The Role of the Bank of Portugal as a Central Bank (1931-1999)

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Introduction

This paper tries to describe and assess the action of the Bank of Portugal as a central bank between 1931 and 1999. 1931 was chosen because it was the moment when the Bank of Portugal became, *de jure* and *de facto*, a central bank. 1999 was chosen because it was the moment when Portugal was integrated in the euro zone, and the Bank of Portugal was replaced as a monetary authority in the country by the European System of Central Banks (of which the Bank of Portugal is a member).

Section 1 describes briefly how the Bank of Portugal became a central bank. Sections 2 to 4 deal with the action of the Bank of Portugal as a central bank during the seven decades under consideration[1]. These may be divided into three periods:

(i) From the early 1930s till the mid-1970s, the Bank of Portugal followed a macroeconomic policy according to classical standards (aiming at monetary stability as its main priority), and relied on direct controls for microeconomic intervention – this period is dealt with in section 2.

(ii) From the mid-1970s till the mid-1980s, the Bank of Portugal followed a macroeconomic policy according to Keynesian standards

[1] Besides the particular references made below the text, this analysis is based mainly on the perusal of the annual reports of the board of administrators of the Bank of Portugal.

(aiming at stimulating economic activity to curb unemployment as its main priority), and relied on direct controls for microeconomic intervention – this period is dealt with in section 3.

(iii) From the mid-1980s till the late 1990s, the Bank of Portugal followed a macroeconomic policy according to classical standards (aiming at monetary stability as its main priority), and relied on indirect market actions for microeconomic intervention – this period is dealt with in section 4.

1. The formation of a central bank in Portugal[2]

As most central banks, the Bank of Portugal was not created to be a central bank, that is to say, a bank with the functions of monetary management and regulation of the banking system. It belonged to the type of bank created to reestablish a normal monetary circulation and provide financial help to the government[3]. This happened in 1822, under the name of Bank of Lisbon.

It may be said that the Portuguese banking system did not have a central bank until the early 1870s because it did not need one. Between the early 1820s and the mid-1850s, it was too simple – there were only one (1822-1835), two (1835-1844 and 1846-1856) or three (1844-1846) banks, under the clear hegemony of the Bank of Lisbon (until 1846), later the Bank of Portugal (from 1846 onwards)[4]. Between the mid-1850s and the early 1870s, it developed very peacefully – smooth growth, with neither speculative behaviour nor banking crises[5].

[2] For a more detailed analysis of the formation of a central bank in Portugal see Valério, 2001.

[3] On this question, see Goodhart, 1987.

[4] There was a first banking crisis in 1827, which the Bank of Lisbon survived without much damage, and a second one in 1846, which led to the merger of the Bank of Lisbon and another bank created in 1844 (the National Trust Company) to form the Bank of Portugal. The main reference about the history of the Portuguese banking system is Reis, 1994. On this period see also Reis, 1996.

[5] During this period, the Bank of Portugal lost the overwhelming dominant role it had enjoyed among commercial banks during the previous period, although it retained a dominant role among issuing banks (whose number increased until it reached a maximum of nine).

Everything changed between 1873 and 1875. There was a staggering growth in the number of banks (from thirteen to fifty-one). More important still, speculative behaviour arose. As a consequence, the Portuguese banking system experienced a standard experience of speculative bubble, followed by crisis and breakdown.

When the crisis broke, the commercial banks turned to the Bank of Portugal for help. The Bank of Portugal agreed to play the role of lender of last resort. The success of this action was not complete, and the Bank of Portugal itself had to suspend convertibility during one week (18 to 24 August 1876). As a consequence, the intervention of the Bank of Portugal was subject for contradictory assessments. Even so it provided arguments for those who supported the concentration of the banknote issue in the hands of the Bank of Portugal.

However, a definitive decison in that sense had to wait for a further decade, and even on that occasion (1887), ending the note issue of the other issuing banks was made conditional on an agreement between them and the Bank of Portugal. The negotiations dragged on at first. A new banking crisis in 1891 was needed to bring about the agreement.

Of course, the idea was to adopt the model of a unified and convertible banknote issue. However, the very day when the Bank of Portugal became the only issuing bank, a government decree gave inconvertible legal tender status to its banknotes. Thus, Portugal got a conventional monetary regime, after having lived under the gold standard since 1854. This brought the question of the value of money, both internal (the price level) and external (the exchange rate), to the forefront of the concerns of the Bank of Portugal.

The dominant perspective among the Portuguese economists of the epoch was clear: the banknote issue grew as a function of the needs of the government; the issue of the price level grew and that of the exchange-rate depreciated as a function of the banknote issue. The solutions were also clear: there was need for balancing the public accounts, reducing the public debt and, above all, paying the government debt to the Bank of Portugal, so that convertibility could be resumed.

This perspective was correct concerning the causes of the increase of the banknote issue, but wrong concerning the causes of the increase of the price level and the depreciation of the exchange rate. The price level was influenced mainly by the international price level. The level of the exchange rate fluctuated mainly according to the economic situation in Brazil (more precisely according to the exchange rate of the Brazilian currency)[6].

Concerning the remedies, they were easy to design and quite difficult to implement. On the eve of the First World War, the goal of balancing the public accounts had been achieved, but the road to convertibility seemed still a long one. The classical question of time inconsistency in the financial behaviour of the government and the credibility in the measures taken to foster the return to convertibility appeared in all its guises. It was certainly possible to balance the public accounts and to pay the debt of the government towards the Bank of Portugal gradually. However, as long as the reserves of the Bank of Portugal remained modest in proportion of the banknote issue, resuming convertibility risked drying them up quickly, because of the preference of economic agents for the precious metal. Similarly, it was possible to stabilise the exchange rate, but, as long as the dependence upon the economic situation in Brazil was not broken, this would remain a fragile achievement.

In Portugal, as in Europe in general, the First World War changed deeply the conditions of monetary life. It is true that inconvertibility, which the war imposed on most European countries, had already been a characteristic of the Portuguese banknote issue since 1891. However, the increase in banknote issues to provide loans to the government for war expenditure and the internal and external depreciation of the monetary unit reached levels which made impossible the return to convertibility at the old par.

Inflation continued during the post-war years until 1924. Stabilization was obtained in 1924, thanks to the reduction of the deficits in the public accounts allowed by the 1922 fiscal reform, and

[6] This happened because the emigrants' remitances from Brazil were the main balancing item in the Portuguese overall balance of payments.

a joint intervention in the foreign exchange markets by the government and the Bank of Portugal. The government provided the foreign exchange by means of a tax on exports; the Bank of Portugal managed the fund established with this revenue.

Formal confirmation of the stabilization took place only in 1931, with the decrees given force of law 19869 and 19870 of 9 June, which defined a new monetary regime (the adoption of the gold-exchange-system, with indirect convertibility by means of the pound sterling), and a reform of the Bank of Portugal, which confirmed its responsibility for the internal and external value of the currency. According to the preamble of the decrees: "Once the reform has been legalized and the contract with the Bank of Portugal signed, it becomes the obligation of the Bank to maintain the legal value of the currency". Thus, the Bank of Portugal became, *de jure* and *de facto* , the Portuguese central bank, at least from a macroeconomic point of view (on the question of banking supervision, see the discussion of this topic below)[7].

2. The period of classical macroeconomic policy and direct microeconomic controls (1931-1973)

Macroeconomic goals. The macroeconomic action of the Bank of Portugal as a central bank immediately after the 1931 monetary reform was dominated by the lessons learned from the events of the First World War, the post-First World War inflation and the mid-1920s stabilization. Monetary stability was the undoubted first priority. Economic development was accepted as an important secondary goal. These goals and priorities were to remain until the country was hit by the first oil shock in 1973[8]. This persistence of classical objectives as the framework of macroeconomic policy in Portugal may be explained by two reasons:

a) The good performance of the Portuguese economy during these four decades – monetary stability was attained concerning the

[7] On the history of the Bank of Portugal between 1891 and 1931 see Mata, Valério, 1982. On the First World War and post-First World War inflation and mid-1920s stabilization see Santos, 1996.

[8] On the history of the Bank of Portugal between 1931 and 1974 see Valério, 1996.

external value of the monetary unit (see below for the discussion of the exchange rate policy), although some problems arose concerning the internal value of the monetary unit.Prices remained roughly stable during the 1930s, the second half of the 1940s and the 1950s, but there were two inflationary spurts, one during the Second World War – prices doubled between 1940 and 1945 – another from the late 1950s onwards[9] – prices increased by more than 50% between 1960 and 1973. Economic development was also attained: although there are still many doubts about Portuguese retrospective national accounts[10], it is possible to say that per capita gross domestic product increased during the 1930s (by some 20%), stagnated during the Second World War and increased very significantly between 1947 and 1973 (an almost fourfold).

b) The evolution of the Portuguese intellectual scene – although Keynesian (and Marxian) ideas spread in the universities, the government and the monetary authorities remained faithful to classical ideas until the early 1970s[11].

Exchange rate policy. The exchange rate policy was devoted to achieving monetary stability as its main aim and competitiveness as its secondary aim. Stabilization of the exchange rate appeared as the best intermediate target, because it ensured the direct stabilization of the external value of the monetary unit, and was believed to contribute also to the indirect stabilization of the internal value of the monetary unit, by avoiding the inflationary impact of devaluation. Although competitive devaluation to increase competitiveness was rejected on these grounds, competitiveness was a clear purpose of several exchange-rate policy decisions, as it will be presently seen.

As could be expected in the context of classical standards, convertibility was the preferred guideline of exchange-rate policy. As

[9] Official concern about rising prices only appeared in 1964, as far as it can be judged from the reports of the Bank of Portugal and the Ministry of Finance.

[10] Valério, 1998 provides a summary of the debates and some new estimates.

[11] Ferreira, Cardoso, 1986, provides several vivid testimonies about the evolution of economic doctrines in Portugal during this period. On this matter see also Bastien, 2000.

direct convertibility was out of the question, for the reasons already explained above, indirect convertibility was the only possible mechanism. Quite understandably, the pound sterling was chosen for indirect convertibility of the Portuguese currency when the gold-exchange standard was adopted, on 1 July 1931. It was one of the leading international currencies, and Great Britain was the main commercial and financial partner of the Portuguese economy. The exchange rate was 1 pound sterling = 110 Portuguese escudos, almost 25 times lower than the theoretical pre-First World War par value(1 pound sterling = 4.5 Portuguese escudos). In practical terms this was the pre-1891 value, as explained above.

Things soon became more complicated than expected, because of the declaration of inconvertibility of the pound (21 September 1931). The Portuguese monetary authorities choose to peg the escudo to the pound sterling, as a mid-point to avoid inflation (the expected consequence of autonomous devaluation) and loss of competiveness (the expected consequence of sticking to gold)[12]. This situation lasted until the beginning of the Second World War[13].

The devaluation of the pound sterling during the early months of the Second World War led the Portuguese monetary authorities, always worried about inflation, to adopt a strategy of following only partially this devaluation. As a consequence, the Portuguese escudo appreciated against the pound sterling until 20 July 1940. By then, the Bank of England had signed an agreement with the American Federal Reserve Bank that brought a stabilization of the pound sterling as against the American dollar. So, the Bank of Portugal felt confident to sign an

[12] The priority given to the goal of stability may be proved by the fact that the Portuguese monetary authorities decided not to follow the pound sterling in cases of seemingly excessive devaluation. Thus, the American dollar and the French franc (after the declaration of dollar inconvertibility) were used to peg the Portuguese escudo for several short periods during the 1930s.

[13] It is interesting to notice that the Portuguese monetary authorities seemed to believe in the possibility of a restoration of the original gold-exchange standard until the declaration of inconvertibility of the dollar (11 April 1933). As a matter of fact, the suspension of the gold-exchange standard was always considered as provisional until April 1933, and became formally *sine die* after that date.

agreement with the Bank of England to stabilize the exchange rate at 1 pound sterling = 100 Portuguese escudos (and indirectly at 1 American dollar = 25 Portuguese escudos)[14].

These exchange rates persisted almost until the end of the 1940s, in spite of the political and economic upheavals of the decade. It was the decision of the British monetary authorities to devaluate the pound sterling on 18 September 1949 that forced some adjustments. Once more, the Portuguese monetary authorities choose a middle way: a 25% appreciation as against the pound sterling and a 15% depreciation as against the American dollar. The new exchange rates were 1 pound sterling = 80 Portuguese escudos and 1 American dollar = 28.75 Portuguese escudos.

In fact, the American dollar had become the main standard. Thus, the Portuguese escudo was pegged firmly to the dollar until the declaration of its inconvertibility, on 15 August 1971. In particular, the dollar / escudo exchange rate was not changed when Portugal became a member of the International Monetary Fund in 1960[15].

The favourable situation of the Portuguese balance of payments led to an appreciation of the Portuguese escudo as against the American dollar in the attempts to maintain a fixed exchange-rate system between 1971 and 1973. The agreed exchange rates were 1 American dollar = 27.25 Portuguese escudos in December 1971 and 1 American dollar = 25.50 Portuguese escudos in February 1973. However, these attempts proved ephemeral: on 19 March 1973, everybody gave up and the fixed exchange-rate system was officially

[14] This agreement also provided the background for Portuguese war loans to Great Britain, which amounted to around 80 million pounds.

[15] There is no explicit explanation for the fact that the Portuguese monetary authorities decided to abide by the Bretton Woods rules but not to participate in the International Monetary Fund between the 1940s and 1960, although Portugal was a member of the European Organization for Economic Cooperation (from 1948 onwards), a (minor) beneficiary of the Marshall Plan (from 1949 onwards), a member of the European Payments Union (from 1950 onwards) and a subscriber to the European Monetary Agreement (1955). It is reasonable to speculate that there was some reluctance to subject Portuguese political decisions to any kind of international control, because of purely nationalistic feelings (and, of course, no external payments problems that might lead to the need of help from the International Monetary Fund occurred).

dropped. Soon a new and quite different period was to begin: in October of the same year the world in general and Portugal in particular were severely hit by the first oil shock.

Interest rate policy. During the period under consideration, while the exchange-rate policy was mainly concerned with the main macroeconomic goal (monetary stability), although some attention was paid to its impact on the second macroeconomic goal (economic development), interest-rate policy was mainly concerned with the second macroeconomic goal (economic development), although, of course, it was not allowed to disturb the achievement of the main macroeconomic goal (monetary statability).

In this context, the Bank of Portugal kept its discount and rediscount rates as low as possible, with the aim of fostering investment, but trying to avoid what could be considered artificially low interest rates, as they were supposed to trigger inflationary pressures.

In practical terms, the 1930s saw a gradual lowering of the rediscount rate. Its level was rather high (7.5%) in 1931[16] as a result of some uncertainties after the end of the First World War and post-First World War inflation. It became 7% (10 August 1931), 6.5% (4 April 1932), 6% (13 March 1933), 5.5% (11 December 1933), 5% (13 December 1934), 4.5% (11 May 1936) and 4% (11 August 1937). As the price level may be considered more or less stable during these years, this meant the reduction of the real interest rate to traditional (meaning pre-First World War) levels.

The lowering of the rediscount rate went on during the Second World War: it became 3.5% (31 March 1941), 3% (8 April 1943), 2.5% (16 August 1943) and 2% (12 January 1944). Now, as an inflationary process had been triggered by the economic situation prevailing during

[16] The figure mentioned is the rediscount rate in Lisbon and Oporto. As a rule, the rediscount rate was half a percentage point higher in the rest of the country. The discount rate was the same as the rediscount rate in 1931. This situation changed later, and is dealt with in detail below, when discussing the relations of the Bank of Portugal with the commercial banks.

the war (see more on this below), the real interest rate became clearly negative.

The end of the inflationary process and the stability of the rediscount rate during the post-Second World War period, brought a situation of low nominal and real interest rates, which lasted until the early 1960s.

The 1960s and the early 1970s witnessed the development of a new inflationary process, as already mentioned. There was an initial rise in the rediscount rate to 2.5% (1 September 1965)[17], but further rises were mitigated by the introduction of different rediscount rates according to the purpose of the credit. Thus, the maximum rediscount rates were raised to 2.75% (6 January 1969), 3.5% (25 April 1970), 3.75% (5 February 1971) and 4% (18 December 1972), but preferential rediscount rates were introduced at the level of 2.25% (6 January 1969) and 2% (25 April 1970). In any event, the real interest rate tended to become negligible or even negative during the late 1960s and early 1970s.

Isuing policy. Excessive banknote issues were, of course, considered the main error to avoid, according to the classical ideas that prevailed in the Bank of Portugal during the 1930s. Thus, a rule prescribing that every additional issue had to be fully backed by gold or convertible foreign exchange was introduced in the 1931 monetary reform and kept until 1946[19].

By then, it was clear that full gold backing of additional note issues was not enough to avoid inflation. Indeed, balance of payments

[17] At this moment, the difference between the rediscount rate in Lisbon and Oporto and the rest of the country was abolished. Thus, the rediscount rate rose only in Lisbon and Oporto, but these were the really important places.

[18] 2,200 million escudos could be issued with only 30 % backing (in other words, 1,540 million escudos could be issued without backing). Such a rule was needed to avoid a costly deflationary process, although it may be noticed that the unbacked issue existing in 1931 amounted to around only 1,094 million escudos.

[19] To be precise, the requirement of convertibility for the exchange reserves was dropped as soon as the pound sterling was declared inconvertible. Otherwise, most of the acceptable foreign exchange reserves of the Bank of Portugal would have disappeared, because they were valued in pounds.

surpluses had triggered a significant growth of the money supply and some price increases during the Second World War, and the Bank of Portugal had been unable to sterilize its additional reserves. But the impending risk at the moment was the reverse: a deflationary contraction due to the worsening of the external payments situation in the post-war years. To avoid such an evolution, the issuing rules were changed: the new rules required only half gold or foreign-exchange backing for the whole banknote issue (decree-law 35575 of 3 April 1946).

However, the issuing policy of the Bank of Portugal did not really change. Compensation for the reduction in the reserves during the immediate post-Second World War years and compensation for the increase in the reserves during the 1960s and early 1970s were very imperfect. Thus, a new inflationary process was triggered by balance-of-payments surpluses from 1960 onwards[20].

Meanwhile, the Portuguese monetary authorities became more and more aware that banknote issues did not coincide with money supply and that monetary policy should address the latter, not the former. Calculation of the M1 aggregate began to appear in the reports of the Bank of Portugal from 1947 onwards and calculation of the M2 aggregate from 1962 onwards. This was not only a question of technical knowledge. Portuguese monetary habits were also changing. It was only after the Second World War that most joint-stock banks opened branches in the main towns of the country and that many Portuguese people began to use their banking accounts as a means of payment.

Banking supervision. The 1931 reform made the Bank of Portugal what is today called a central bank from a macroeconomic point of view, but the preamble of the above-mentioned decrees with force

[20] According to the Bank of Portugal, this failure to follow an active monetary policy was the result of the excess of reserves held by commercial banks, which made them insensitive to the rediscount rate of the Bank of Portugal. Changes of the minimum legal reserves were, of course, too blunt an instrument for monetary fine-tuning and open-market operations were impossible due to the unsophisticated state of Portuguese financial markets.

of law also stated that "It is impossible to make the Bank only a rediscount bank [...]. But, [...], the Bank must gradually approach the type of central bank, that may play, in the monetary policy of the country, the high policy mission which is needed and the role of regulator and distributor of the credit". In other words, it was thought that it was still impossible to make the Bank of Portugal what is today called a central bank from the microeconomic point of view.

The main problem was the question of competition between the Bank of Portugal and the other commercial banks, especially in the domain of direct discounts. Such a problem had become more and more pressing since the time of the First World War. The decree 10474 of 17 January 1925 tried for the first time to provide an answer to the protests against the competition of the Bank of Portugal with the other commercial banks, by forbidding the Bank of Portugal direct discounting in Lisbon and Oporto. This rule was not strictly respected. The Bank of Portugal interpreted the text of the law in the sense of an interdiction to increase the level of direct discount sin these places, and the 1931 decrees accepted this interpretation, although, as the quotation above shows, the preamble suggested that an effort should be made to change the situation.

The main sign that the Bank of Portugal was willing to accept this evolution came a few years later, on 11 August 1937, when the Bank of Portugal reduced its rediscount rate to 4%, but kept its direct discount rate at 4.5%[21]. It is true that, on 3 September 1942, the rediscount and direct discount rates again became equal, at the level of 3.5%, but less than one year later, on 16 August 1943, they became different again, because, when the rediscount rate was lowered to 3%, the direct discount rate was kept at 3.5%. The half-point difference between the two rates was kept thereafter.

All this does not mean that the question of banking supervision was ignored by the Portuguese monetary authorities at the time. By

[21] As stressed above, these are the rates applied in the places of Lisbon and Oporto. Both rediscount and direct discount rates in the rest of the country were half percentage point higher.

1931, the Portuguese banking system had already faced six significant crises. Those of 1827, 1846, 1876 and 1891 have already been mentioned. The post-First World War years and the Great Depression provided two further difficult periods. Since the 1876 crisis, the Bank of Portugal had performed the role of lender of last resort, as already mentioned. However, whatever supervision there was, was considered to be the role of the government, not that of the Bank of Portugal. The main measure taken by the government in this context was a tacit freezing of the banking system concerning existing enterprises. Thus, except for some mergers and the transformation of banking houses into joint-stock banks, the Portuguese banks remained almost the same from the early 1930s till the 1980s[22].

Some reference must be made in this context to the main laws that regulated the banking system. The decree of 12 July 1894, confirmed by the law of 3 April 1896, imposed a strict specialization on banking firms (meaning that the credit institutions were forbidden to perform business in other sectors), the principle of government authorisation of banks and the practice of a minimum backing for 'sight' liabilities. The decree 10474 of 17 January 1925, as amended by the decree 10634 of 20 March 1925, imposed a minimum level of equity capital on the commercial banks. The decree 20983 of 7 March 1932 established a ceiling to the passive interest rate of the commercial banks equal to the rediscount rate of the Bank of Portugal plus one and a half percentage points. The law 1894 of 11 April 1935 tried to apply the corporative framework of the 1933 Constitution to the banking sector. However, only the decree 41289 of 23 September 1957 organised a proper Corporation of Credit and Insurance, which was intended to become the main corporative organisation in the financial sector. The decree 41403 of 27 November 1957 established a new legal framework for the whole banking system, confirming the principles of specialisation, government authorisation, and joint control by the Ministry of Finance and the Bank of Portugal. In practice, the

[22] The number of joint-stock commercial banks was initially around forty, but tended to decline because of mergers.

Ministry of Finance remained always more important than the Bank of Portugal in this supervision function. The decree 46492 of 18 August 1965 introduced new rules for the operation of the banking system, but did not change the previous principles[23].

3. The period of Keynesian macroeconomic policy and direct microeconomic controls (1973-1985)

Macroeconomic goals. The first oil shock changed the monetary, financial and economic situation in Portugal very greatly. Firstly, there was a very significant increase in the trade deficit, because of the rise in the oil price and the reduction of exports due to the economic crisis that followed in the most developed countries, which were the main outlets for Portuguese exports. Secondly, an external payments deficit appeared, as the joint consequence of the increase in the trade deficit and the reduction of emigrants' remmitances, also due to the economic crisis that followed in the most developed countries, especially in those that were the main destinations for Portuguese emigration[24]. Thirdly, for the first time since the late 1940s, there was a reduction in the level of economic activity, which may be attributed partly to the external payments problems, partly to the political transformations brought about by the revolution of 25 April 1974. In fact, the spurt of strikes that followed, the structural transformations (nationalisation of the main firms and the basic sectors of the economy, and the agrarian reforms) that were attempted and the inflow of refugees triggered by the decolonisation of Portuguese possessions in Africa combined to increase the difficulties.

This complex situation brought about a change in the macroeconomic action of the Bank of Portugal as a central bank[25]. The traditional goals of monetary stability and economic development

[23] On the evolution of the Portuguese banking system during the post-Second World War period see Sérgio, 1993.

[24] During the 1960s and early 1970s, Portuguese emigrants went mainly to the most developed European countries, especially to France.

[25] On this change see Sousa, 1989.

ceded their place to the goal of fighting short-term difficulties. Recession and unemployment, just because of their novelty in the Portuguese economy, appeared as the crucial problems. The means used to fight them were typically Keynesian. It was assumed that an increase of public expenditure and the money supply would provide the decisive stimuli for the level of economic activity[26].

Exchange rate policy. For a while, the large total of international means of payment allowed the Keynesian policy to be pursued unfettered by any concern with external payments, and without harming the stability of the exchange rate. The only significant modification between 1973 and 1975 was the decision to align the Portuguese escudo with the European currencies of the so-called 'monetary serpent', instead of pegging it to the dollar. From January 1976 onwards, however, the Portuguese monetary authorities accepted the fact that sticking to a stable exchange rate was a rather odd option in the context of the Keynesian policy they were practising, and began to give priority to supporting the international competiveness of Portuguese economic activities. During the first quarter of 1976, there was a first experiment in gradual devaluation against a currency bundle which was supposed to represent Portuguese external economic relations. This experiment of gradual devaluation was interrupted during most of the second quarter of 1976, and reestablished between December 1976 and February 1977. To the 10% devaluation brought about by these measures, a 25% devaluation was added on 25 February 1977. Then, there was a new attempt at stabilization. A new turning point came on 25 August 1977. A scheme of a 'crawling-peg' was adopted to ensure permanent support for competitiveness, even at the cost of some imported inflation. At first, a devaluation of 1% per month was chosen, but a few months later it became clear that this was not enough. For the first time Portugal called for help from the

[26] Constâncio, 1983 and Sarmento, 1986 provide two syntheses of the evolution of economic policy during this period.

International Monetary Fund (March 1978). The resulting austerity package envolved an immediate 6.1% devaluation (5 May 1978), and an acceleration of the 'crawling-peg' devaluation to 1.25% per month.

The austerity package was an almost complete success: external payments problems were rapidly solved without much harm to the level of economic activity. Only the inflation figures remained too high. Thus, the concern with inflation came for a while to the forefront. The 'crawling-peg' devaluation was reduced to 1% per month in April 1979 and to 0.75% per month in June of the same year. On 12 February 1980 even a revaluation of 6% was made, and in June of the same year the 'crawling-peg' devaluation was once more reduced to 0.5% per month. However, the on-going second oil shock implied that the following years witnessed a renewed worsening of the situation: 'crawling-peg' devaluation of 0.75% per month in December 1981, devaluations of 1.3% on 1 April 1982, 9.4% on 16 June 1982 and 2% on 23 March 1983, 'crawling-peg' devaluation of 1% per month from that date on, 12% devaluation on 22 June 1983. Moreover, a second call for help from the International Monetary Fund (September 1983) and a second austerity package (revised in June 1984) were needed.

This second austerity package achieved a success similar to the success of the first one: once more external payments problems were solved without much harm to the level of economic activity, and only the inflation figures remained too high. At the same time, the international background improved by the mid-1980s, not only because oil prices, international interest rates and the dollar exchange rate started to move down, but also because Portugal became a member of the European Communities (the respective treaty was signed on 11 June 1985 and integration took place on 1 January 1986). This allowed the slowing down of devaluation measures, which, however, would go on until October 1990.

Interest rate policy. During the period under consideration, inflation gathered momentum in Portugal, partly as a consequence of the

Keynesian stimuli (increased public deficits and increased money supply) applied to the economy, partly as a consequence of the gradual devaluation of the escudo, as explained. Portuguese economic agents became accustomed to volatile but consistently high inflation rates that would peak at a 30% level in 1984. Between the first oil shock and the mid-1980s, the price level was multiplied by a factor higher than 10.

As could be expected in this context, the movement of the interest rate was upwards. Shortly after the first oil shock, a new scheme of three rediscount rates (3% – 3.75% – 5%) according to the purpose of credit was introduced (21 December 1973). These rates were raised to 4% – 5% – 6.5% (10 July 1974) and 4.5% – 6% – 7.5% (21 December 1974). On 19 December 1975, there was an attempt to lower them to 3% – 4.5% – 6.5%. But, when the first competitive devaluation was made on 28 February 1977, the upward movement was resumed: the rediscount rates became 8% – 9.5% – 12%, according to the purpose of credit and the amount already reached by the rediscount rate. Fresh increases came on 26 August 1977 to 13% – 15.5% – 18% (this rise coincided with the adoption of the crawling-peg system), on 16 July 1981 to 18% – 20.5% – 23%, on 20 April 1984 to 19% – 21.5% – 24%, on 23 March 1983 to 23% – 25.5% – 28% and on 8 August 1983 to 25% – 27.5% – 30%. It is difficult to say that these rises had an effective role as a monetary policy instrument. In a certain sense, they just responded to inflation. At the same time, the volatility of the inflation rate implied a high volatility of the real interest rate, which fluctuated between rather high positive figures and very low and even negative figures.

The control of money supply. As interest rate policy lost efficiency as a monetary policy instrument (in a certain sense it never had worked very well, as suggested above), direct credit controls stepped in to perform the task of controling the money supply (and legal limits to the active and passive interest rates of the banking institutions according to the rediscount rate of the Bank of Portugal were strengthed). Decree-law 644/75 of 15 November put an end to formal limits to the banknote issue[27] and the Bank of Portugal began to accomodate more or less willingly the credit demands of the government. At the same time, direct control of the banking system by the state, mainly through nationalization, as will be explained below, eased the task of credit control. The purpose was to keep the economy on the narrow path between the abysses of high unemployment and hyper-inflation. As could be expected, the result was a more or less successful standard experience of 'stop-and-go' policies.

The counter-cyclical 'go' of the mid-1970s failed from an economic point of view[28], as already explained above. Economic activity receded, inflation rose and recovery led to unbearable balance of payments problems. There followed an IMF-led 'stop', the austerity package linked to the first IMF loan already mentioned. Its success ensured a relatively smooth landing during the late 1970s, but paved the way for another counter-cyclical 'go' during the second oil shock of the early 1980s. Immediate results were better than in the previous experiment of the mid-1970s, but the ultimate results were similar. By the mid-1980s, the Portuguese economy was experiencing stagflation and balance of payments problems, and had to call again for IMF help. The second IMF-led 'stop', the austerity package linked to the second IMF loan already mentioned, was a renewed success: it would combine with the favourable evolution of the international economy to curb inflation and produce a significant expansion during the late 1980s.

In fact, the decennial evolution between the mid-1970s and the mid-1980s was far from catastrophic: in spite of the high inflation figure already mentioned (multiplication by a factor higher than 10), there was some real growth (nearly 30% increase of per capita gross domestic product), although at a disappointing rate compared with pre-first oil shock standards.

[27] According to article 13, the monetary issue of the Bank (defined as the monetary base) was to be planned in order to coordinate "the management of exchange reserves and the credit to be granted by the Bank with the needs of stabilization and development of the economy", "in strict cooperation with the Ministry of Finance".
[28] Although not from a social point of view, especially concerning the goal of smoothing the integration of refugees from the ex-Portuguese colonies into a Portuguses society living in revolutionary turmoil.

Banking supervision. After the revolution of 25 April 1974 the legal framework of banking activity in Portugal underwent very deep transformations. The decree 452/74 of 13 September 1974 nationalised the Bank of Portugal. The decree 132-A/75 of 14 March 1975 nationalised all credit organisations, with the exception of departments of foreign banks, savings banks and rural mutual banks[29]. The decree 644 /75 of 15 November 1975 enacted a new statute for the Bank of Portugal[30]. The decree 729-F/75 of 22 December transformed all nationalised banks into public enterprises[31].

Of course, these measures changed the framework of the banking supervision system, because the Ministry of Finance could now control directly the administration of all banks. In practice, most of the control was delegated to the Bank of Portugal. According to the already mentioned decree 644 /75 of 15 November 1975, the Bank could decide the interest rates, define the qualitative and quantitative criteria for credit and determine the level and composition of the reserves to be held by monetary and financial institutions. However, according to article 21 of the same decree, "The functions of the Bank in the domain of supervision of banking institutions [...] will be defined through adequate specification with the Ministry of Finance". This meant that any independent role of the Bank of Portugal in this context completely disappeared.

4. The period of classical macroeconomic policy and indirect microeconomic action (1985-1999)

Macroeconomic goals. While the transition from the first to the second

[29] As the decree 156-A/75 of 25 March 1975 imposed a government-appointed administration to the Montepio Geral, the pension fund that owned the Lisbon Savings Bank, the only significant credit organisation which had not been nationalised, it may be said that the whole banking system came for a while under government control.

[30] Among other measures, this decree put a definitive end to the direct relations of the Bank with non-financial economic agents (with the obvious exception of the government).

[31] Several mergers aimed at profiting from economies of scale among the smallest nationalised banks gradually reduced their total number to less than twenty.

period considered in this study was a very quick one, as a consequence of the radical changes brought about by the first oil shock and the political transformations of 1974, the transition from the second to the third period was quite slow. It may be said that it lasted from the integration of Portugal in the European Communities in 1985 till the end of the 1980s. In fact, once the external payments problems that had led to the second call for IMF help had been overcome and Portugal had become a member of the European Communities, the goal of being also a full participant of the European Monetary System was accepted as the guideline for the action of the Portuguese monetary authorities. However, dismantling the burdensome, but in some sense comfortable, mechanisms of the 'crawling-peg', direct credit controls and easy monetary creation proved to be a complicated task. It may be said that the approval of the Delors Plan in 1989 and the increased demands that the plans for a European Monetary Union put on the would-be candidates for entry was the decisive impulse to the completion of the switch of the Portuguese monetary authorities to classical macroeconomic standards, indirect mechanisms of microeconomic action and, above all, renewed independence of the Bank of Portugal in its relations with the government.

Decree 337/90 of 30 October 1990, which enacted a new basic law for the Bank of Portugal, may be considered as the crucial change in this matter. There was a complete reversal of the 1975 rules that had made the Bank dependent on the Ministry of Finance. The purpose was now to implement an independent central bank, able to participate in the process of creation of the European System of Central Banks. Thus, any financing of the government by the Bank of Portugal, except by means of the sale of Treasury bills under market conditions, and any technical influence of the government on the action of the Bank were strictly forbidden.

Exchange rate policy. As was pointed out above, the crawling-peg exchange-rate policy to support the competitiveness of Portuguese exports went on until October 1990, although its pace was slowed down from late 1985 onwards. The crawling peg was interrupted between November 1985 and March 1986 and then resumed at a pace of 0.9% per month, which was reduced to 0.7% per month in June 1986, 0.6% per month in October 1986, 0.5% per month in January 1987, 0.4% per month in January 1988, 0.3% per month in April 1988 and 3% per year in January 1989. When the 'crawling-peg' policy came to an end, the escudo / dollar exchange rate was around 1 American dollar = 140 Portuguese escudos (it had peaked at 1 American dollar = 170 Portuguese escudos by the mid-1980s). From October 1990 onwards, there was a return to the attempt to stabilize the effective exchange rate of the escudo.

From 1 September 1991 onwards, as a consequence of the decree 176/91 of 14 May 1991, which liberalised most exchange operations, the bulk of the exchange-control schemes that existed in the Portuguese economy were lifted. Complete liberalization of exchange operations was concluded on 16 December 1992.

On 6 April 1992, the Portuguese escudo was integrated in the exchange-rate mechanism of the European Monetary System, with the initial central rate of 178.735 escudos / ecu, and the Bank of Portugal started the market interventions needed to ensure that the fluctuation as against the other currencies within the system remained within the established margins (at first ± 6%). Both the central rate and the fluctuation margins were later modified several times: the central rate became 182.194 escudos / ecu on 23 November 1992, 194.036 escudos / ecu on 13 May 1993 and 200.827 escudos / ecu on 6 March 1995; the fluctuation band was enlarged to ± 15% on 2 August 1993. These changes were not caused by serious direct attacks on the Portuguese escudo. They were an indirect consequence of the turmoil of the European Monetary System during the late first phase and early second phase of the European Monetary Union, and may be interpreted as precautionary measures against market behaviour which might (erroneously) identify the situation of the Portuguese escudo with the situation of the Spanish peseta (as a matter of fact, the Spanish peseta had much weaker fundamentals at the time). Curiously, the Portuguese monetary authorities seem to have adopted a somewhat passive stance in this context: they never asked for a change in the central parity of the Portuguese escudo (so that it would be impossible to invoke their initiative against the participation of the country in the third phase of the European Monetary Union), and they never opposed the proposed changes (so that unpleasant surprise attacks on the Portuguese escudo might be avoided as much as possible).

From 1999 onwards, the Portuguese monetary unit ceased to exist legally, as a consequence of the integration of Portugal in the euro zone, with the conversion factor of 1 euro = 200.482 Portuguese escudos.

Interest rate policy. As could be expected, the positive impact of membership of the European Communities, the reduction of inflation and the efforts to participate in the European Monetary System and later in the European Monetary Union combined to bring a reduction in interest rates. In spite of a small hiccup in 1989, the rediscount rate came down, slowly but steadly, from its 25%– 27.5% – 30% peak. It became 23% – 25.5% – 28% on 3 August 1985, 19%– 21.5% – 24% on 26 November 1985, 17.5% – 20% – 22.5% on 9 April 1986, 16% – 18.5% – 21% on 28 June 1986, 15.5% – 18% – 20% on 6 January 1987, 15% – 17.5% – 19.5% on 20 March 1987, 14.5% on 15 October 1987 (together with the end of the three-level scheme that dated back to 1973), 14% on 5 February 1988, 13.5% on 5 May 1988, 14.5% again on 18 March 1989, 13.5% on 20 May 1993, 12% on 20 January 1994, 10.5% on 30 September 1994, 8.75% on 1 February 1996, 8.25% on 23 April 1996, 7% on 12 December 1996 and 6% on 6 May 1997. During 1998, the final alignement with the rediscount rates of the other members of the eurosystem was made, bringing the rate to 3%.

As the inflation rate came back to single-digit levels by the early 1990s and to less than 3% by the late 1990s (the overall evolution of the price level during the last fifteen years of the XXth century had produced a three-fold increase), this means that the real interest-rate gradually came back to traditional low and stable levels.

Control of the money supply. Three aspects must be underlined concerning the monetary policy followed by the Portuguese monetary authorities during this period.

First, there was a change of goals. Monetary stability, meant chiefly to curb inflation, and later fulfilling the criteria needed to participate in the third phase of the European Monetary Union from its beginnings became the main purposes of the action of the Portuguese monetary authorities.

Second, there was a change of means. Direct credit controls were gradually dropped and were completely abolished in March 1990. At the same time, the increasing sophistication of the Portuguese financial markets allowed the introduction of the full paraphernalia of indirect monetary controls, envolving open-market operations, and the reduction and stabilization of inflation restored the sensitivity of the banking system to the manipulation of the rediscount rate.

Third, there was the general success of the economic policy pursued. Nominal convergence towards the European standards needed to participate in the European Monetary Union was achieved. In fact, the stabilization of the exchange rate, the reduction of the inflation rate and the reduction of the interest rate were obtained, as already explained. At the same time, the deficit in the public accounts was also reduced to just below the 3% of gross domestic product level needed to abide by the Maastricht criteria, and the ratio of public debt to gross domestic product was also controlled, although it remained above the ideal 60% level. More important still, nominal convergence was achieved without harming the continuation of gradual real convergence. In spite of some sensitivity to the mid-1990s recession, the Portuguese economy was able to grow during the last fifteen years of the XXth century which saw its real per capita gross domestic product doubled.

Banking supervision. The almost complete direct state control of the banking system did not last more than a decade. In fact, decree 51/84 of 11 February 1984 made it possible to set up new private banks and decrees 23/86, 24/86 and 25/86 of 18 February 1986 incorporated the European Community rules relating to banking activity, into the Portuguese legal system, which does not allow any exclusive activity, of public companies in the banking sector. Furthermore, during the following years and until the mid-1990s, the banks nationalised in the mid-1970s were gradually privatised, except for the Bank of Portugal[32]. At the same time, many foreign banks began to establish Portuguese branches or bought significant shareholdings in the privatised banks. As a result, the Portuguese banking system lived through a decade of very deep transformation: new Portuguese groups emerged and foreign financial groups began to act in the Portuguese market[33] .

The end of state control of the banking institutions went in parallel with the end of the direct control of financial markets. In particular, when credit controls were abolished in March 1990, legal limits to active and passive interest rates according to the level of the rediscount rate of the Bank of Portugal were also abolished.

As a consequence of these changes, the already-mentioned decree 337/90 of 30 October 1990 set out a new definition of the supervisory role of the Bank of Portugal. First of all, the supervision role should no longer consist of instructions concerning the business activity that the financial institutions must obey; it should consist of regulations, accounting, the collection of statistics and supervision in the strict sense of the word. Second, when performing this task, the Bank of Portugal should no longer act in coordination with the Ministry of Finance, according to the general rule of technical independence. Thus, in a certain sense, the Bank of Portugal became for a while a true central bank from a microeconomic point of view, just a few years before it became the Portuguese element in the European System of Central Banks.

[32] The National Overseas Bank (BNU), the former issuing bank for the Portuguese colonial empire, also remained a state-owned bank, being linked to the Caixa Geral de Depósitos (CGD), a former state-owned savings bank which became the leader of a significant state-owned banking group.

[33] The total number of banks rose to around sixty.

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