10 per cent of its capital as from July 1999. Three operators have entered the domestic mobile market, and competition is fierce. Some barriers remain in the fixed line (voice telephony) sector, where Portugal Telecom still benefits from certain privileges. These restrictions are expected to be phased out by January 2000, however. As in other countries, some tariff re-balancing took place after liberalisation – with local rates increasing and long-distance rates falling. Portugal's performance indicators in the telecommunication sector have been converging with those in more advanced OECD countries (Figure 30). The number of access lines per capita, which was among the lowest in the OECD in 1997, has increased rapidly since then, especially when including mobile telephony.[95] On the other hand, average prices – both residential and business – were still among the highest in the OECD area in August 1998.

Other public utilities have undergone significant liberalisation in the past few years, including the oil products' distribution sector. The national oil company, Petrogal, has been partially privatised – in stages, in 1992 and 1995 – but the government still retains 55 per cent of the capital. With the liberalisation process starting in 1986, private companies' market share has increased, reaching about half of the oil distribution market to date. Few restrictions remain, but prices for unleaded gasoline and diesel are still subject to maximum price levels, based on an average of European retail prices.

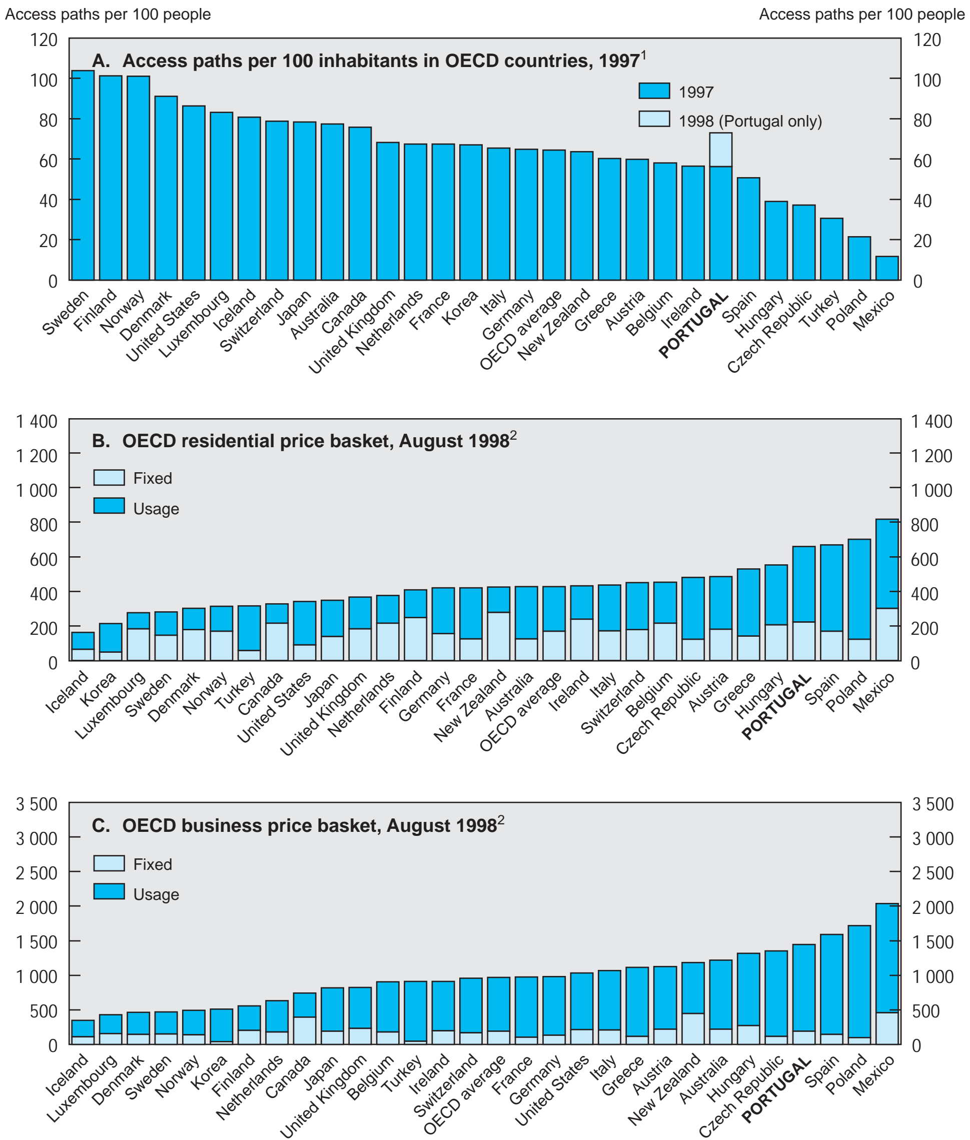
The scope of the privatisation programme has contributed to increase competition. Nonetheless, although relevant regulatory frameworks have been implemented in conjunction with the opening up of the sectors, and regulatory agencies have been created, there is a need for a more active and independent anti-trust authority. Furthermore, there are remaining rigidities: no action has been taken to lift restrictions on the housing market; there is also scope for liberalising retail trade and removing barriers to entry on certain professional services.[96]

Figure 29. **Electricity prices**
In DM/kWh



Source: OECD, *Energy Prices and Taxes*, 1998.

Figure 30. **Performance indicators in telecommunications, 1997-1998**



1. Telecommunication access paths include the total of fixed access lines and cellular mobile subscribers.
2. Average annual spending, including tax, expressed in US$ PPP.

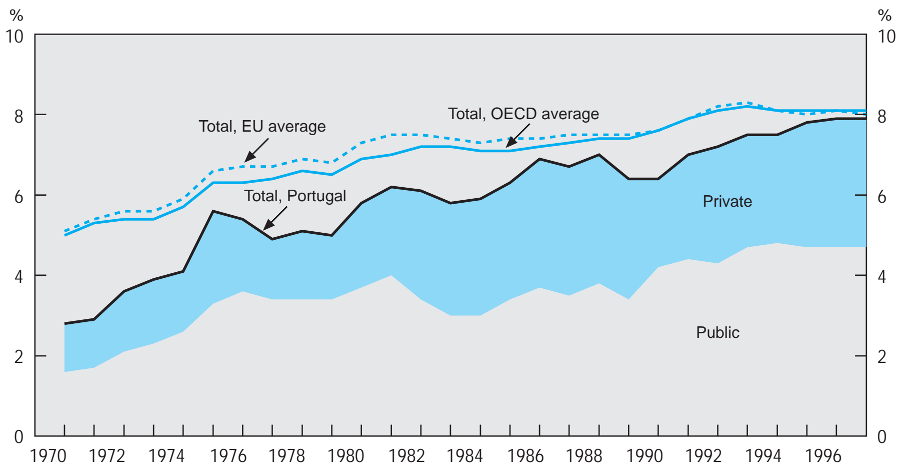
Source: OECD, *Communications Outlook,* 1999.

Reforming the health care sector

The health care system is a significant source of spending pressure (Figure 31). Expenditure on health care has risen more rapidly than in most other OECD countries over the past three decades – reaching 8.2 per cent of GDP in 1997, of which two-thirds were public – while health outcomes are still lagging significantly behind those of other OECD countries. Most countries that channel similar resources into the health sector achieve superior results, suggesting that Portugal's health sector suffers from a relatively low level of efficiency. This is the result of a complex mix of private and public provision that leads to high costs and poor resource allocation. Weak budget constraints and a lack of management autonomy and accountability exacerbate inefficiencies in the public sector, while insufficient competition and distorted incentives increase the cost of private health care provision.

Identifying several shortcomings of the system, the 1998 OECD *Economic Survey of Portugal* made proposals for reforming the sector. Recommendations included proposals for changes affecting both the public and private health care sector, as well as measures to reduce the overlap in health insurance coverage and induce households to use health care services more economically. Since the

Figure 31. **Expenditure on health care**
As a percentage of GDP



Source: OECD Health Data 99.

Table 25. **The reform of the health care system: a synopsis**

OECD Proposals[1]	Action taken	OECD Assessment and Recommendations
I. Place public health care institutions under pressure to provide cost-effective services		
– Change managerial structure of public health institutions	New regulatory framework approved, creating management teams for primary health care centres	Implement new framework. Broaden reforms to hospital managers, giving them more autonomy and increasing accountability
– Make budget allocations more therapy-based	Mixed system used to determine part of hospitals' initial budget	Broaden the use of the new system
– Broaden the ability of RHAs to set contracts	Five regional contracting agencies are being developed	Continue programme and rapidly develop new agencies
– Give hospitals the status of public enterprises	Pilot programmes including one with private management	Broaden the experiment
II. Improve the co-ordination and integration of public health institutions		
– Strengthen gate-keeper function of general practitioners	No action	Improve co-ordination between hospitals and primary health care centres
– Co-ordinate budgets of health care centres and hospitals	Local health systems (SLS) are being developed to co-ordinate different care providers	Implement new systems
III. Change the system of doctors' remuneration		
– Strengthen merit-based pay component	Voluntary experimental model under implementation.	Continue implementation
– Allow special compensation to attract professionals to less developed areas	Increased role for local governments in health planning and new incentives for relocation of public sector workers	Increase flexibility of health professionals' remuneration
IV. Strengthen competition in private health provision and in the sale of pharmaceutical products		
– Abolish system of reference prices for doctors' services	No action	Should be considered
– Abolish entry restrictions and fixed margins for pharmacies	No action	Should be considered
– Liberalise the sale of certain drugs outside pharmacies	Proposals sent to Parliament	Implement proposals
– Eliminate disincentives for the production and sale of generic drugs	No action	Should be considered
– Control potential conflict of interest by public sector doctors with private practices	Some limits now apply to the ability of these doctors to provide private services to the NHS	Extend limits and implement new remuneration system
– Monitor prescribing practices and punish collusive behaviour	Relationship between doctors and the pharmaceutical industry clarified	Tighten rules and step up enforcement

Table 25. **The reform of the health care system: a synopsis** *(cont.)*

	OECD Proposals[1]	Action taken	OECD Assessment and Recommendations
V.	**Induce households to use health services sparingly**		
	– Restructure system of co-payments	Increased differentiation according to cost-effectiveness criteria	Raise co-payments and differentiate according to income levels
	– Abolish unlimited tax deductibility of health expenditures	Most tax deductions changed into tax credit	No further action needed
	– Introduce identity cards	80% of population will have ID cards by late 1999	Continue
	– Step up education and prevention campaigns.	National health strategy and policy with quantified targets for 1998-2002 formulated	Continue. Make wider use of prevention campaigns in the strategy
	– Better reflect citizens' choices in operation and planning	Mechanisms being developed by regional agencies, including the creation of a "citizen representative"	Move to implementation phase
VI.	**Reduce overlapping insurance coverage**		
	– Draw a clear line between public and private health systems	New legislation opening the possibility of opting-out approved	Define clear and explicit rules concerning financial responsibilities
	– Re-assess role of sub-systems	Negotiations with sub-systems started	Continue. Ensure financial transparency

1. Proposals are discussed in detail in OECD (1998), Chapter III.
Source: OECD Secretariat.

1998 *Economic Survey* was finalised several measures have been taken, as part of a reform process which is gradual and sequential, in part following the recommendations formulated by an independent commission (*Conselho de Reflexão sobre a Saúde*) in late 1997. The policy recommendations made by the OECD are summarised in Table 25, together with an evaluation of progress made in a number of areas.

Place public health care institutions under pressure to provide cost-effective services

The government has adopted a new strategy, focusing on the provision of primary health care, based on increasing the capacity and efficiency of health centres. A new regulatory framework has been approved, which will lead to the creation of new management teams for primary health care centres, while making these more autonomous and financially accountable. Implementation is expected for late 1999. No action has been taken to change the managerial structure of hospitals, however. Ideally, these changes would give hospital managers greater discretion and autonomy, as well as performance-related pay. In this regard, progress could also be achieved through the implementation of measures to give hospitals the status of public enterprises or to introduce private management, as such schemes are conducive to enhanced accountability and efficiency. Pilot programmes along these lines are in operation, involving three hospitals.

Progress has also been made in making budget allocations more therapy-based, including through the introduction in 1997 of a case-mix system whereby DRGs (diagnostic-related groups) are used to define in-patient and ambulatory surgery cases. This system affects only part of hospitals' initial budget allocation, however. Action is needed to broaden its use to other hospital activities and to the determination of final budget allocations. This would create a hard-budget constraint and help prevent spending overruns. Finally, five regional agencies are being developed to introduce a contracting approach into the public health care system. This is also expected to facilitate monitoring of the responsiveness of the institutions in the system.[97]

Improve the co-ordination and integration of public health institutions

The five regional contracting agencies mentioned above are also expected to help define budgets for hospitals and primary health care centres in a co-ordinated fashion. A geographical approach based on health care needs and existent resources is also being developed. These "local health systems" (SLSs) will be given the responsibility to co-ordinate the activities of different health providers – including private ones – within a region. It is expected that this will lead to the strengthening of the gatekeeper function of general practitioners, allowing a better integration of the in-patient and ambulatory sectors. Progress in

this area is important and should continue. Moreover, budget co-ordination and joint planning should also be applied to capital outlays.

Change the system of doctor's remuneration

A voluntary experimental remuneration model for general practitioners (GPs) involving 500 doctors at the national level is being implemented. It combines a minimum guaranteed income – based on the responsibility for a patient list – with a fee-for-service component. The flexibility of the system is enhanced by features such as: *i)* adjusted "capitation" income according to the age and gender composition of the patient list; *ii)* supplementary payments for the addition of new patients to the list; and *iii)* a system of premia for the completion of specific health care episodes, such as pre-natal surveillance. This pilot project also contains the innovative feature of requiring participating doctors to organise themselves in groups, so as to enhance peer pressure within the new remuneration model. A new performance-related pay system for hospital doctors and other health care professionals is also under study. Finally, local governments have been given an increased role in health planning, and new incentives have been created to help the relocation of public sector workers to remote areas. These measures, combined with the increased flexibility of health professionals' remuneration, is expected to help attract doctors and nurses to less developed areas, easing the problem of the unequal distribution of professional resources – and thus of the difference in health outcomes – among regions.

Strengthen competition in private health provision

It is expected that the development of contracting agencies will lead to more transparency and strengthened competition among health care providers, both public and private. Two laws, approved in 1998, are also expected to have a positive impact in this regard. The first limits the ability of public sector doctors to provide private services to the national health system, thus aiming at controlling potential conflicts of interest. The second clarifies the relationship between doctors and the pharmaceutical industry and imposes fines for unethical behaviour. The government has also presented to Parliament a series of proposals to ease entry restrictions in the pharmacy sector, eliminate disincentives for the production and sale of generics, and allow the sale of certain non-prescription drugs in outlets other than pharmacies; but the proposed measures have not yet been approved. Such measures could help keep a lid on the price of pharmaceutical products which, on average, are still among the lowest in the EU but are expected to experience further upward pressure in the context of the overall convergence of price levels within the euro area. Other recommendations aimed at strengthening competition in private health provision, and on which no action

has been taken, include changes to the systems of reference prices for doctors' services and fixed margins for pharmacies.

Induce households to use health services more economically

A public health care identity card has been introduced and is expected to cover 80 per cent of the population by the end of 1999. This card should reduce fraud and other abuse and help curb multiple consultations and associated over-consumption of diagnostic tests and drugs. The recent revision of the unlimited tax deductibility of health expenditures is also likely to affect household behaviour, since that feature of the personal income tax system had the effect of increasing demand for health services by high income earners. In the 1999 budget, many deductions were transformed into tax credits subject to an overall ceiling. Also, a formal national health care strategy and policy was announced in late 1998. It contains quantified targets for the 1998-2002 period and gives emphasis to prevention and education campaigns. These campaigns should improve health outcomes, helping to reduce the incidence of preventable diseases. Consumer education and the introduction of reference prices for pharmaceuticals – proposed but not yet adopted – should also help curb frivolous demand.

Measures are also envisaged to better reflect citizens' choice in the operation and planning of health care provision. Mechanisms to this effect are being developed, including the creation of "citizens' representatives" – in principle chosen by municipal councils – to serve as intermediaries between regional agencies and public health care users. Some initiatives have also been taken to change the cost-sharing mechanism on the part of patients, mainly by increasing the differentiation of these co-payments according to cost-effectiveness criteria. Co-payments still need to be revised and generally increased, however, as this could limit excessive use of what appears to be a free service to consumers of health care. It is important, however, that any increase in co-payments should not conflict with equity objectives. This can be achieved through increased differentiation of co-payments according to income levels and through the creation of a compensating tax credit.

Reduce overlapping insurance coverage

The overlapping of insurance coverage is estimated to affect 2.5 million people, or a quarter of the population. New legislation was published at the end of 1998, opening the possibility of "opting-out" of the national health system (SNS). Negotiations are underway with the sub-systems and other insurers to define clear and explicit rules regarding this option, including the definition of the financial responsibilities of each health care provider. Although this "opting out" model can give rise to "adverse selection" and "cream-skimming" among insurers, the tax credits given to those who opt out can be scaled to ensure that they

still make a net contribution to the SNS. The recent introduction of public health care users' identity cards are also expected to make "opting-out" viable, by making it possible to identify patients with other types of health insurance.

Summary

The reform of the health care sector has continued over the past two years, following a step-by-step approach, as intended in the government strategy. This strategy has consisted in fixing regulatory standards at the beginning, then introducing new organisational models in health centres and hospitals, and finally modifying the financing of health spending. Changes to the regulatory framework have included laws that open the possibility of "opting out" of the national health system, enhance the role of local governments, and create new management structures for primary health care centres. Other measures already taken include the introduction of national health system identity cards, changes to the unlimited tax deductibility of health expenditures and the development of new budget procedures, for instance making budget allocations more therapy-based. Some important measures have been sent to Parliament but have not yet been approved, including several that would increase competition in private health care provision. Also lagging are measures that would effectively impose a hard-budget constraint for the public health care institutions and give hospital managers more discretion and autonomy. In this respect, the switch to public enterprise status for hospitals is likely to enhance efficiency and accountability. Private management and other innovative schemes, such as those that have been used in pilot programmes, have yielded promising results. Concerning new remuneration models for general practitioners, initial results obtained in pilot programmes have also been encouraging. Finally, the authorities are working on new financial models for funding public health spending in the future – proposals are expected to be presented to Parliament in 2000. Although it is too early to evaluate the results of the measures already taken, the authorities are moving in the right direction on many fronts.[98] The pace of reforms, especially the move to the implementation stage, should be accelerated, however.

Notes

1. In particular, there was a steep fall in mortgage interest rates – most of which are floating rates – and part of this additional income was probably transferred to purchases of durable goods. For further details concerning the growth of household debt, see Chapter III.
2. Investment loans by banks to businesses virtually doubled between 1995 and 1998, mainly on account of the boom in credit with a maturity of over five years. Over the same period, the average interest rate for medium- and long-term loans fell from 12 per cent to about 6 per cent in nominal terms. From December 1997 to December 1998, these rates fell by 2.3 percentage points in nominal terms, and thus by more in real terms, since inflation had picked up.
3. Due to a change in the survey sample in the first quarter of 1998, employment and unemployment data are not strictly comparable with previous years.
4. In addition to cyclical factors, the decline in youth participation rates from 1992 to 1995 was also due to the impact of the lengthening of compulsory schooling. The female participation rate, which is usually less affected than the youth and male rates by slowdowns in the economy, continued its upward trend of recent years.
5. The new methodology uses a stricter definition of unemployment than before, in line with Eurostat's recommendations. On the new basis, the unemployment rate is about ¾ percentage point lower than that calculated with the old survey method. The break in the series hardly affects the evaluation of labour market conditions, since the most marked fall in unemployment was recorded between the second and third quarters of 1998, for data compiled using the same methodology.
6. Before the recent improvement, the impact of long-term unemployment (more than 12 months) seemed to be a source of particular concern since it was relatively higher than in other European countries with an overall unemployment rate comparable with that of Portugal.
7. The changes in inflation have been more marked when considering the national CPI, which increased from 2.2 per cent in 1997 to 2.8 per cent in 1998. However, after rising to 3.2 per cent in December, it fell back to 2.3 in June 1999 (on a year-on-year basis).
8. In 1998, as oil prices fell, excise duties were raised in Portugal, so that consumer prices of energy products remained virtually flat during the year. In contrast, the other countries in the euro area, where the fall in prices was passed on to the consumer, benefited from "imported" disinflation, the energy component of the CPI for the area falling by 4.8 per cent in December 1998 (on a year-on-year basis). In the first half of 1999, the opposite occurred, as the Portuguese authorities reduced excise duties, partly shielding consumers from the rise in world oil prices.

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9. The prices of services in 1998 rose by 2.0 per cent in the euro area and by 3.6 per cent in Portugal. In May 1999, the year-on-year rise was, respectively, 1.7 per cent and 3.3 per cent.

10. For more details on inflation differentials, see OECD, *EMU: Facts, Challenges and Policies*, 1999, (Box 2) and Larre and Torres (1991) "Is convergence a spontaneous process? The experience of Spain, Portugal and France", OECD *Economic Studies* No. 16.

11. Wage formation is described in the OECD *Economic Survey of Portugal*, 1996, Chapter IV.

12. Under the fifth edition of the *IMF Balance of Payments Manual*, applied by Portugal since March 1999, only current transfers (including those from the EU and emigrant workers' remittances) are recorded under current transactions, while capital transfers (essentially those from the EU) are now recorded in the capital account (in line with the IMF *Balance of Payments Manual*, 5th edition). The adjustment represented 2.3 percentage points of GDP in 1998; the size of the deterioration was similar on both definitions – slightly more than 2 percentage points overall between 1996 and 1998.

13. See Martine Durand *et al.* (1998) "Trends in OECD countries' international competitiveness, the influence of emerging market economies", OECD *Economic Department Working Papers* No. 195.

14. The bulk of EU transfers comes from the European Agricultural Guidance and Guarantee Fund (EAGGF) and structural funds under the European Regional Development Fund (ERDF), followed by the European Social Fund (ESF) and the cohesion fund. The cohesion programme applies to Portugal, Greece, Spain and Ireland, Portugal being the second largest beneficiary in terms of per capita transfers for the structural funds and the cohesion programme. The cohesion fund and part of the ERDF and EAGGF transfers are now excluded from current transactions and are recorded in the capital balance.

15. Capital movements (or financial flows) proper and the errors and omissions item (which includes arbitrage effects and statistical adjustments) are considered separately here.

16. Foreign direct investment reached record levels in 1997, in part as a result of privatisations.

17. For this year, the assumption used by the OECD Secretariat is consistent with that of the 1999 budget. For 2000, it differs slightly from the official target specified in the Stability and Growth Programme – a reduction of the deficit to 1½ per cent – since it is based on no policy change, *i.e.* taking into account only measures announced and already approved.

18. After expanding by 9.7 per cent in 1998, Portugal's export markets for manufactured goods would grow by about 5 per cent in 1999 and a little under 6 per cent in 2000.

19. Preliminary data for April 1999 show credit aggregates growing by 16 per cent year-on-year. The growth of credit to the private sector rose to above 27 per cent, with credit to non-financial enterprises and households growing by 26 and 33 per cent, respectively.

20. A decision by Eurostat in October 1998 that certain dividends and income taxes directly related to the privatisation process had to be reclassified, had a significant impact on the budget, reducing above-the-line revenues by 0.6 per cent of GDP at a time when the execution of the budget was already in its final stages.

21. The growth rates of tax receipts and expenditures in 1998 discussed in this section are calculated by comparing 1998 figures with the 1997 outturn and not with preliminary estimates made in September 1997, at the time the 1998 budget was prepared.
22. The growth rates for receipts and expenditures budgeted for 1999 that are discussed in this section are calculated by comparing the budget projections with the preliminary estimates for 1998, which were available in September 1998, at the time the budget was being prepared.
23. Most foreign currency debt was swapped to euro-denominated debt during 1998. The share of debt denominated in US dollars fell from 12.6 to 6.7 per cent of non-escudo denominated debt between 1997 and 1998, and the share of debt denominated in Japanese yen fell from 7.7 to 1.7 per cent.
24. Calculated as residual maturity.
25. The public debt is managed by a semi-autonomous debt agency (IGCP) within the Ministry of Finance.
26. Any foreign currency debt issued in 1999 is expected to be swapped to euros.
27. See OECD, *Economic Outlook 62*, December, 1997.
28. In the OECD Secretariat medium-term reference scenario, which assumes real output growth of 3 per cent, the output gap is virtually zero in 2002.
29. Maastricht definition.
30. See OECD, *Economic Survey of Portugal*, 1996, for a detailed review of the social security system.
31. The health system was the subject of a special chapter in OECD, *Economic Survey of Portugal*, 1998.
32. The European Community became the European Union with the Maastricht Treaty of 1992.
33. Banks' excess liquidity derived from the system of credit ceilings, which limited their capacity to lend, even if faced with increased deposits. This excess liquidity was normally placed at the Central Bank and remunerated at negative real interest rates.
34. "Round-tripping" occurs when a "priority" borrower profits from its access to credit at preferential rates by behaving like a financial intermediary and lending money to other borrowers at higher, market, rates.
35. The First Banking Co-ordination Directive of 1977 aimed at co-ordinating legislative, regulatory and administrative provisions related to market access and the setting up and operation of credit institutions.
36. For simplification purposes, the European Community and the European Union will be referred to as EU throughout the rest of this chapter.
37. See Edey and Hviding (1995).
38. See OECD (1993) for the role of OECD liberalisation codes in this context.
39. Although liberalisation was often determined by EU deadlines, these were often negotiated between the European Commission and Portuguese authorities, which often obtained temporary derogations and delayed implementation schedules, allowing for some flexibility in determining the sequencing of reform measures.
40. This measure should be interpreted with caution, however. In the case of Portugal, interest rate controls – both on loans and deposits – distorted the figures.

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41. The move towards a system of remunerated excess liquidity has also played an important role in the increase of state-owned banks' profitability.
42. In spite of significant circumvention, capital controls had an effect on interest rate spreads, evidenced by the existence of a positive differential between the domestic interest rate and the euro-escudo rate until the early 1990s.
43. Measuring operating costs as a per cent of gross income would suggest increased efficiency of financial intermediation in the 1980s and a sharp decline in the 1990s. Such figures should be interpreted with caution however, since the denominator (*i.e.* gross income) had been inflated by the abnormal jump in financial margins in Portugal between 1984 and 1990. Measuring staff and other operating costs as a per cent of total assets instead of gross income, gives a better picture of the efficiency of the Portuguese financial system. Using cross-country comparisons of bank product measured by balance sheet total also presents some problems, since the share of interbank activity in balance sheet and the prevalence of off-balance-sheet transactions varies from country to country. These transactions normally include the provision of guarantees, forward transactions, the underwriting of shares and bonds, the provision of credit before the actual drawing-down period has started and the provision of back-up lines of credit to capital market participants. More recently, they have also included derivatives transactions.
44. This "securitisation" process has been facilitated by two main developments. First, there has been a proliferation of collective investment institutions – including mutual funds, unit trusts and investment funds – which in turn have played an increasing role in capital mobility. Second, stock exchanges and markets for corporate bonds and commercial paper have been developed, permitting larger companies to raise funds directly on capital markets.
45. The share of different financial intermediaries on the net acquisition of financial assets by financial institutions has typically fluctuated sharply from one year to another. Banks' share has fluctuated between 57 and 82 per cent between 1994 and 1998, for an average of 70 per cent of total (excluding the Bank of Portugal). Banks' share of loans on the other hand, has increased steadily, reaching 98 per cent of total lending in 1998, up from 86 per cent in 1994.
46. Within the EU, only Luxembourg, Ireland (which both have more favourable tax regimes), France, Belgium and Spain had a larger fund asset base as a percentage of GDP.
47. Regulatory changes affecting the insurance industry were undertaken in parallel with other financial sector reforms. The insurance market was opened to the private sector in 1983 and state-owned companies were privatised between 1989 and 1994. As in the banking system, the deregulation process – in large part driven by EU directives – took place in stages, culminating with the lifting in April 1994 of remaining guidelines concerning the setting of insurance premia.
48. At the end of 1997, only 27.4 per cent of mutual fund assets were short-term (cash, deposits and short-term government paper). In recent years, an increasing part of mutual funds' portfolio has been on "risk" assets, especially shares, which by the end of 1997 represented 12.2 per cent of total portfolio, up from 6.7 per cent in 1996 and less than 2 per cent in 1992. Most of this increase however is explained by share price increases.
49. The over-the-counter market, limited in large part to the trading of unlisted stocks, is still significant, even though its share of total trading has been declining.

50. By 1997, MEOG had captured 85 per cent of the bond market (by turnover) and accounted for 40 per cent of capitalisation and 60 per cent of the turnover in Portuguese securities markets. MEOG continued to grow rapidly in 1998, with turnover jumping by 77 per cent over the previous year.
51. See Edey and Hviding (1995).
52. Credit institutions are subdivided into universal banks and specialised credit institutions. The latter (known as "*Caixas*") are generally small mutual institutions of local scope (often supporting agriculture or dealing with mortgages) which together account for less than 5 per cent of assets in the banking system. The Caixa Geral de Depósitos is included among universal banks.
53. They were all majority-owned subsidiaries of foreign groups and had not been nationalised in 1974, like the rest of the banking system. These three banks ("Banco do Brasil", "Crédit Franco-Portugais", a subsidiary of Crédit Lyonnais, and Lloyds Bank) concentrated mostly on transactions involving foreign trade and emigrants' remittances, and had virtually no lending operations.
54. Empirical studies of branching decisions by banks in the Portuguese market show that the sharp increase in the number of branches was to a large extent a pre-emptive move by incumbents regarding possible entry by *de novo* entrants, both domestic and foreign, in retail segments. See Leite and Ribeiro (1998), Cabral and Majure (1993), Barros and Leite (1994), and Barros (1995).
55. In the late 1980s, this market segment – with the exception of insurance – benefited from fiscal incentives and a more advantageous regulatory framework than banking, as entrants generally offered "new" financial services and did not directly compete with public sector institutions. As commercial banks could not engage in activities such as leasing, factoring and real estate investment, smaller institutions generally occupied those niche markets. By late 1989, there were over 200 non-bank financial institutions.
56. The only remaining restriction in Portugal concerns stock market brokerage and dealing operations in the Lisbon spot market, but this is scheduled to be phased-out by the end of 1999.
57. The five largest financial groups are the "Caixa Geral de Depósitos", "Banco Comercial Português", "Banco Pinto & Sotto Mayor", "Banco Espírito Santo e Comercial de Lisboa"; and "Banco Português de Investimento".
58. Gearing ratios are defined as banks' capital and reserves as a percentage of balance-sheet total and, although not exactly the same as solvency ratios used for prudential purposes, can serve as a crude measure of the solvency of financial institutions.
59. Not only investment in public sector securities was compulsory, but the monetisation of budget deficits imposed a further burden on the banking sector. Combined with credit ceilings, this led to an accumulation of involuntary excess liquidity, which was normally held at the Central Bank with below market returns. Liquidity hovered between 20 and 25 per cent in the early 1980s, compared with required reserves in the order of 6 per cent.
60. The spread between credit operations and deposits remained in the 5 to 6 percentage point range in the second half of the 1990s. Quantitative restrictions in the loans market may have contributed to this persistently high spread. The combination of credit ceilings and accelerating economic activity may have created pressures towards increases in loan rates, which partly compensated for greater price competition in the loan market.

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61. In spite of the decline on non-interest income, the deepening of financial markets and the diversification of banking activities still had a significant impact on the Portuguese banking system, leading to a jump in the contribution of small items to financial margins – such as investments in credit institutions abroad and interbank operations between domestic banks. See Bank of Portugal (1997).

62. The number of employees per branch declined significantly in the period, as new branches were relatively small and the use of new technology increasingly substituted for labour.

63. The main exception was New Zealand, where alleviating macroeconomic imbalances was an explicit objective of financial sector reforms. These included the achievement of price stability, the enhancement of the economy's overall savings and the concomitant reduction in the current account deficit, and the promotion of output growth. See OECD (1998*a*).

64. The elimination of credit restrictions and the liberalisation of the capital account led to a sharp increase in the availability of credit in most countries – see Bisat *et al.* (1992). While in some less advanced economies, the elimination of restrictions on time deposits increased the returns available to savers and resulted in significant improvements in savings performance, in others – including most of the OECD area – this was more than offset by the effects of greater access to credit facilities, which boosted consumption. This was the case in the United Kingdom and several Nordic countries, where household savings fell considerably following financial deregulation and the removal of important credit ceilings or interest rate controls – see Edey and Hviding (1995). These effects tended to be temporary however – only in a few cases is there evidence that saving ratios were permanently reduced by financial market reforms. More often, the permanent effect of financial market reforms on saving ratios have been small or difficult to determine – see OECD (1997*b*) and Baoyoumi (1993).

65. The decline in household savings was significantly smaller when adjusted for inflation, however – between 1991 and 1998, it fell by 2 percentage points.

66. See *Regulatory Reform in the Financial Services Industry*, OECD (1997).

67. The experience of many OECD countries following financial deregulation shows the importance of the interaction between macroeconomic policies and structural changes in the financial sector. The latter generally implies significant changes to the environment for macroeconomic policy making, from changes in the monetary transmission mechanism to increased difficulties of interpreting and controlling financial variables. In turn, prudent macroeconomic policies with consistent objectives are generally conducive to financial stability. See Edey and Hviding (1995).

68. This section is partly based on McCauley and White (1997); BIS (1998); EC (1997*a, b, c*); ECB (1999); and Leite and Ribeiro (1998).

69. Although other barriers remain – mostly related to differences in legal framework such as labour regulations, social security and the tax system – the existence of national currencies had been a major barrier to the full integration of European financial systems. In the tax area, there are differences between EU countries' taxation of savings income, often reflecting deliberate fiscal or social policy choices. Distinct labour codes and practices, including those related to social security regulations, can also constitute a barrier to the emergence of a fully integrated financial market by reducing labour mobility. Finally, in a number of EU countries, specific regulatory barriers remain. See EC (1997).

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70. EMU is also expected to affect securities trading, with smaller national exchanges, such as the ones in Lisbon and Porto, under pressure to reduce fees or see trading migrate to other euro zone countries.
71. The need to update information technology – both EMU and Y2K-related – is estimated to be in the range of 1 and 2 per cent of EMU banks' capital. See *The Banker* (1998).
72. Faster diffusion of new technology – such as Internet and telephone banking – will increase competition in the delivery of financial services, making banks' branch networks increasingly obsolete. The role of collective investment institutions should also be further enhanced by EMU, to the extent that the activities of mutual funds, unit trusts and investment funds will be facilitated by the elimination of exchange risks and by the increase in market liquidity. Moreover, stock exchanges and markets for corporate bonds and commercial paper will be boosted by the increase in liquidity and depth associated with EMU, so firms are likely to find it increasingly easy to bypass banks and raise funds directly in capital markets. Finally, a low interest rate environment and easier (and cheaper) securities trading may also prod savers to channel funds away from bank deposits and through institutional investors.
73. Indeed, a process of consolidation has been underway in the EU since at least the mid-1980s, with branch density falling steadily between 1985 and 1997. More recently, merger and acquisition (M&A) activity in the financial sector has increased sharply, leading to a decline in the number of credit institutions. Employment levels have been more stable, however.
74. Foreign banks had difficulties in establishing a foothold in Portuguese retail banking in the early 1990s, to a large extent as a result of the pre-emptive expansion of the branch network by domestic banks.
75. Commissions from foreign exchange trading will also depend on the volatility of exchange rate movements.
76. See McCauley and White (1997).
77. Data shown in Figure 26 should be interpreted with caution. Labour productivity measures based on balance sheet data are not easily comparable since the prevalence of off-balance-sheet transactions varies widely among countries.
78. See Ledingham (1996).
79. In the US, the market for mortgage-backed securities (MBS) has existed since the 1970s and has reached over $4 trillion. Mortgage loans originating from a network of financial institutions, including commercial banks and savings and loans associations, are purchased, under strict credit quality guidelines, by three agencies that convert them into flexible, liquid instruments before selling them to investors. These agencies were originally public institutions, but are now privately-managed, shareholder-owned corporations, which do not benefit from a US government guarantee and assume all risk of default on the underlying mortgage investment. The financial institutions that were the original mortgage lenders keep the management responsibility to collect loan payments, but carry no residual risk in case of default. In the case of Germany, which has the second largest market for MBS and where the regulatory system is similar to the one prevailing in Portugal, the nature of these securities differs considerably from their US equivalent: banks issue securities (mortgage *Pfandbriefe*) that are used to finance mortgage loans. These securities are fully collaterised by a pool of first mortgage loans, which have to meet strict eligibility guidelines. Investors who purchase those securities are exposed to the quality of the assets used

as collateral, but also to the possibility of default on the part of the issuing bank. More importantly, contrary to their US counterparts, German MBS are not structured to remove assets from the originator bank's balance sheet. As a result, the bank keeps a credit risk exposure to mortgage default.

80. See OECD (1998*b*).

81. These arrangements include co-operation in the interconnection of networks and database maintenance, the operation of international credit card systems, national debit transfer systems or payment clearing systems, and the joint development and promotion of new products. See OECD (1998*b*).

82. The participation rate for women (nearly 61 per cent in 1996-98) is higher than the average for the EU and for the OECD area. For the intermediate age group (25 to 54 years) in particular, this rate reaches nearly 75 per cent, comparable with those in the United States and Canada, and just short of the record rates in the Scandinavian countries; the rates in Italy, Spain and Greece are between 55 and 60 per cent (1997 data).

83. The role that labour markets can play in cushioning shocks in the new context of Economic and Monetary Union is analysed in detail in OECD, *EMU, Facts, Challenges and Policies*, 1999.

84. The Ministry of Education is augmenting the NONIO 21st Century Programme, which provides incentives for better integrating the new information technologies into education. At the same time, the Ministry for Science and Technology is increasing access to the Internet in public and private schools and in vocational schools.

85. In this case, as in that of youth unemployment, it can be seen how heavily low educational attainment is penalised in the Portuguese labour market. Long-term unemployment is experienced mostly by poorly educated adults; it often becomes irreversible, leading to marginality of the families affected.

86. The initiatives contained in the Action Plan are based on the EU recommendations. The programmes for persons unemployed for less than 6 months (INSERJOVEM) for youth, or 12 months in the case of adults (REAGE), and the RUMO programme for the long-term unemployed are akin to the individualised schemes of this type conducted in Ireland since 1998 with some success. A scheme has also been introduced to assist the reskilling of workers at risk in sectors or firms in the process of restructuring (FACE), and regional or sectoral mobility grants are being offered to workers at risk before they become unemployed.

87. Transfers from the European Social Fund account for a large share of active policy financing.

88. These initiatives are being implemented by the Institute for Employment and Vocational Training, several ministries being involved.

89. One-third of CSF funding has been allocated to human resource development, one-third to infrastructure and the remainder to the productive sector.

90. According to estimates by the Ministry for Infrastructure, Planning and Territorial Administration, which take into account only the demand-side effects, EU funds helped to raise the level of GDP by 2.7 per cent over the period 1994-97, with positive effects on employment, disposable income and private consumption. Their cumulative impact on the level of investment was 10 per cent and job creations attributable to them represented 2.2 per cent of total employment over the period 1994-97. These estimates were made with a model using input/output matrices, on the basis of

expenditure financed by Community funds and assuming that the counterpart national contribution was spent in every case. As a comparison, estimates for Spain encompassing both demand-side and supply-side effects for total Community aid received by that country between 1989 and 1999 put the cumulative impact on GDP at 3.3 per cent (Sosvilla-Rivero and Herce, 1999).

91. Reduction of regional disparities also forms part of the government's strategy: introduction in 1998 of the Regional Networks for Employment (defined at the national level) and the Territorial Pacts for Employment (defined in the context of the EU).

92. A national network of Business Formality Centres was set up in 1998. The Centres are designed to facilitate administrative formalities and provide all information on business incorporation. Seven centres will have been created by the end of 1999. Four were already in operation at the end of 1998. At that time the length of the company incorporation process had been shortened to about 20 days as opposed to six months, in some cases, previously.

93. About half of the stock market capitalisation corresponds to privatised companies.

94. EDP was partly privatised in 1997 and 1998, the government retaining 50 per cent of the capital. It is expected that a further 10 to 15 per cent of the company will be sold during 1999, bringing the government participation to below 50 per cent. At present, the Portuguese electricity system consists of the Public Service Electricity System and an independent electricity system, which integrates non-binding generators, distributors and customers and small independent generators.

95. Furthermore, given that the average size of families is larger in Portugal than on average in the OECD, the number of access lines measured in relation to family unit suggests a smaller gap between Portugal and other OECD countries – in 1996 there were 90.5 lines per 100 households in Portugal, compared with 94.8 for the OECD average.

96. These areas were identified as areas for action in the 1996 *Economic Survey*.

97. Within the public sector, contracting will include negotiations over issues such as projected productivity, cost-effectiveness, the degree of responsiveness to health care needs and to the demands of the population covered.

98. In this context it should be noted that health spending continued to grow rapidly in 1998 (8 per cent from a year earlier), even though overruns were more limited than previously: state health spending was only 0.8 per cent above budget in 1998 – against 5.6 per cent above budget in 1997.

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Annex I

Background information to Chapter III

The financial sector reform process

Financial market reforms in Portugal had three distinct phases. In the first phase (which covered broadly the second part of the 1980s), the slow pace of reforms was explained in large part by the authorities' reluctance to phase out credit ceilings and other regulations that played an important role in macroeconomic management. In the second phase (in the early 1990s), liberalisation was rapid and wide, with Portugal meeting all the deadlines for the implementation of relevant EU Directives. The third phase (which started in 1993) was marked by further EU-wide progress in the creation of a single market for financial services and by the preparation for EMU.

First phase (1984-1989): the increasing role of the private sector

In the second half of the 1980s, the primary focus of reforms was to promote greater efficiency in financial markets and to increase the authorities' scope for managing monetary policy. The key measure in this period was the opening of financial intermediation to the private sector, mostly through the easing of entry restrictions, which for banks and insurance companies took effect from 1983. Some changes to the regulatory framework for financial institutions were also carried out in the mid-1980s, including the easing of restrictions on shareholdings and the partial liberalisation of specialisation and segmentation rules. This had the effect of enlarging the number of instruments financial institutions could offer and the range of transactions in which they could engage.

The main macroeconomic focus of the reforms during this phase was on improving the efficiency of monetary policy. Measures were taken to liberalise and deepen the interbank market, including making relevant regulations more flexible and creating new government debt instruments. Authorities also started to dismantle interest rate controls – most deposit rates were liberalised in 1984, while lending rates were fully freed by 1989. These measures had the effect of turning the interbank money market into a genuine cash management instrument, the pre-existing interbank bond market remaining mostly a vehicle for the redistribution of "structural" liquidity imbalances between financial institutions. Finally, some relatively small steps towards the liberalisation of capital movements were taken, consisting mostly of freeing capital flows related to Foreign Direct Investment (FDI), supplier's credit or export finance. This gradual liberalisation of money and foreign exchange markets facilitated the fine-tuning of monetary conditions and laid the ground for the introduction of monetary control via open-market operations in the early 1990s.

Even though entry was liberalised and interest rates freed, competition in the financial sector was still strictly limited. Private sector banks were in practice under a threat of re-regulation, which limited their freedom to set interest rates.[1] Furthermore, the establish-

ment of new financial institutions was still subject to non-prudential requirements, while a series of legal and administrative controls remained. First, the scope of financial products that new entrants were able to offer was severely limited, curtailing their ability to attract new customers. Second, regulatory restrictions governing the opening of new branches forced most new entrants to concentrate on the relatively small wholesale end of the market. Finally, and most importantly, credit ceilings continued to be imposed at the bank level for macroeconomic management purposes, severely limiting competition on the deposit end of the market as well, since more competitive banks had a limited possibility of increasing lending, even if they gained market share through a larger deposit base.

Second phase (1990-1992): fast pace liberalisation

The pace of reforms accelerated significantly in the early 1990s. Helping to galvanise authorities' efforts were the deadlines for the implementation of EU Directives, several of which fell on 1 January 1993. These included the EU Second Banking Co-ordination Directive, which established the model of universal banking and, together with the Directives on own funds and capital adequacy, gave banks established in an EU country the freedom to set up or provide services elsewhere in the Union. In meeting the deadline, entry and branching restrictions in the financial sector were completely liberalised and the scope of activities in which banks were allowed to engage was greatly enlarged (including leasing and factoring for instance), as specialisation and segmentation restrictions were gradually suppressed.

Competition in the financial sector was further enhanced by the privatisation process. Between 1989 and 1996, 11 banks and five insurance companies were transferred to the private sector, with a significant impact on public sector debt revenues amounted to almost a trillion PTE, approximately 12 per cent of 1990 GDP. Today, only the "*Caixa Geral de Depósitos*" group remains in the public sector. This group, which has always been in public hands, has no special privileges. Privatisation often led to enhanced efficiency throughout the 1980s and early 1990s, private sector banks consistently outperformed their publicly owned counterparts, both in terms of profitability and solvency ratios. Also important in this second phase of reforms was the complete abolition of interest rate controls. By 1989, most of these controls had already disappeared, but some significant ones remained, including a maximum rate for demand deposits. These were removed at the end of 1992. Other regulatory changes not directly related to EU Directives included the enactment of the Security Market Act of 1991, which greatly streamlined government intervention in the securities markets.

These changes were complemented by the modernisation of instruments to accomplish monetary and financial stability. Main changes were introduced in steps between 1990 and 1991. Formal credit ceilings for commercial banks were suspended in March 1990 and credit guidelines in early 1991. This marked the evolution from a system of direct quantitative limits on credit, in place since 1977, to a more indirect form of monetary control via open market operations.[2] The implementation of indirect monetary control was facilitated by a series of accompanying reforms, including changes to compulsory reserve requirements. In three steps between March 1990 and February 1991, the minimum reserve ratio was established at 17 per cent and remuneration rates were standardised across all reserve assets and aligned at the margin with the Bank of Portugal's money-market intervention rate.[3] Also, a new "Organic Law" governing the operation of the Bank of Portugal was enacted in October 1990, granting it more autonomy, prohibiting it from financing the State other than by underwriting Treasury Bills under negotiated conditions[4] and strengthening the Bank's prudential supervisory responsibilities.

This second phase of financial market reforms culminated with the full liberalisation of external capital flows, as foreseen in the 1988 EU Directive establishing the free movement of capital. This Directive foresaw a deadline of 1 July 1990 for all member states, except Greece, Ireland, Portugal and Spain, which had a transitional period running until 1 January 1993. Greece and Portugal had the possibility of extending this deadline for a further three years, but Portugal did not make use of this extension. Even though Portugal met the original deadline, the lifting of exchange controls was subject to a series of setbacks. Initial steps towards easing restrictions on capital movements in the late 1980s were met with large capital inflows, jeopardising liquidity targets and exerting upward pressure on the exchange rate. This complicated macroeconomic policy at a time when one of its main objectives was disinflation. By mid-1990, it became clear that the tight monetary policies and high interest rates pursued at the time were inconsistent with the fixed (crawling-peg) exchange-rate regime in place. This led the government to abandon the crawling peg and re-impose some temporary restrictions on short-term capital inflows.[5] Only in December 1992 were most remaining capital controls abolished, eight months after the escudo had entered the Exchange-rate mechanism (ERM) of the European Monetary System (EMS).

Third phase (since 1993): the single market in financial services

By 1993, the regulatory framework governing the Portuguese financial system had already largely converged towards the rest of the EU. Since then, EU-wide regulatory developments have been to a large extent marked by the implementation of legislation aimed at further progress in the creation of a single market in financial services. The EU Directive on investment services implemented in 1996 established a single authorisation system for investment companies and led to the liberalisation of foreign entry into the investment services industry. Other Directives were aimed at harmonising and strengthening supervision and control of credit institutions, including the Capital Adequacy Directive, which fixed minimum standards for the coverage of market risk by the means of own funds of credit institutions and investment companies.

This phase of financial market reforms also included further initiatives aimed at modernising monetary policy instruments. These consisted of the creation in 1993 of a standing facility for the provision and absorption of liquidity and the introduction in 1994 of variable repurchase rates, giving the Bank of Portugal an important monetary tool to influence exchange rates. Moreover, reserve requirements were reduced to 2 per cent and reserves became unremunerated as of 1994. Finally, the government's privileged access to capital markets was discontinued and the withholding tax on coupon payments to non-residents abolished.[6] These measures represented a step towards the harmonisation of monetary policy tools available to ERM countries and of the conditions governing financial markets in general in the context of preparations for EMU. Treaty provisions governing the transition to EMU also led to significant legislative changes. In 1995, the "Organic Law" of the Bank of Portugal was amended in line with EMU provisions, cementing its autonomy. Amendments included making price stability the Bank's primary objective and prohibiting direct purchases of government paper.

Cross-country comparisons of the structure and performance of the financial system

Figures A1 to A6 below show selected indicators of structure and performance of the Portuguese financial system in comparison with other OECD countries.

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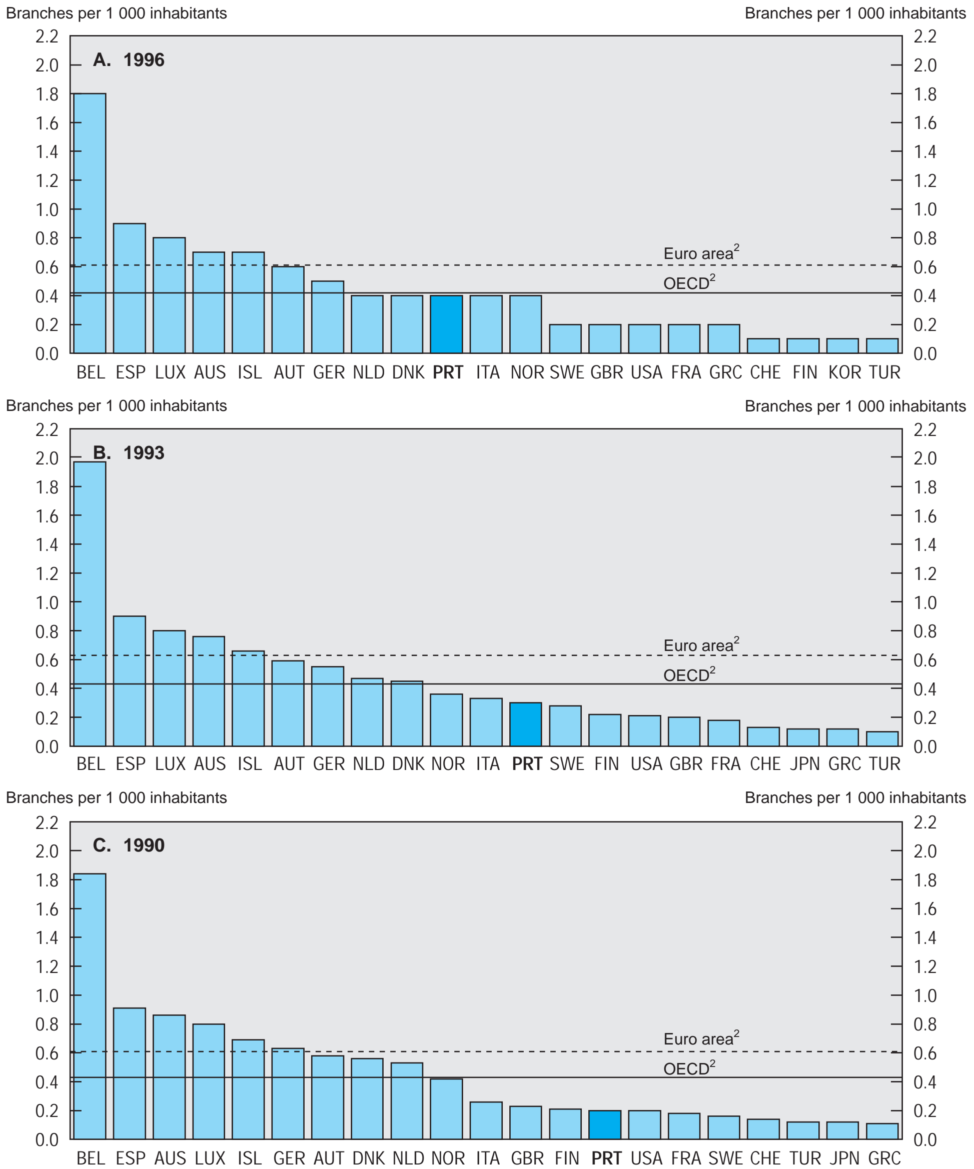
Figure A.1. **Bank branch density**[1]

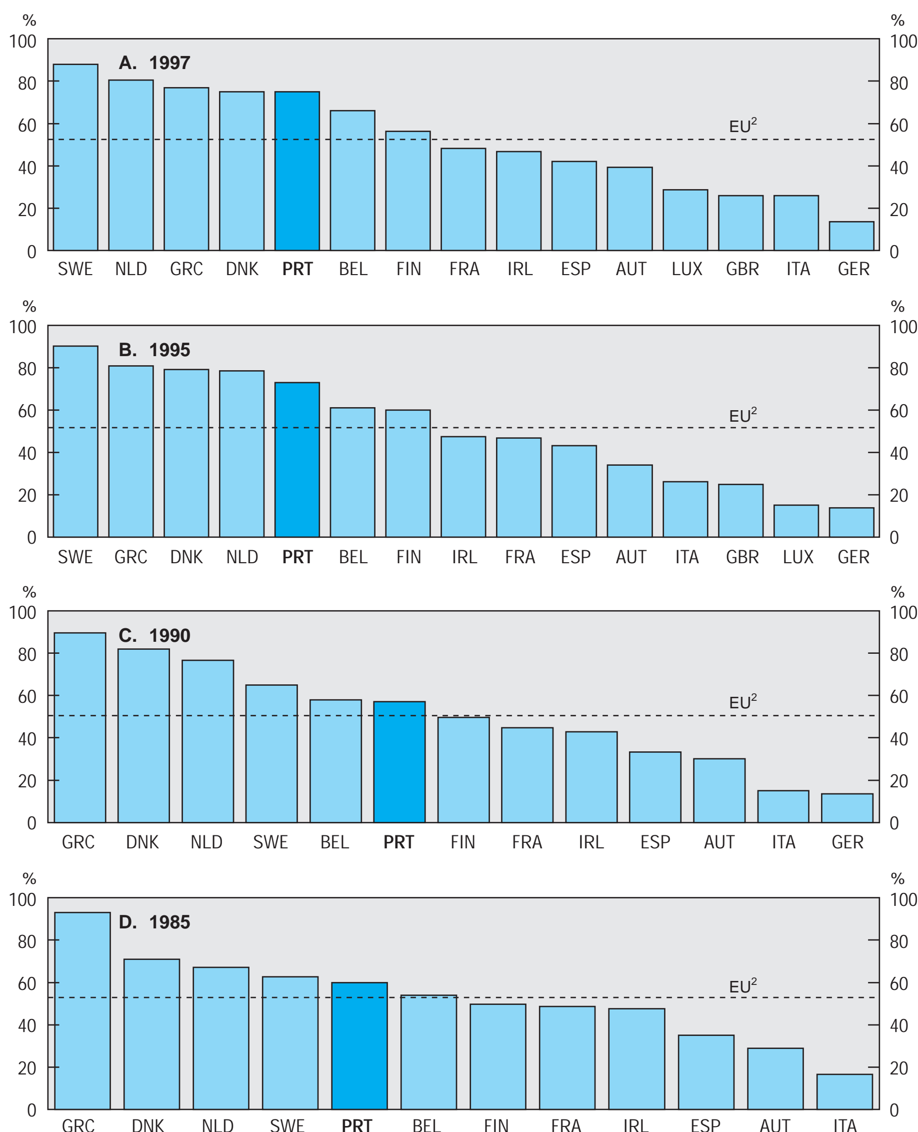


1. Commercial banks, except for Denmark, Iceland and Switzerland.
2. Unweighted average.

Source: OECD, *Bank Profitability,* 1998.

Figure A.2. **Concentration ratio**

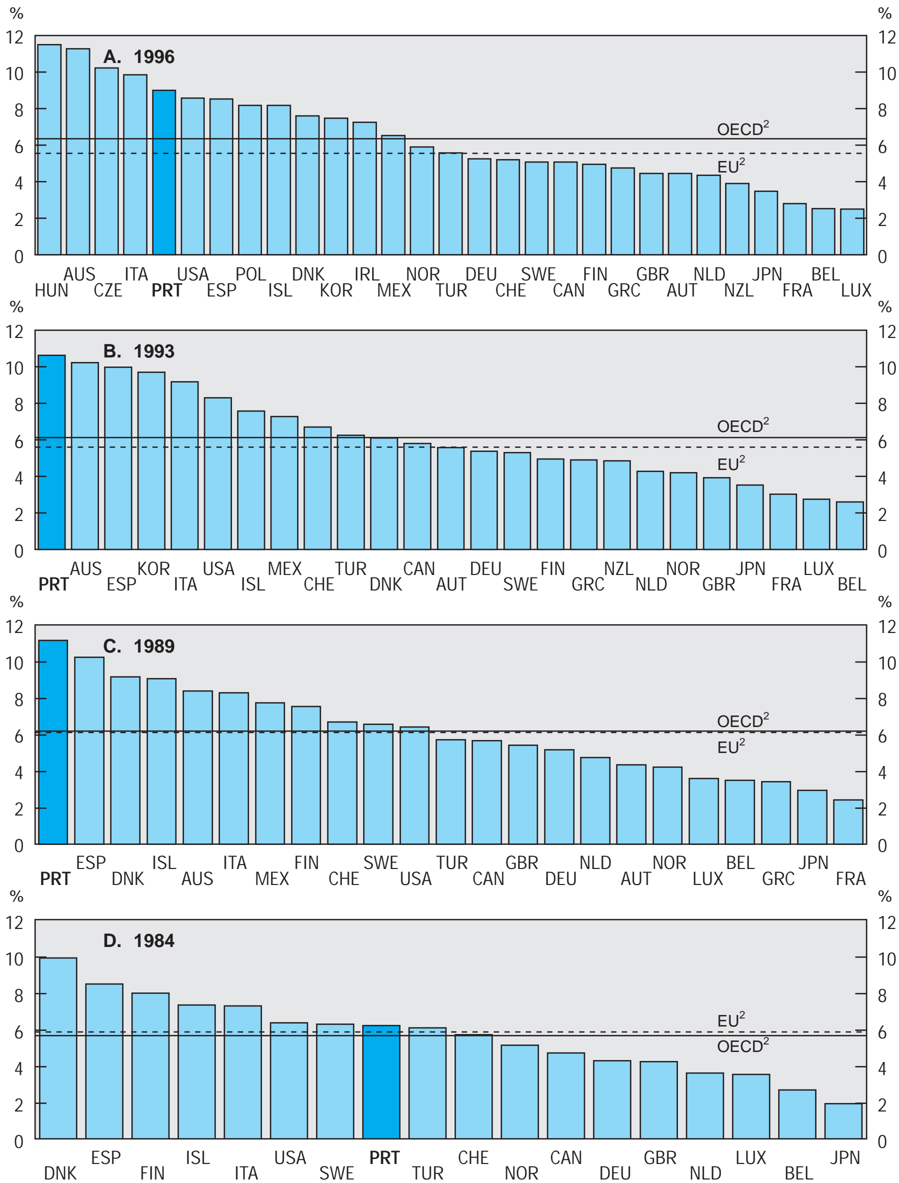
Market share of the five largest banks[1]



1. As a percentage of total loans.
2. Unweighted average.

Source: ECB.

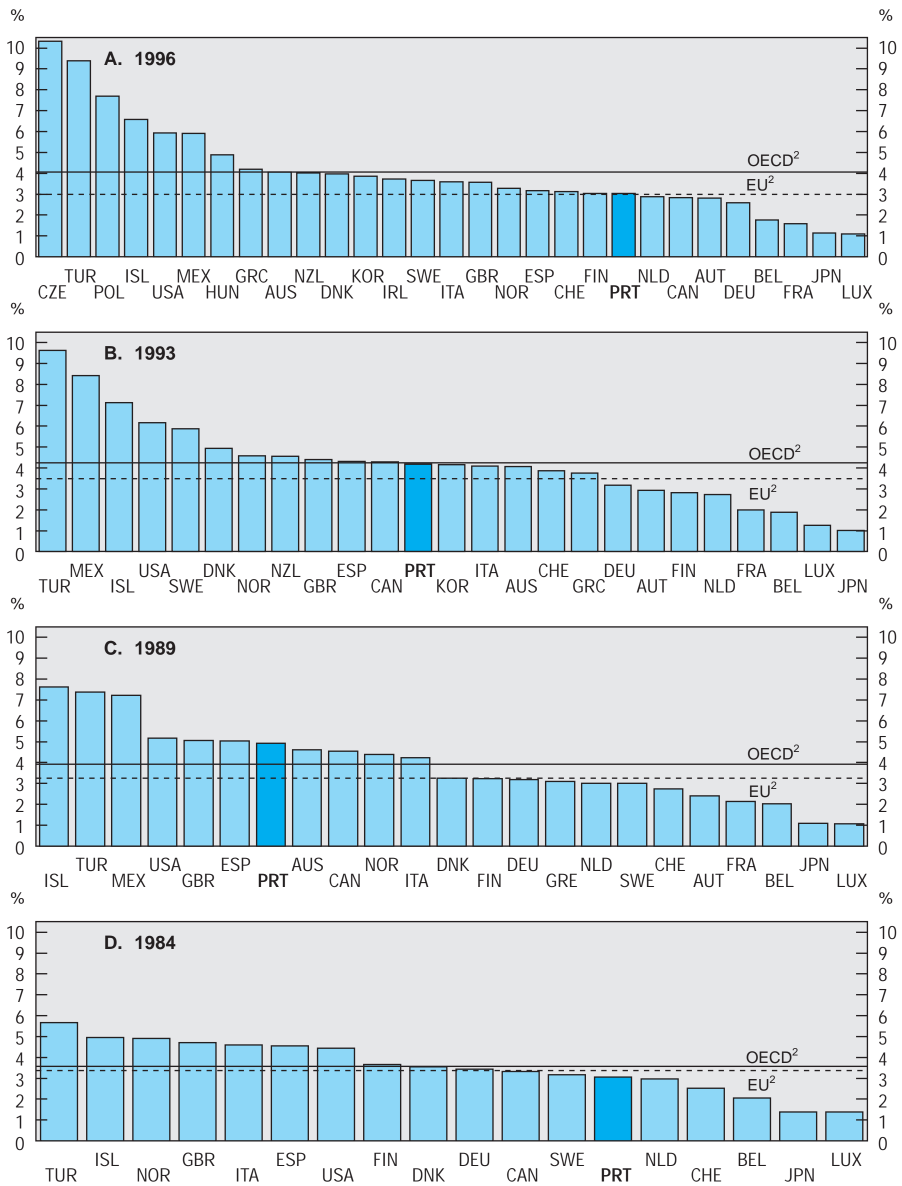
Figure A.3. **Gearing ratio**[1]



1. Commercial bank's capital and reserves as a percentage of balance sheet total.
2. Unweighted average.

Source: OECD, *Bank Profitability,* 1998.

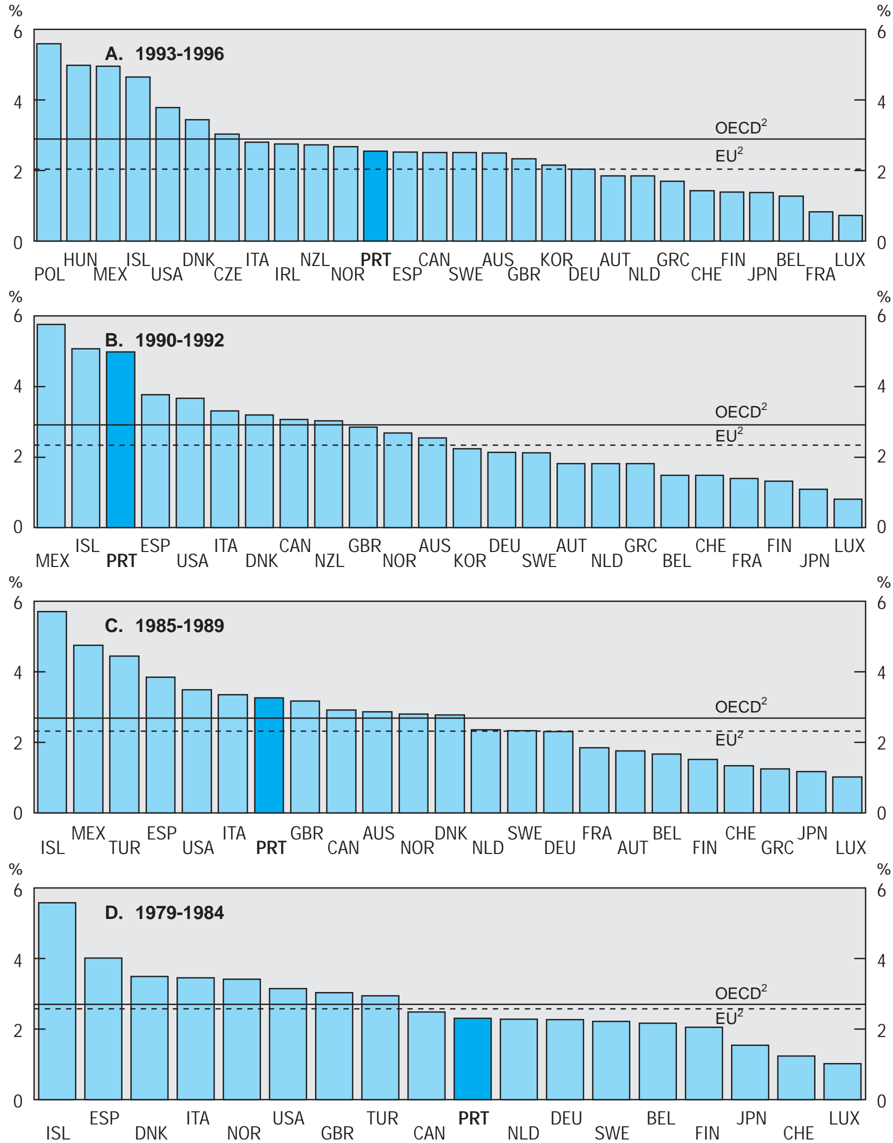
Figure A.4. **Profitability ratio**[1]



1. Commercial bank's gross income as a percentage of balance sheet total.
2. Unweighted average.

Source: OECD, *Bank Profitability,* 1998.

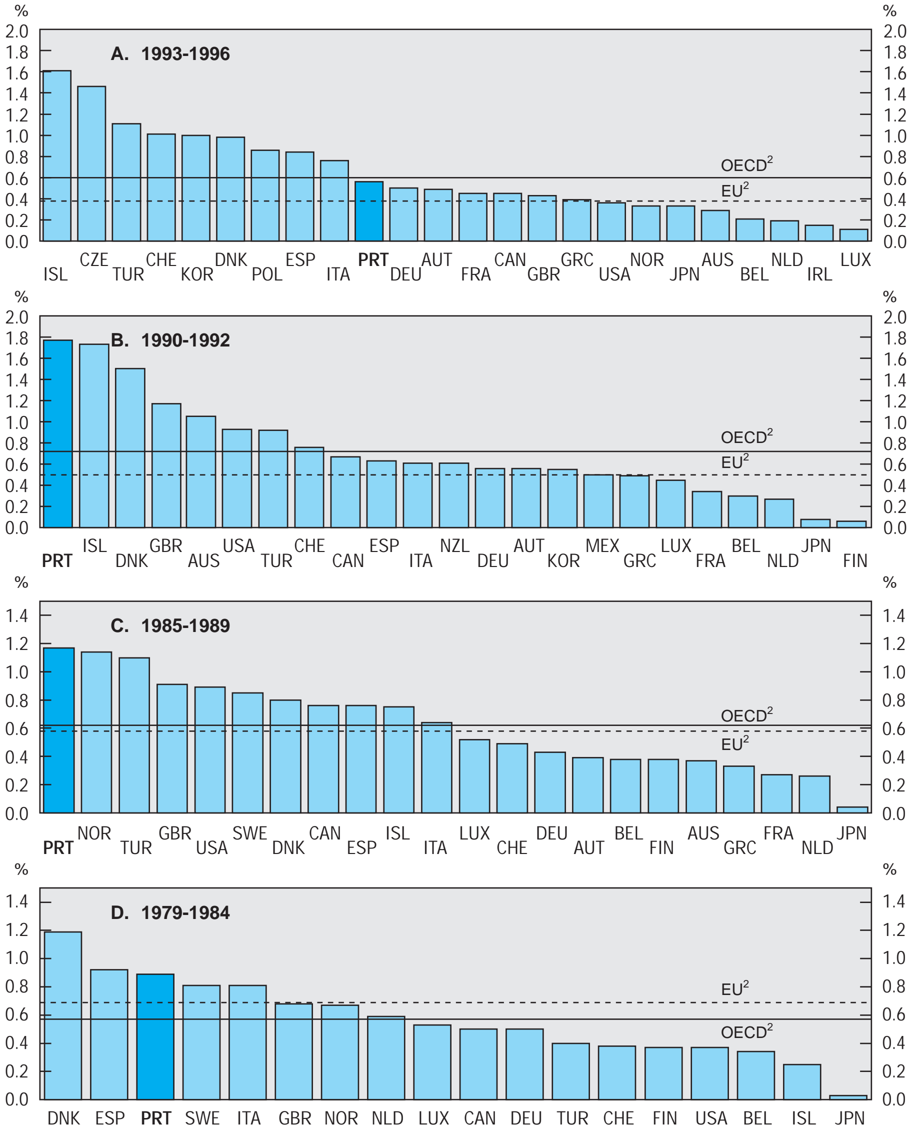
Figure A.5. **Financial margin**[1]
As a percentage of balance sheet total



1. Commercial banks.
2. Unweighted average.

Source: OECD, *Bank Profitability,* 1998.

Figure A.6. **Provision against losses**[1]
As a percentage of balance sheet total



1. Commercial banks.
2. Unweighted average.

Source: OECD, *Bank Profitability*, 1998.

Notes

1. In 1986, when private banks started to offer higher interest rates on demand deposits, a ceiling was temporarily re-introduced.
2. Through the new system, liquidity was determined by the setting of cash reserves for the banking system, but targets for the growth of monetary aggregates were only indicative, as the effect of ongoing regulatory changes on demand for money was uncertain at the time. This allowed for some flexibility in the conduct of monetary policy, as authorities shifted focus towards the determination of nominal interest rates and exchange rates.
3. Under the previous system, remuneration was well below inflation and asymmetrical requirements across assets led to inefficiencies as banks tried to evade reserve obligations.
4. This measure was later complemented by the abolition of the Treasury's interest-free overdraft facility in December 1992 (which was replaced by a ten-year loan).
5. In July 1990, a 40 per cent unremunerated deposit requirement for non-trade-related foreign borrowing by non-financial residents was imposed, followed by a series of further measures in 1991, including the introduction of a deposit requirement for foreign escudo accounts (which reached 90 per cent in the case of offshore branches) and the requirement for prior authorisation for non-resident purchases of floating-rate bonds.
6. Since June 1994, the 20 per cent withholding tax on coupon payments for all treasury obligations (except on issues prior to 1992) has been immediately reimbursed. This has removed an important constraint to the development of the Portuguese financial market, by harmonising fiscal conditions with those prevailing in most other European capital markets.

OECD 1999

Annex II

Calendar of main economic events

1998

January

The liquidity absorption rate, the repo rate and the overnight credit facility rate of the Bank of Portugal are cut by 10 basis points to 4.8, 5.1 and 6.8 per cent, respectively.

Publication of the White Book on Social Security, prepared by an independent commission.

February

The liquidity absorption rate, the repo rate and the overnight credit facility rate of the Bank of Portugal are cut by 20 basis points to 4.6, 4.9 and 6.6 per cent, respectively.

Mars

The liquidity absorption rate, the repo rate and the overnight credit facility rate of the Bank of Portugal are cut by 20 basis points to 4.4, 4.7 and 6.4 per cent, respectively.

April

Publication of the government's Employment Action Plan in the context of the European Union strategy for employment defined at the Luxembourg Summit in 1997.

May

Expo 98 opens in Lisbon.

Portugal's participation in the third phase of EMU is confirmed. Bilateral exchange rates are irrevocably fixed.

The Bank of Portugal lowers the liquidity absorption rate, the repo rate and the overnight credit facility rate by 20 basis points to 4.2, 4.5 and 6.2 per cent, respectively.

September

Expo 98 in Lisbon closes.

October

The liquidity absorption rate, the repo rate and the overnight credit facility rate of the Bank of Portugal are cut by 50 basis points to 3.7, 4.0 and 5.7 per cent, respectively.

OECD 1999

November

The 1999 budget is approved by Parliament. In line with the convergence programme, it targets the budget deficit at 2.0 per cent of GDP.

The Bank of Portugal lowers the liquidity absorption rate and the overnight credit facility rate by 20 basis points to 3.5 and 5.5 per cent, respectively. The repo rate was cut by 25 basis points to 3.75 per cent.

December

The Bank of Portugal cut the liquidity absorption rate, the repo rate and the overnight credit facility rate by 75 basis points to 2.75, 3.0 and 4.75 per cent, respectively.

The government presents its Stability and Growth Programme, calling for a cut in the general government requirement to 0.8 per cent of GDP in 2002.

Report by the government summarising reforms in the goods, services and capital markets (Cardiff process).

1999

January

The third stage of the Economic and Monetary Union begins. The euro is introduced.

Eligibility requirements for mortgage subsidies were tightened.

Mars

Meeting of EU heads of state and government in Berlin: the Council of Ministers adopts the draft regulations on the reform of the Structural Funds for the period 2000-2006.

April

The European Central Bank lowers the repo rate by 50 basis points to 2.5 per cent.

The Bank of Portugal tightens the provision requirement on consumer credit.

BASIC STATISTICS:

INTERNATIONAL COMPARISONS

BASIC STATISTICS: INTERNATIONAL COMPARISONS

	Units	Reference period [1]	Australia	Austria	Belgium	Canada	Czech Republic	Denmark	Finland	France	Germany	Greece
Population												
Total	Thousands	1996	18 289	8 060	10 157	29 964	10 316	5 262	5 125	58 380	81 877	10 465
Inhabitants per sq. km	Number	1996	2	96	333	3	131	122	15	106	229	79
Net average annual increase over previous 10 years	%	1996	1.3	0.6	0.3	1.3	0	0.3	0.4	0.5	3	0.5
Employment												
Total civilian employment (TCE)[2]	Thousands	1996	8 344	3 737 (94)	3 675 (95)	13 676	4 918	2 593	2 087	21 951	35 360	3 824 (95)
of which: Agriculture	% of TCE	1996	5.1	7.2 (94)	2.5 (95)	4.1	6.3	4	7.1	4.6	3.3	20.4 (95)
Industry	% of TCE	1996	22.5	33.2 (94)	26.7 (95)	22.8	42	27	27.6	25.9	37.5	23.2 (95)
Services	% of TCE	1996	72.4	59.6 (94)	71.4 (95)	73.1	51.7	69	65.3	69.5	59.1	56.4 (95)
Gross domestic product (GDP)												
At current prices and current exchange rates	Bill. US$	1996	398.9	228.7	268.2	579.2	56.2	174.9	125.1	1 536.6	2 353.5	91.2 (95)
Per capita	US$	1996	21 812	28 384	26 409	19 330	5 445	33 230	24 420	26 323	28 738	8 722 (95)
At current prices using current PPPs[3]	Bill. US$	1996	372.7	172.4	222	645.1	..	118	96.7	1 198.6	1 736.1	133.5
Per capita	US$	1996	20 376	21 395	21 856	21 529	..	22 418	18 871	20 533	21 200	12 743
Average annual volume growth over previous 5 years	%	1996	3.9	1.6	1.2	2.2	2	2.2	1.6	1.2	1.4	1.3 (95)
Gross fixed capital formation (GFCF)	% of GDP	1996	20.3	23.8	17.3	17.7	33	16.7	16.1	17.4	20.6	17 (95)
of which: Machinery and equipment	% of GDP	1996	10.2 (95)	8.8 (95)	7.5 (95)	6.6	..	7.9 (95)	6.4 (95)	7.8	7.6	7.7 (95)
Residential construction	% of GDP	1996	4.6 (95)	5.9 (95)	4.6 (95)	5.4	..	3.2 (95)	3.5 (95)	4.4	7.3	3.3 (95)
Average annual volume growth over previous 5 years	%	1996	5.6	2.1	0.3	2.2	9.4	2	–4.1	–1.5	0.2	0.5 (95)
Gross saving ratio[4]	% of GDP	1996	18	21.9	22.2	17.8	..	17.6	19.6	18.7	20	16 (95)
General government												
Current expenditure on goods and services	% of GDP	1996	17	19.8	14.5	18.7	21.5	25.2	21.9	19.4	19.8	20.8 (95)
Current disbursements[5]	% of GDP	1995	35.6	48.6	52.2	45.8	..	59.6	55.9	50.9	46.6	52.1
Current receipts	% of GDP	1995	34.9	47.4	49.9	42.7	..	58.1	52.8	46.9	45.9	45
Net official development assistance	% of GNP	1995	0.36	0.33	0.38	0.38	..	0.96	0.32	0.55	0.31	0.13
Indicators of living standards												
Private consumption per capita using current PPPs[3]	US$	1996	12 596	12 152	13 793	12 959	..	12 027	10 282	12 506	12 244	9 473
Passenger cars, per 1 000 inhabitants	Number	1994	460	433	416	466	282	312	368	430	488	199
Telephones, per 1 000 inhabitants	Number	1994	496	466	449	576	209	604	551	547	483[8]	478
Television sets, per 1 000 inhabitants	Number	1993	489	479	453	618	476	538	504	412	559	202
Doctors, per 1 000 inhabitants	Number	1995	2.2 (91)	2.7	3.7 (94)	2.2	2.9	2.9 (94)	2.8	2.9	3.4	3.9 (94)
Infant mortality per 1 000 live births	Number	1995	5.7	5.4	7.6 (94)	6.3 (94)	7.7	5.5	4	5.8 (94)	5.3	8.1
Wages and prices (average annual increase over previous 5 years)												
Wages (earnings or rates according to availability)	%	1996	1.7	5.2	2.7	2.4	..	3.2	3.8	2.6	4.2	11.8
Consumer prices	%	1996	2.4	2.9	2.2	1.4	11.9	1.9	1.5	2	3.1	11.6
Foreign trade												
Exports of goods, fob*	Mill. US$	1996	60 288	57 870	170 223[7]	202 320	21 910	51 030	40 576	288 450	521 263	11 501
As % of GDP	%	1996	15.1	25.3	63.5	34.9	39	29.2	32.4	18.8	22.1	12.9 (95)
Average annual increase over previous 5 years	%	1996	7.5	7.1	7.6	9.7	..	6.2	12.1	6.3	5.4	5.8
Imports of goods, cif*	Mill. US$	1996	61 374	67 376	160 917[7]	170 931	27 721	44 987	30 911	271 348	455 741	27 402
As % of GDP	%	1996	15.4	29.5	60	29.5	49.3	25.7	24.7	17.7	19.4	30.4 (95)
Average annual increase over previous 5 years	%	1996	9.7	5.9	5.9	7.7	..	5.6	7.3	3.9	3.3	6.6
Total official reserves[6]	Mill. SDRs	1996	10 107	15 901	11 789[7]	14 202	8 590	9 834	4 810	18 635	57 844	12 171
As ratio of average monthly imports of goods	Ratio	1996	2	2.8	0.9	1	..	2.6	1.9	0.8	1.5	5.3

* At current prices and exchange rates.
1. Unless otherwise stated.
2. According to the definitions used in OECD *Labour Force Statistics*.
3. PPPs = Purchasing Power Parities.
4. Gross saving = Gross national disposable income minus private and government consumption.
5. Current disbursements = Current expenditure on goods and services plus current transfers and payments of property income.
6. End of year.
7. Data refer to the Belgo-Luxembourg Economic Union.
8. Data refer to western Germany.
9. Including non-residential construction.
10. Refers to the public sector including public enterprises.

Sources: Population and Employment: OECD, *Labour Force Statistics.* GDP, GFCF and General Government: OECD, *National Accounts,* Vol. I and *OECD Economic Outlook,* Historical Statistics. Indicators of living standards: Miscellaneous national publications. Wages and Prices: OECD, *Main Economic Indicators.* Foreign trade: OECD, *Monthly Foreign Trade Statistics,* Series A. Total official reserves: IMF, *International Financial Statistics.*

BASIC STATISTICS: INTERNATIONAL COMPARISONS *(cont'd)*

	Units	Reference period[1]	Hungary	Iceland	Ireland	Italy	Japan	Korea	Luxembourg	Mexico	Netherlands	New Zealand
Population												
Total	Thousands	1996	10 193	270	3 621	57 473	125 864	45 545	418	96 582	15 494	3 640
Inhabitants per sq. km	Number	1996	77	3	52	191	333	458	161	48	380	14
Net average annual increase over previous 10 years	%	1996	–0.3	1.1	0.2	0	0.4	1	1.3	2	0.6	1.1
Employment												
Total civilian employment (TCE)[2]	Thousands	1996	3 605	142	1 307	20 036	64 860	20 764	212 (95)	32 385 (95)	6 983	1 688
of which: Agriculture	% of TCE	1996	8.4	9.2	10.7	7	5.5	11.6	2.8 (95)	23.5 (95)	3.9	9.5
Industry	% of TCE	1996	33	23.9	27.2	32.1	33.3	32.5	30.7 (90)	21.7 (95)	22.4	24.6
Services	% of TCE	1996	58.6	66.2	62.3	60.9	61.2	55.9	66.1 (90)	54.8 (95)	73.8	65.9
Gross domestic product (GDP)												
At current prices and current exchange rates	Bill. US$	1996	43.7 (95)	7.3	70.7	1 214.2	4 595.2	484.8	17	329.4	396	65.9
Per capita	US$	1996	4 273 (95)	27 076	19 525	21 127	36 509	10 644	40 791	3 411	25 511	18 093
At current prices using current PPPs[3]	Bill. US$	1996	..	6.3	68.8	1 148	2 924.5	618.5	13.5	751.1	324.5	63.6
Per capita	US$	1996	..	23 242	18 988	19 974	23 235	13 580	32 416	7 776	20 905	17 473
Average annual volume growth over previous 5 years	%	1996	–2.4 (95)	1.5	7.1	1	1.5	7.1	4.8	1.7	2.3	3.7
Gross fixed capital formation (GFCF)	% of GDP	1996	19.3 (95)	17.5	17.2	17	29.7	36.8	20.8	18	19.7	20.9
of which: Machinery and equipment	% of GDP	1996	..	6.7	5.5 (95)	8.8	10.1 (95)	13	..	8.8	9.4	10
Residential construction	% of GDP	1996	. .	3.9	4.9 (95)	4.5	5.3 (95)	7.6	..	4.7	5	5.6
Average annual volume growth over previous 5 years	%	1996	–0.9 (95)	–1.4	6	–1.4	1.3	6.9	0.2	–0.7	2.2	9.6
Gross saving ratio[4]	% of GDP	1996	..	15.6	21.7	20.5	31.4	34.2	37.5	22.7	25.7	16
General government												
Current expenditure on goods and services	% of GDP	1996	24.9 (95)	20.8	14.1	16.4	9.7	10.6	13.6	9.7[10]	14	14.4
Current disbursements[5]	% of GDP	1995	..	35.1	39.2 (94)	49.5	28.5	15.1	..	..	51.8	..
Current receipts	% of GDP	1995	..	36	39.3 (94)	44.5	32	25.1	..	..	50	..
Net official development assistance	% of GNP	1995	..	..	0.29	0.15	0.28	0.03	0.36	..	0.81	0.23
Indicators of living standards												
Private consumption per capita using current PPPs[3]	US$	1996	..	14 244	10 020	12 224	13 912	7 354	17 811	5 045	12 477	10 895
Passenger cars, per 1 000 inhabitants	Number	1994	212	434	264	517	342	115	544	91	383	457
Telephones, per 1 000 inhabitants	Number	1994	170	557	350	429	480	397	564	93	509	470
Television sets, per 1 000 inhabitants	Number	1993	427	335	301	429	618	215	261	150	491	
Doctors, per 1 000 inhabitants	Number	1995	3.4	3.9 (94)	3.4	3.0 (94)	1.7	1.6 (92)	1.8 (94)	1.1	2.2 (93)	1.6
Infant mortality per 1 000 live births	Number	1995	11	6.1	6.3	6.6 (94)	4.3	9	5.3 (94)	17 (94)	5.5	7.2 (94)
Wages and prices (average annual increase over previous 5 years)												
Wages (earnings or rates according to availability)	%	1996	..	..	3.7	3.5	1.8	..	..	–1.6	2.4	1.5
Consumer prices	%	1996	23.2	2.6	2.2	4.5	0.7	5.3	2.4	19.7	2.5	2
Foreign trade												
Exports of goods, fob*	Mill. US$	1996	15 674	1 891	48 416	250 842	411 067	129 715	..	96 000	203 953	14 316
As % of GDP	%	1996	35.9	26	68.5	20.7	8.9	26.8	..	29.1	51.5	21.7
Average annual increase over previous 5 years	%	1996	8.9	4	14.8	8.2	5.5	12.5	..	17.6	8.9	8.2
Imports of goods, cif*	Mill. US$	1996	18 105	2 032	35 763	206 904	349 149	150 340	..	89 469	184 389	14 682
As % of GDP	%	1996	41.4	27.9	50.6	17	7.6	31	..	27.2	46.6	22.3
Average annual increase over previous 5 years	%	1996	9.6	3.4	11.5	2.5	8	13.9	..	12.4	7.8	11.8
Total official reserves[6]	Mill. SDRs	1996	6 812	316	5 706	31 954	150 663	23 670	..	13 514	18 615	4 140
As ratio of average monthly imports of goods	Ratio	1996	..	1.9	1.9	1.9	5.2	..	..	1.8	1.2	3.4

* At current prices and exchange rates.
1. Unless otherwise stated.
2. According to the definitions used in OECD *Labour Force Statistics*.
3. PPPs = Purchasing Power Parities.
4. Gross saving = Gross national disposable income minus private and government consumption.
5. Current disbursements = Current expenditure on goods and services plus current transfers and payments of property income.
6. End of year.
7. Data refer to the Belgo-Luxembourg Economic Union.
8. Data refer to western Germany.
9. Including non-residential construction.
10. Refers to the public sector including public enterprises.

Sources: Population and Employment: OECD, *Labour Force Statistics.* GDP, GFCF and General Government: OECD, *National Accounts,* Vol. I and *OECD Economic Outlook,* Historical Statistics. Indicators of living standards: Miscellaneous national publications. Wages and Prices: OECD, *Main Economic Indicators.* Foreign trade: OECD, *Monthly Foreign Trade Statistics,* Series A. Total official reserves: IMF, *International Financial Statistics.*

BASIC STATISTICS: INTERNATIONAL COMPARISONS *(cont'd)*

	Units	Reference period[1]	Norway	Poland	Portugal	Spain	Sweden	Switzerland	Turkey	United Kingdom	United States
Population											
Total	Thousands	1996	4 370	38 618	9 935	39 270	8 901	7 085	62 695	58 782	265 557
Inhabitants per sq. km	Number	1996	13	123	108	78	20	172	80	240	28
Net average annual increase over previous 10 years	%	1996	0.5	0.3	–0.1	0.2	0.6	0.8	2	0.3	1
Employment											
Total civilian employment (TCE)[2]	Thousands	1996	2 110	14 977	4 475	12 394	3 963	3 803	20 895	26 088	126 708
of which: Agriculture	% of TCE	1996	5.2	22.1	12.2	8.7	2.9	4.5	44.9	2	2.8
Industry	% of TCE	1996	23.4 (95)	31.7	31.4	29.7	26.1	27.7	22	27.4	23.8
Services	% of TCE	1996	71.5 (95)	46.2	56.4	61.6	71	67.4	33.1	71	73.3
Gross domestic product (GDP)											
At current prices and current exchange rates	Bill. US$	1996	157.8	117.9 (95)	103.6	584.9	251.7	294.3	181.5	1 153.4	7 388.1
Per capita	US$	1996	36 020	3 057 (95)	10 425	14 894	28 283	41 411	2 894	19 621	27 821
At current prices using current PPPs[3]	Bill. US$	1996	106.7	..	130.1	587.2	171.4	180.6	383.3	1 095.5	7 388.1
Per capita	US$	1996	24 364	..	13 100	14 954	19 258	25 402	6 114	18 636	27 821
Average annual volume growth over previous 5 years	%	1996	4.1	2.2 (95)	1.5	1.3	1	0.1	4.4	2.2	2.8
Gross fixed capital formation (GFCF)	% of GDP	1996	20.5	17.1 (95)	24.1	20.1	14.8	20.2	25	15.5	17.6
of which: Machinery and equipment	% of GDP	1996	8.4	..	11.7 (93)	6.1 (95)	7.9	9.3	11.9	7.6	8.3 (95)
Residential construction	% of GDP	1996	2.6 (94)	..	5.2 (93)	4.3 (95)	1.9	11[9]	8.4 (95)	3	4.1 (95)
Average annual volume growth over previous 5 years	%	1996	2.8	5.4 (95)	2.2	–1	–2.6	–0.8	6.9	1.3	6.9
Gross saving ratio[4]	% of GDP	1996	29.9	..	21.6	20.7	16	27.1	22.3	14.6	16.6
General government											
Current expenditure on goods and services	% of GDP	1996	20.5	16.9 (95)	18.5	16.3	26.2	14.3	11.6	21.1	15.6
Current disbursements[5]	% of GDP	1995	45.8	..	42.5 (93)	41.2	63.8	47.7	..	42.3 (94)	34.3
Current receipts	% of GDP	1995	50.9	..	39.8 (93)	37.9	57.5	53.8	..	37.2 (94)	32.1
Net official development assistance	% of GNP	1995	0.87	..	0.27	0.24	0.77	0.34	0.07	0.28	0.1
Indicators of living standards											
Private consumption per capita using current PPPs[3]	US$	1996	11 593	..	8 522	9 339	10 096	15 632	4 130	11 865	18 908
Passenger cars, per 1 000 inhabitants	Number	1994	381	186	357	351	406 (93)	451	47	372	565
Telephones, per 1 000 inhabitants	Number	1994	554	131	350	371	683	597	201	489	602
Television sets, per 1 000 inhabitants	Number	1993	427	298	190	400	470	400	176	435	816
Doctors, per 1 000 inhabitants	Number	1995	2.8	2.3	3	4.1 (93)	3.1	3.1 (94)	1.2	1.6 (94)	2.6 (94)
Infant mortality per 1 000 live births	Number	1995	4	13.6	7.4	6 (94)	4	5	46.8 (94)	6.2 (94)	8 (94)
Wages and prices (average annual increase over previous 5 years)											
Wages (earnings or rates according to availability)	%	1996	3.2	..	..	5.8	4.8	..	..	4.9	2.7
Consumer prices	%	1996	1.9	..	5.6	4.7	2.7	2.2	81.6	2.7	2.9
Foreign trade											
Exports of goods, fob*	Mill. US$	1996	49 576	24 417	24 614	102 067	84 836	79 581	23 301	259 941	625 075
As % of GDP	%	1996	31.4	20.7	23.8	17.5	33.7	27	12.8	22.5	8.5
Average annual increase over previous 5 years	%	1996	7.8	..	8.6	11.2	9	5.3	11.1	7	8.2
Imports of goods, cif*	Mill. US$	1996	35 575	37 185	35 192	121 838	66 825	78 052	43 094	287 033	795 289
As % of GDP	%	1996	22.5	31.5	34	20.8	26.5	26.5	23.7	24.9	10.8
Average annual increase over previous 5 years	%	1996	6.9	..	6.1	5.5	6	3.2	15.1	6.5	10.3
Total official reserves[6]	Mill. SDRs	1996	18 441	12 409	11 070	40 284	13 288	26 727	11 430	27 745	44 536
As ratio of average monthly imports of goods	Ratio	1996	6.2	..	3.8	4	2.4	4.1	3.2	1.2	0.7

* At current prices and exchange rates.
1. Unless otherwise stated.
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5. Current disbursements = Current expenditure on goods and services plus current transfers and payments of property income.
6. End of year.
7. Data refer to the Belgo-Luxembourg Economic Union.
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