# INFLATION AND MONETARY POLICY IN PORTUGAL BEFORE THE EURO

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## 1. INTRODUCTION

This article reviews inflation developments in Portugal in the 25-year period from the collapse of the Bretton Woods system to the adoption of the euro[(1)]. The emphasis is placed on the interaction between the behaviour of prices and the evolution of the monetary policy strategy, reflecting the monetary origins of inflation from a medium to long-run perspective. Against this background, section 2 provides an overview of inflation behaviour in the post-Bretton Woods era, and section 3 describes the evolution of monetary and exchange rate policy strategy over the same period. Section 4 concludes. A set of chronologies completes the present review: Table I provides relevant information on the computation of inflation statistics; Table II covers relevant changes in taxation; and Table III sets out the changes to the monetary and exchange rate policy objectives and to the *Statutes of the Banco de Portugal*.

## 2. OVERVIEW OF INFLATION DEVELOPMENTS IN THE POST BRETTON WOODS ERA

The Portuguese inflation experience since the fall of the Bretton Woods system can be divided into two major sub-periods: a period of very high and volatile inflation up to the mid-1980s, followed by a period of disinflation from the mid-1980s to the late-1990s[(2)] (Table 1 and Chart 1).

In the 1970s, the Portuguese economy had to cope with a series of severe negative shocks. The domestic political and social turmoil that followed the April 1974 revolution magnified the impact of the first oil shock. Substantial wage increases were enacted, and a large part of the productive sector was nationalised in 1975 (in particular the whole financial sector became state-run). In addition, the country had to absorb a significant increase in its population (about 7 per cent in 1974-76), as Portuguese citizens returned from the ex-colonies in Africa. As a result, a big recession occurred – GDP declined 4.5 per cent in 1975 (Chart 2) –, and unemployment increased substantially. Inflation, which had shown a slight upward trend since the early 1960s, rose sharply, to about 30 per cent in 1974.

In spite of a relative normalization of the political situation in the late 1970s, significant macroeconomic instability prevailed until the mid-1980s, reflecting the combined impact of the two world oil price shocks and the unsound macro policies pursued for most of the period. Substantial public sector deficits, essentially financed by the central bank, fuelled inflation; the resulting loss of competitiveness forced devaluation of the nominal exchange rate, which in turn added to price pressures: the country was caught in a vicious circle of inflation and devaluation. In the period 1973-1985,

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(1) The article was written as a contribution to a joint project within the Eurosystem Inflation Persistence Network.

(2) For an account of the Portuguese disinflation experience, see Abreu (2001).

Table 1

**PORTUGAL – INFLATION DEVELOPMENTS 1973-1998**

| | Average | Volatility |
|---|---|---|
| 1973-1998 . . . . . . . . . | 14.8 | 3.5 |
| 1973-1985 . . . . . . . . . | 21.8 | 4.7 |
| 1986-1998 . . . . . . . . . | 7.7 | 1.7 |

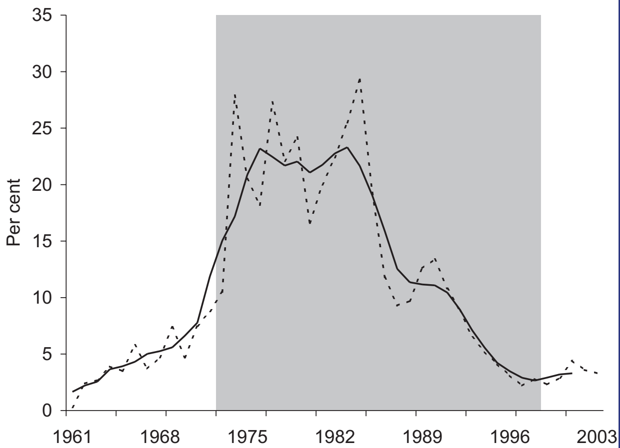
Notes:

(a) Inflation measured by the annual percentage change of the CPI;

(b) Volatility corresponds to the standard deviation of the differences between actual and trend inflation (measured as a five-year centred-moving average).

Chart 1

**PORTUGAL – CPI INFLATION[(a)]**



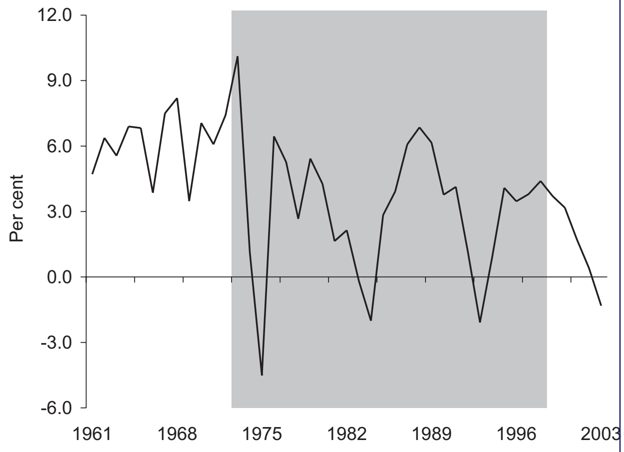

Source:
Banco de Portugal and INE.
Note:
(a) Average CPI inflation. Trend computed as 5-year moving average.

CPI inflation averaged 22 per cent, and fluctuated between 17 and 29 per cent.

When Portugal joined the European Community (EC) in January 1986, it had the second highest inflation rate amongst EC Member-States (only surpassed by Greece), and the differential against the EC average stood at about 14 percentage points. At this time, disinflation became a major goal of economic policy. To ensure a sustained decline of inflation, exchange rate policy became progressively less accommodating, so as to break the vicious circle of inflation and devaluation (see section 3). In addition, economic agents were encouraged to set nominal wages on the basis of expected (rather than past) price increases. Inflation, which was close to 30 per cent in 1984, declined to levels broadly compatible with price stability by the end of the 1990s.

Chart 2

**PORTUGAL - REAL GDP GROWTH**

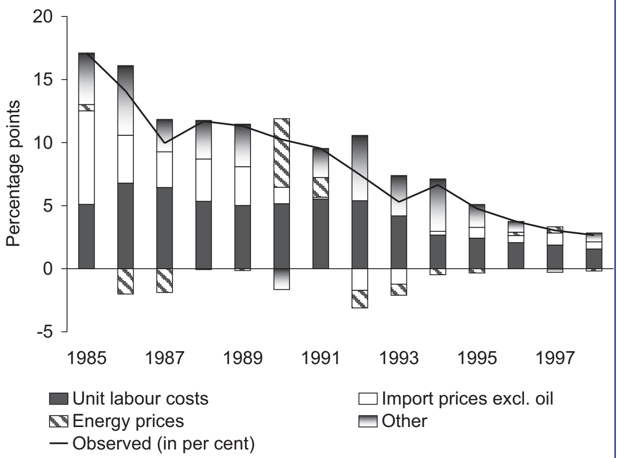



Source:
European Commission AMECO Database.

Chart 3 shows the contributions to the change in the private consumption deflator during the disinflation period[(3)]. In the early years, disinflation benefited from favourable international price developments (including oil prices) and significant productivity gains, both of which contributed to the steep deceleration of prices in a context of strong GDP growth. In the late 1980s and early 1990s, as the Portuguese economy began to overheat and international price developments turned less favourable, the inflation rate temporarily resumed an upward trend and the pursuit of disinflation had to rely on a less accommodative stance of exchange rate policy. In the mid-1990s, the deceleration of unit labour costs following the 1993 recession also gave an important contribution to the decline of inflation.

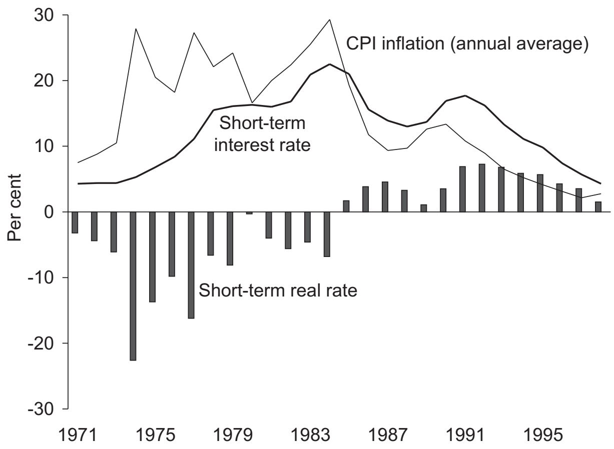
(3) The figures were obtained from the relevant equations of an annual macroeconomic model currently used in the projection exercises carried out by the Banco de Portugal.

Chart 3
**CONTRIBUTIONS TO THE CHANGE IN THE PRIVATE CONSUMPTION DEFLATOR**




Source:
Banco de Portugal *Long Term Series for Portuguese Economy* and *INE*.

Chart 4
**PORTUGAL - SHORT-TERM REAL INTEREST RATE**




Source:
European Commission AMECO Database and *INE*.

## 3. MONETARY AND EXCHANGE RATE POLICY FROM THE COLLAPSE OF THE BRETTON WOODS SYSTEM TO EMU

The collapse of the Bretton Woods system, the first oil shock and the 1974 Revolution brought profound changes to the conduct of macroeconomic policies in Portugal. In 1974-75, the priority of economic policy was to cope with the recession and the increase in unemployment. The money supply was adjusted to finance a widening public sector deficit, and a selective rediscount policy was put in place to promote activities linked to agriculture, exports and investment. Interest rates, which were subject to limits set by the central bank, were increased only slightly, resulting in significantly negative real rates (Chart 4)(4).

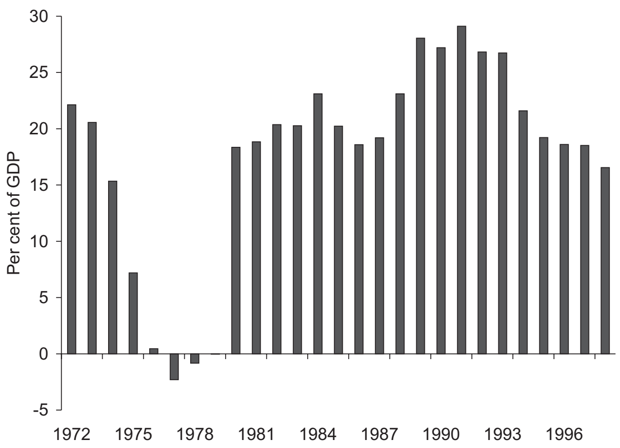
Although the escudo had been formally floating since March 1973, the effective exchange rate was kept broadly stable in 1974-75 so as to contain the inflationary pressures resulting from the increase in oil prices and steep wage acceleration(5). However, as from 1976, the rapid decline of foreign exchange reserves (Chart 5) and the need to restore the competitiveness lost in the previous years led to a policy of gradual devaluation of the escudo. In 1977, severe balance of payments difficulties imposed a shift of priorities in economic policy. On 25 February 1977, the escudo suffered a 15 per cent devaluation, and six months later a crawling-peg regime was established (Chart 6). The crawling-peg consisted of a pre-announced monthly depreciation rate of the escudo vis-à-vis a basket of 13 currencies. The monthly rate of depreciation was initially set at 1 per cent. In 1978, a stabilisation programme had to be negotiated with the IMF. The package provided for a discrete devaluation of the escudo (6.1 per cent on 5 May), an increase of the pre-announced monthly rate of depreciation to 1.25 per cent, and the introduction of quantitative limits for bank credit, as a way of controlling the money supply. The package set a limit

(4) Following the 1974 Revolution, the Banco de Portugal was nationalised. The new *Statutes of the Bank*, approved in November 1975 (Decree-Law No.664/75 of 15 November), provided that the issue of money should be planned in order to coordinate "the management of foreign exchange reserves and the credit to be granted by the Bank with the economy's needs for stabilisation and development" (Article 13). This provision put an end to the close link between the monetary base and the level of foreign exchange reserves that had prevailed under the Bretton Woods system. The Statutes also provided for the possibility of extensive credit to be granted by the Bank to the public sector (Article 23 and 25). Finally, the Statutes conferred upon the Bank the power to determine the interest rate regime applying to the banking sector, as well as to set the conditions governing the banks' credit operations (Article 27).

(5) Extensive capital controls made it possible for the authorities to simultaneously control domestic interest rates and the exchange rate.

Chart 5

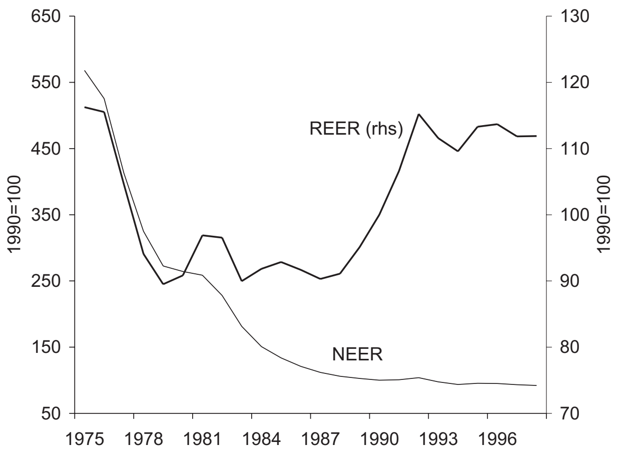
**BANCO DE PORTUGAL NET FOREIGN ASSETS**




Source:
Banco de Portugal and European Commission AMECO Database.
Note:
The gold reserves of Banco de Portugal were revalued in 1980 so as to bring their book value close to the market value of gold (Decree-Law N.107/80 of 10 May 1980). The change in gold reserves amounted to 16.6 per cent of GDP, explaining 90 per cent of the increase in net foreign assets in 1980.

Chart 6

**NOMINAL AND REAL EFFECTIVE EXCHANGE RATE**




Source:
Banco de Portugal.

for the balance of payments deficit (i.e. for the change in the consolidated banking sector net external assets) and a corresponding target for the expansion of total domestic credit. In practice, given the behaviour of the general government deficit, credit to the private sector was adjusted to ensure compliance with the limit set for the growth of total credit.

In the early 1980s, as the world economy was hit by the second oil shock, an expansionary macroeconomic policy was put in place in Portugal. On 12 February 1980, the escudo was revalued by 6 per cent, and in June of the same year the crawling-peg monthly devaluation rate was reduced to 0.5 per cent. At the same time, credit controls were eased and no fiscal consolidation took place. The expansionary policy stance, which was clearly motivated by the political calendar (general elections were to be held in October), aggravated the impact of the second oil shock and external accounts again went out of control. As the current account deficit (including capital transfers) reached 13 per cent of GDP in 1982, a second stabilisation package had to be negotiated with the IMF. Credit controls were tightened and the depreciation of the escudo was intensified. Like the previous package, the second IMF programme was quite successful in restoring balance of payments equilibrium. This came however, at the cost of a new recession (after stagnating in 1983, GDP fell by 2 per cent in 1984), and a renewed increase of inflation, which again came close to 30 per cent.

In short, monetary policy in Portugal in the mid-1980s was still based on credit ceilings and administered interest rates. Extensive capital controls were in place, and the exchange rate followed a crawling peg regime aimed at preserving the competitiveness of Portuguese exporters in a context of high inflation, chronic budget deficits and recurrent payments crises. The poor economic performance of the previous period made it clear that a regime shift on macroeconomic stability and structural reform would be needed to put the economy on a sustainable growth path. Accordingly, in the mid-1980s, an ambitious economic programme aimed at sustained disinflation, budgetary consolidation and wide-ranging structural reform was put in place(6). The country's integration in the European Community in 1986 provided the catalyst for implementation of the reform programme. The exchange rate was chosen as the central piece in the disinflation strategy, a natural

(6) See the 10th Constitutional Government Programme, dated November 1985 (*Diário da Assembleia da República*, II *série*, N.4, 16/11/1985).

choice for a small open economy, where import prices play a key role in the inflation process. The monthly rate of depreciation was gradually cut back from 1986, and no more discrete devaluations were carried out. As seen previously, inflation declined very rapidly up to 1987, but resumed an upward trend in 1988-90. Since the monthly rate of devaluation of the escudo continued to be cut back, the inflation differential against Portugal's main trading partners was no longer fully offset, and the escudo started appreciating in real terms (Chart 6).

In the late 1980s, in the context of the gradual liberalisation of the capital account, the monetary authorities experienced significant difficulties in controlling domestic liquidity. The decline in the country's risk premium after EC accession attracted significant amounts of foreign direct investment to Portugal. In addition, a large interest rate differential vis-à-vis the core European currencies, coupled with a tightly managed (and thus highly predictable) exchange rate in the context of the crawling-peg regime, fostered massive inflows of short-term capital. The central bank was caught in a vicious circle, as it tried to simultaneously control domestic interest rates and the exchange rate. Foreign exchange interventions to contain the pressure towards the appreciation of the escudo increased domestic liquidity, impairing the effectiveness of credit ceilings.

The interruption of the disinflation process in the late 1980s and the difficulties in controlling domestic liquidity prompted radical changes in the conduct of monetary and exchange rate policies in the early 1990s. New Banco de Portugal Statutes were adopted in October 1990, imposing strict limits to the financing of the public sector by the central bank. Credit ceilings were abolished and market-based liquidity management was put in place (most interest rate controls had already been eliminated during the second half of the 1980s). In addition, controls to short-term capital inflows were temporarily re-imposed and the crawling-peg regime had to be abandoned. As from October 1990, the escudo was allowed to fluctuate within an undisclosed band against a basket composed of the five main ERM currencies. The authorities wished to introduce some short-term unpredictability in the exchange rate of the escudo, so as to discourage short-term capital inflows. The new exchange rate policy was also aimed at preparing the country for future participation in the ERM.

The new regime failed to discourage capital inflows since, as before, the Banco de Portugal continued to impose high domestic interest rates to fight inflation, while at the same time intervening in the foreign exchange market to contain the pressure towards the appreciation of the escudo. In an environment characterised by strong optimism regarding the prospects for the creation of a monetary union in Europe, and by favourable prospects for the Portuguese economy, investors saw the Portuguese currency as a "one-way bet". In spite of the massive sales of escudos by the Banco de Portugal - the central bank's net foreign assets stood at around 30 per cent of GDP in 1989-1991 (Chart 5) - the nominal effective exchange rate appreciated by almost 3 per cent in the 18 months that followed the abolition of the crawling-peg. Given that the inflation differential against the EU average was still significant, this translated into a substantial real appreciation of the currency. The conduct of monetary policy in this period was further complicated by the expansionary stance of fiscal policy[7], which added to the strong growth of private sector expenditure, giving rise to an increasingly unbalanced policy-mix. In spite of the difficulties in running monetary policy, inflation resumed a downward path in 1991, as high domestic real interest rates and the appreciation of the currency helped contain price pressures (Charts 4 and 6).

In April 1992, the Portuguese currency joined the exchange rate mechanism (ERM) of the European Monetary System[8]. From an operational point of view, participation in the ERM was not radically different from the exchange rate policy that was actually being followed from October 1990. However, the formal commitment to keeping the escudo within a pre-established band was expected to reinforce the medium-term credibility of the Portuguese authorities' anti-inflation stance, and to have a favourable impact on inflation expectations. Exchange rate stability vis-à-vis a set of currencies characterised by a high degree of nomi-

(7) For an account of fiscal policy in the period 1986-1994, see Cunha and Neves (1995).

(8) Abreu (2003) provides a detailed account of the experience of the Portuguese escudo in the ERM.

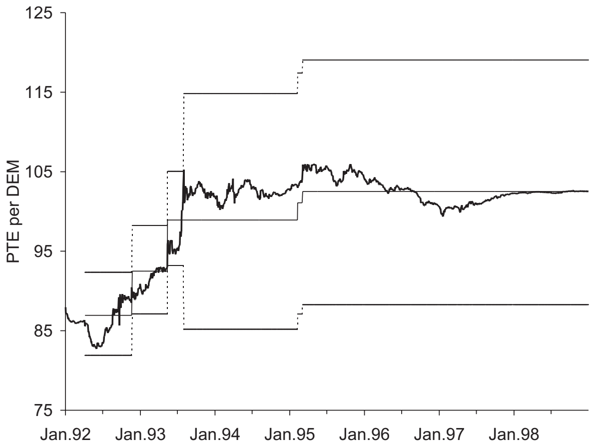
nal stability should provide a powerful anchor to reach and maintain price stability over the medium-run. ERM membership was also a necessary step to ensure that the country would be a candidate for participation in Economic and Monetary Union (EMU).

The escudo joined what was then called the wide band, which allowed for a ±6 per cent fluctuation of the market rate around the bilateral central rates against the other ERM currencies. The central rate against the German currency, which was effectively the anchor of the system, was set at 86.9393 escudos per German mark. The entry rate was broadly in line with available estimates for the escudo's equilibrium real exchange rate. The strong performance of the external sector since the mid-1980s, as evidenced by the market share gains of Portuguese exporters and a broadly balanced current account, suggested that the steep real appreciation of the currency in the previous years had been, at least to a large extent, an equilibrium phenomenon[(9)].

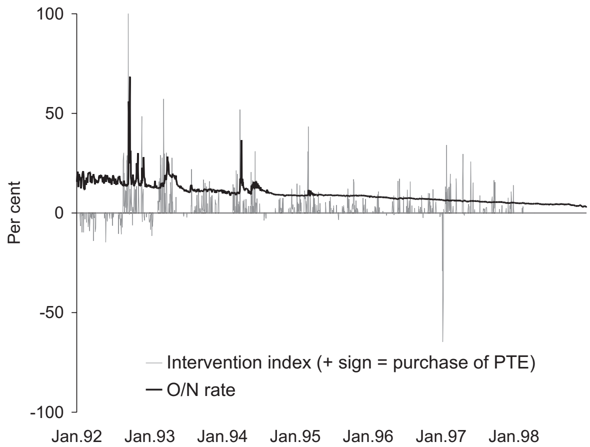
In the early months of participation in the system, foreign capital continued to be attracted by the high interest rate differentials, putting upward pressure on the escudo. However, the situation changed radically in the summer of 1992, with the onset of the ERM crisis, which ultimately led to a widening of the fluctuation bands to ±15 per cent in August 1993. During the ERM crisis, the central rate of the escudo was devalued twice, and the Portuguese currency depreciated by about 10 per cent in effective terms, and by twice as much against the German mark. The ERM crisis and the related depreciation the Portuguese escudo did not prevent a steady decline of the inflation rate in the period of ERM membership. Consistent with the announced strategy, the authorities did not make use of the enlarged room for manoeuvre provided by the wider ERM bands: official interest rates were adjusted and substantial interventions were carried out whenever necessary to preserve exchange rate stability. The period from the enlargement of the ERM bands to the end of 1998 was thus one of increasing stability of the escudo, as attested by the fact that, in spite of a third realignment in March 1995, the escudo's conversion rate into the euro was very close to the market exchange rate vis-à-vis the German mark prevailing in August 1993 (Chart 7).

As shown in section 2 above, average CPI inflation declined from double-digit levels in the early 1990s to a range of 2-3 per cent in 1997-98. The transmission of the exchange rate depreciation of 1992-93 to CPI inflation was rather limited, and did not show up in the overall index. The signifi-

Chart 7
**THE PORTUGUESE ESCUDO IN THE ERM**
(A) Exchange rate and intervention limits




(B) Foreign exchange interventions and PTE overnight interest rate




Source:
Banco de Portugal

(9) Manteu and Mello (1992) provide an estimate for the path of the fundamental real equilibrium exchange rate of the Portuguese escudo in the period 1980-1992. Later studies reported similar results (see, for instance, Costa (1998)). For a survey of the arguments pointing to an equilibrium appreciation of the Portuguese escudo, see Manteu and Neves (1998).

cant deterioration of the cyclical position in 1992-1993, and the fact that the realignments of the Portuguese escudo were not perceived as a regime shift(10) helped contain the transmission of the depreciation to domestic prices. When the Portuguese economy re-bounded from 1994 onwards, the successful preservation of exchange rate stability since the enlargement of the bands anchored inflation expectations and allowed for continued disinflation. From the mid-1990s onwards, the country benefited from a virtuous circle: improved nominal convergence increased the prospects of meeting the criteria for euro adoption, while at the same time enhanced prospects for EMU participation facilitated exchange rate stability, the decline of interest rate differentials and the improvement of the budget balance.

## 4. CONCLUSION

The history of Portuguese inflation from the collapse of the Bretton Woods system to the adoption of the euro contains two very distinct chapters.

From the mid-1970s to the mid-1980s, inflation was high and volatile, reflecting a monetary and exchange rate policy that was primarily designed to finance huge public sector deficits and to contain the large external deficits that emerged as a result of the economy's overall economic imbalances. The significantly negative real interest rates and the continuous depreciation of the Portuguese escudo illustrate the highly accommodative stance of monetary and exchange rate policy throughout the decade.

In the mid-1980s, coinciding with the country's accession to the European Community, control of inflation became the main objective of monetary and exchange rate policy. As policy became progressively less accommodating, the escudo started appreciating in real terms and real interest rates turned clearly positive. In 1990, the crawling-peg regime gave way to a new monetary policy strategy, based on exchange rate stability as the intermediate target to reach the final goal of price stability. The subsequent integration of the escudo in the exchange rate mechanism of the European Monetary System was a further step in the authorities' attempt to gain anti-inflation credibility. The commitment to the policy of exchange rate stability anchored inflation expectations, and helped prevent a re-emergence of inflation pressures after the depreciation of the escudo in the context of the ERM crisis, and during the economy's upswing in the second half of the 1990s.

(10) This probably reflects the fact that the escudo realignments took place in a context of systemic adjustments, and were likely regarded as unavoidable in the context of the devaluations of the central rate of the Spanish peseta.

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Table I

## RELEVANT CHANGES TO THE COMPUTATION OF INFLATION STATISTICS

Table 1A – Relevant changes on the computation of the country´s reference for inflation

| Date | Country's reference for inflation | Computation | Reference prices | Period | Weighting structure | Geographic coverage | Number of prices collected | Methodological notes |
|---|---|---|---|---|---|---|---|---|
| 1961 | Monthly CPI, excluding housing rentals | Laspeyres index | 1963=100 | 1961 - 1977 | Surveys on "Household Living Conditions" carried out in six cities | Six cities of the mainland: Lisboa, Porto, Coimbra, Évora, Viseu and Faro | n. a | Weighted average index, based on population coefficients. |
| 1977 | Monthly CPI, excluding housing rentals | Laspeyres index | 1976=100 | 1976 - 1987 | Households Budget Survey 1973/74 | Mainland´s urban agglomerates | 18000 | |
| 1988 | Monthly CPI, excluding housing rentals | Laspeyres index | 1983=100 | 1988 - 1991 | Households Budget Survey 1980/81 | Mainland | 30000 | Inclusion of actual and imputed rentals for housing, only in the average yearly index. |
| 1992 | Monthly CPI, excluding housing rentals | Laspeyres index | 1991=100 | 1991 - 1997 | Households Budget Survey 1989/90 | National | 63000 | |
| 1998 | Monthly CPI, including actual rentals for housing | Laspeyres index | 1997=100 | 1997 - 2002 | Households Budget Survey 1994/95 | National | 80000 | 1) Change in the frequency of the price collection for actual rentals for housing from a yearly to a monthly basis; 2) Inclusion of price reductions (sales and promotions) in the index. |
| 2003 | Monthly CPI, including actual rentals for housing | Chain Laspeyres index | 2002=100 | >2002 | Households Budget Survey 2000 | National | 93149 | 1) Adoption of an annual chain index, with the base month December acting as the linking month; 2) Change in the treatment of seasonal products. |

Table I

**RELEVANT CHANGES TO THE COMPUTATION OF INFLATION STATISTICS**

Table 1B – Relevant changes on the computation of the price index for international comparison

| Date | Price index for international comparison | Computation | Reference prices | Period | Weighting structure | Geographic coverage | Number of prices collected | Methodological notes |
|---|---|---|---|---|---|---|---|---|
| Jan-96 | Monthly Interim Index | Chain Laspeyres index | 1994=100 | 1990 - 1996 | Structure of the $CPI_{b83}$ and of the $CPI_{b91}$ | 88 per cent of the national CPI basket | | Main items not covered: housing rentals, health, education, social protection, insurance and financial services. |
| Mar-97 | Monthly Harmonised Index of Consumer Prices (HICP) | Chain Laspeyres index | 1996=100 | 1995 - 1999 | Structure of the $CPI_{b91}$ and of the $CPI_{b97}$ | 92 per cent of the national CPI basket | | Addition of the subindices of health and education (only non-refundable goods and services subject to market prices), insurance and financial services. |
| Jan-00 | Monthly Harmonised Index of Consumer Prices (HICP) | Chain Laspeyres index | 1996=100 | >2000 | Structure of the $CPI_{b97}$ and of the $CPI_{b02,}$ using a weighting scheme that includes the expenditure of non-residents (estimated with information from the National Accounts and the Expenditure of Non-residents in the Domestic Territory Survey). | At present, the HICP reached the total coverage for the defined scope: "Household Final Monetary Consumption Expenditure" in the economic territory. | | With the extensions introduced in 2002 (i.e., inclusion in the index of the goods and services of the expenditure groups "health" and "education" and of nonresidents´purchases (tourists)) the HICP covers the entire final domestic consumption expenditure. |

Table II

**RELEVANT CHANGES IN INDIRECT TAXATION**

| Date | Value-Added Tax | Estimated impact on annual average CPI inflation rate |
|---|---|---|
| 1986 | Introduction of the Value-Added Tax (VAT): zero rate: 0 per cent (unprocessed food and agricultural inputs); reduced rate: 8 per cent(processed food and some goods and services); 30 per cent(luxury goods); standard rate: 16 per cent(remaining goods and services). Transaction tax eliminated. | |
| 1988 | Standard rate increased to 17 per cent. VAT base broadened slightly. | Effect on CPI of the change of the standard VAT rate: about 0.5-0.75 p.p. |
| 1992 | Zero rate and reduced rate of 8 per cent were abolished; new reduced rate: 5 per cent; rate of 30 per cent unchanged; Standard rate decreased to 16 per cent. Considerable broadening of the VAT tax base. | Effect on CPI of the change of the VAT rates: about 2.0 p.p. |
| 1995 | Standard rate increased to 17 per cent. Elimination of the 30 per cent rate. | |
| 1996 | Reduction in the tax rate on restaurant services and some foodstuffs from 17 to 12 per cent and rise in the VAT tax rate on diesel from 5 to 12 per cent. | |
| 1997 | Increase in the VAT rate on diesel from 12 to the standard rate. | |
| 2001 | | |
| 2002 | Standard rate increased to 19 per cent in June 2002. | Effect on CPI the change in the VAT standard rate in June 2002: about 0.2 p.p. |
| 2003 | | Effect on CPI of the change in the VAT standard rate in June 2002: about 0.4 p.p. |

Table III *(to be continued)*

## CHANGES TO THE MONETARY AND EXCHANGE RATE POLICY OBJECTIVES AND TO THE STATUTES OF THE BANCO DE PORTUGAL

| Date | Event |
|---|---|
| 19 March 1973 | Collapse of the Bretton Woods system; Portuguese escudo (PTE) floats. |
| 25 April 1974 | Revolution puts an end to a 48-year dictatorship. |
| 13 September 1974 | Banco de Portugal is nationalised (Decree-Law N.452/74 of 13 September). |
| Mid-1973 to mid 1975 | PTE officially floating, but stability of effective exchange rate is preserved. |
| March 1975 | Commercial Banks and insurance companies nationalised, except those that were foreign-owned (Decree-Law N. 132-A/75 of 14 March). |
| 15 November 1975 | New *Statutes of the Banco de Portugal* (Decree-Law N.644/75 of 15 November). According to Article 13, the Bank's issue of money is to be planned so as to coordinate "the management of foreign exchange reserves and the credit to be granted by the Bank with the economy's needs for stabilisation and development". Articles 23 and 25 provide for the possibility of extensive credit to be granted by the Bank to public sector. Article 27 confers upon the Bank the power to determine the interest rate regime applying to the banking sector, as well as to set the conditions governing the banks' credit operations. |
| 1976 | Correction of external imbalance becomes the priority of economic policy; exchange rate becomes the key instrument to correct the external imbalance; depreciating trend of the PTE against the major currencies. |
| 25 February 1977 | PTE is devalued by 15 per cent vis-à-vis the currencies quoted by the Banco de Portugal. The aim of keeping the PTE stable in effective terms as from this date is announced. |
| 25 August 1977 | A crawling-peg regime is adopted. The crawling-peg consisted of a pre-announced monthly depreciation rate of the escudo vis-à-vis a basket of 13 currencies. The monthly rate of depreciation was initially set at 1 per cent. |
| August 1977 | Portuguese inter-bank money market is set up (D-L N.353-R/77 of 29 August and Banco de Portugal Circular N.72-21/77/DSOC of 31 August). |
| February 1978 | Portuguese Inter-bank securities market is set-up (Circular N.30-6/78/DSOC de 22/02/1978). |
| April 1978 | First IMF Stabilisation Agreement. |
| 5 May 1978 | 6.1 per cent discrete devaluation of the effective exchange rate; pre-announced monthly rate of depreciation increased to 1.25 per cent. |

Table III *(contd.)*

**CHANGES TO THE MONETARY AND EXCHANGE RATE POLICY OBJECTIVES AND TO THE STATUTES OF THE BANCO DE PORTUGAL**

| Date | Event |
|---|---|
| July 1978. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Mandatory limits to credit growth are introduced. |
| April 1979 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Pre-announced rate of devaluation reduced to 1.0 per cent. |
| June 1979 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Pre-announced rate of devaluation reduced to 0.75 per cent. |
| 12 February 1980. . . . . . . . . . . . . . . . . . . . . . . . . | Discrete 6.0 per cent revaluation of the effective exchange rate. |
| June 1980 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Pre-announced rate of devaluation reduced to 0.50 per cent. |
| December 1981 . . . . . . . . . . . . . . . . . . . . . . . . . . | Pre-announced rate of devaluation increased to 0.75 per cent. |
| 16 June 1982. . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Discrete 9.4 per cent devaluation of the effective exchange rate. |
| 30 September 1982 . . . . . . . . . . . . . . . . . . . . . . . . | First revision of the 1976 Constitution. Private banking and insurance allowed. |
| March 1983 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Pre-announced rate of devaluation increased to 1.0 per cent. |
| 23 March 1983 . . . . . . . . . . . . . . . . . . . . . . . . . . . | Discrete 2.0 per cent devaluation of the effective exchange rate. |
| 22 June 1983. . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Discrete 12.0 per cent devaluation of the effective exchange rate. |
| September 1983. . . . . . . . . . . . . . . . . . . . . . . . . . | Second IMF stabilisation agreement. |
| 1984-1992 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Progressive liberalisation of bank interest rates. |
| December 1985 . . . . . . . . . . . . . . . . . . . . . . . . . . | Pre-announced rate of devaluation suspended. |
| 1 January 1986. . . . . . . . . . . . . . . . . . . . . . . . . . . | Portugal joins the European Economic Community. |
| March 1986-December 1992 . . . . . . . . . . . . . . . . | Liberalisation of capital movements[a]. |
| April 1986 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Pre-announced rate of devaluation re-established at 0.90 per cent. |
| July 1986. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Pre-announced rate of devaluation reduced to 0.70 per cent. |
| October 1986 . . . . . . . . . . . . . . . . . . . . . . . . . . . . | Pre-announced rate of devaluation reduced to 0.60 per cent. |

Table III *(contd.)*

## CHANGES TO THE MONETARY AND EXCHANGE RATE POLICY OBJECTIVES AND TO THE STATUTES OF THE BANCO DE PORTUGAL

| Date | Event |
|---|---|
| January 1987 | Pre-announced rate of devaluation reduced to 0.50 per cent. |
| January 1988 | Pre-announced rate of devaluation reduced to 0.40 per cent. |
| April 1988 | Pre-announced rate of devaluation reduced to 0.30 per cent. |
| July 1988 | Pre-announced rate of devaluation reduced to 0.25 per cent. |
| 8 July 1989 | Second revision of the 1976 Constitution opens up the possibility of re-privatisation of nationalised companies. |
| March 1990 | Compulsory credit ceilings suspended and replaced by recommendations on bank credit expansion (the latter were abolished as from January 1991). |
| May 1990 | Reserve requirement regime substantially modified. Range of institutions subject to reserve requirements and reserve base broadened. Single reserve coefficient set at 17 per cent. Reserves were remunerated. |
| 1 October 1990 | Crawling-peg regime abandoned. The authorities announce that the objective of a yearly depreciation of the effective exchange rate of 3 per cent will be kept, but that in the short-term the escudo will be allowed to fluctuate within a non-announced band. The reference basket against which the escudo is to be measured changed to a basket composed of the 5 main ERM currencies (i.e., the German mark, Sterling, the French franc, the Italian lira and the Spanish peseta). |
| 30 October 1990 | New *Statutes of the Banco de Portugal* (Decree-Law 337/90 of 30 October) confer upon the Bank a greater autonomy in the conduct of monetary policy. The principle of no monetary financing is established, but some exceptions remain: in particular, the State retains the possibility of using an interest-free overdraft facility whose limit was fixed as a percentage of the State's current revenue. |
| December 1990 - March 1991 | Major operation aimed at absorbing the excess bank liquidity deposited with the Banco de Portugal, which amounted to more than 12 per cent of GDP. The operation involved the issue of public debt to be placed with the banking system. Part of this loan was earmarked for early repayment of external public debt, whilst the remainder was reserved for the redemption of public debt securities lying in the Banco de Portugal's portfolio. |
| 1990-1991 | Restrictions to the inflow of foreign capital re-introduced in a context of increasing difficulties to control domestic liquidity. In July 1990, a compulsory non-remunerated deposit amounting to 40 per cent of foreign borrowing by Portuguese residents was introduced. One year later, restrictions were re-imposed on the purchase of floating-rate Portuguese securities by non-residents. |

Table III *(contd.)*

**CHANGES TO THE MONETARY AND EXCHANGE RATE POLICY OBJECTIVES AND TO THE STATUTES OF THE BANCO DE PORTUGAL**

| Date | Event |
|---|---|
| 6 April 1992 .............................. | PTE joins the ERM wide bands (±6 per cent); central rate against the ECU set at 178.735 escudos per ECU and central rate against the DEM set at 86.9393 escudos per DEM. |
| May 1992 ................................ | Remaining interest rate controls abolished (the most important rates had been liberalised up to 1989). |
| 16 September............................. | A number of ERM currencies suffer a major speculative attack. The central rate of the Spanish peseta is devalued by 5 per cent; the British pound and the Italian lira withdraw from the system. Banco de Portugal resorts to massive intervention and interest rate increases and succeeds in defending the attack against the escudo. |
| 23 November 1992 ........................ | 6 per cent devaluation f the PTE central rate (Spanish peseta also devalued by 6 per cent). |
| 16 December 1992.......................... | Remaining capital controls abolished. PTE fully convertible. |
| December 1992 ........................... | The State is interest-free overdraft facility with the Banco de Portugal is abolished (Law No.2/92). The amount outstanding is converted into a non-marketable 10-year loan bearing a 1.3 per cent interest rate that would gradually converge to market rates. |
| 1 February ............................... | 10 per cent devaluation of the central rate of the Irish pound. |
| 13 May 1993............................. | 6.5 devaluation of the PTE central rate (8 per cent devaluation of the Spanish peseta). |
| 2 August 1993 ............................ | Enlargement of the ERM fluctuation bands to ±15 per cent. |
| 1 January 1994............................ | Second phase of EMU – prohibition of monetary financing applies to the European Union countries. |
| 12 July 1994 .............................. | Banco de Portugal money market intervention procedures improved. An absorption facility is created to set a lower limit to very short-term money market interest rates. An upper limit was already established by the rate applying to the Bank's overnight credit facility. Market rates to be steered through repos within the band established by the absorption and overnight credit rates. |
| 1 November 1994 ......................... | New reserve requirement system. Reserve requirement ratio lowered from 17 per cent (partially remunerated) to 2 per cent (non-remunerated). The liquidity released was sterilised through certificates of deposit issued by the Banco de Portugal. |

Table III *(contd.)*

## CHANGES TO THE MONETARY AND EXCHANGE RATE POLICY OBJECTIVES AND TO THE STATUTES OF THE BANCO DE PORTUGAL

| Date | Event |
|---|---|
| 6 March 1995 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | 3.5 per cent devaluation of the PTE central rate (7 per cent devaluation of the Spanish peseta). |
| 12 September 1995 . . . . . . . . . . . . . . . . . . . . . . . . | *Banco de Portugal Statutes* revised (Decree-Law N.231/95 of 12 September). The Bank becomes responsible for maintaining "price stability, taking into account the overall economic policy of the government", and is given more independence in the conduct of monetary policy. The prohibition of monetary financing in accordance with Community law is formally established. |
| 31 January 1998. . . . . . . . . . . . . . . . . . . . . . . . . . . | *Banco de Portugal Statutes* revised (Law No.5/98 of 31 January 1998). The new Law grants independence to the Banco de Portugal and provides for the Bank's integration in the European System of Central Banks as from January 1999. |
| 2 May 1998. . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | European Council decides that Portugal meets the conditions to adopt the euro as from 1 January 1999. |
| 31 December 1998. . . . . . . . . . . . . . . . . . . . . . . . . | Portuguese escudo converted into euro at a rate of 200.482 PTE per euro (102.505 PTE per German mark). |

Note:

(a) For a chronology of the main steps in the process of capital movement liberalisation, see Banco de Portugal, *Annual Report* 1992 (Chapter V).