Changing financial systems in small open economies: The Portuguese case

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1. Introduction

Conscious of the handicaps of an underdeveloped financial system closed to innovative external influences and dominated by nationalised banks, the Portuguese authorities started to modernise the financial system as part of the major structural reforms that were embarked upon within the framework of an IMF agreement during the 1983–85 period of macroeconomic adjustment. Following the first amendment of the Constitution in late 1982, the banking system was opened to domestic and foreign entrants in August 1983. Capital movements were also gradually liberalised, especially after Portugal's accession to the European Community (EC) in 1986. The rationale was that more competition would make the domestic financial sector more efficient, which is precisely what happened.

The liberalisation of the financial system was aimed mainly at restructuring and at strengthening competition in the banking sector, on the one hand, and at promoting a better-functioning capital market, on the other. As regards the banking sector, the major steps taken were:

(i) the opening of the sector to private economic agents, domestic as well as foreign;
(ii) the widening of the range of operations performed by banks;[1]
(iii) the gradual liberalisation of bank deposit and lending rates;
(iv) the privatisation of nationalised banks.

In addition to the favourable environment resulting from the improvement in economic activity and investment from the mid-1980s, a number

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[1] For instance, in 1986 commercial banks were authorised to take deposits of over one year and to grant medium-term housing credit, and in 1987 all banks were allowed to issue certificates of deposit of up to five years at interest rates negotiated between the parties.

of important factors contributed much to the revival of the capital market, viz.:

(i) the establishment of a broad range of non-monetary financial institutions;[2] tax incentives and the scope for taking advantage of the high intermediation margin and of the credit ceilings in the banking system were major encouragements;
(ii) the implementation of measures aimed at better market organisation and operation, in particular through legislative reform;
(iii) the creation of new financial products, particularly public debt instruments, given that the strengthening of the capital market was intended not only to make the financial system more efficient, but also to increase the share of non-monetary financing of the public deficit.

Although the dismantling of restrictions in the domestic market started a little earlier than the gradual relaxation of exchange controls, it is perhaps more appropriate to view the two processes as having taken place in parallel. External liberalisation therefore had its domestic counterpart in the opening of the banking sector and the privatisation of public banks, the development of new financial institutions and instruments, and the transition to indirect monetary control through the deregulation of interest rates and the elimination of credit ceilings.

For the successful modernisation of the financial system (and as part of the above-mentioned standby agreement with the IMF), it was crucial to reduce the government borrowing requirement and to curb inflation. Progress in these areas would facilitate, respectively, the elimination of privileged government financing channels and promote the development of stable financing instruments with interest rates freely responding to market forces.

Capital market financing was buoyed by the creation of new institutions and instruments, by the granting of tax incentives to both securities holders and issuing companies, and by the preparation of an appropriate regulatory framework that aimed at making financial markets function more efficiently.

[2] Including credit companies such as leasing, investment, factoring and hire-purchase financing companies and finance companies such as investment fund management, risk capital and regional development companies. Mention should also be made of the rapid growth of pension funds since their creation in 1995.

Deregulation and development of the domestic financial sector accompanied the transition to indirect methods of monetary control based on market mechanisms, the gradual removal of capital controls and the progressive integration of Portuguese financial markets with those abroad.

The paper is structured as follows. The next section describes the main developments in the money market and the measures taken to move from a method of direct monetary control, depending on compulsory credit ceilings, to one based on open market operations. Section 3 details the gradual liberalisation of capital transactions, with controls on direct and real estate investment, portfolio investment, financial credits and, finally, short-term capital movements being relaxed roughly in that order. Section 4 deals with exchange rate policy and the foreign exchange market, discussing the main developments since the introduction of a crawling-peg exchange rate regime in early 1978. The crawling peg was abandoned in April 1992, when the Portuguese escudo joined the exchange rate mechanism (ERM) of the European Monetary System (EMS). The final section describes the major steps taken towards the liberalisation of Portuguese securities markets. Although the share of the capital market in the overall financing of the economy is not yet very high, the last few years have seen significant progress, mainly as a result of the privatisation of major companies and the elimination of monetary financing of the government deficit.

2. Monetary policy and the money market

From the mid-1970s until the beginning of the 1990s, monetary policy in Portugal was based on credit ceilings, with the main interest rates being set administratively, and on a crawling-peg regime for the escudo, coupled with controls on foreign borrowing. The limits to the expansion of bank lending to the productive sector were fixed by the Bank of Portugal on the basis of a forecast for a broad monetary aggregate,[3] a projection of the change in net foreign assets[4] and the budgeted public sector borrowing requirement.

[3] Comprising money, quasi-money and, after 1985, Treasury bills held by residents.

[4] After August 1983, the projected change in net foreign assets was based on a target for the external current account and an estimate of net capital inflows.

Over time, monetary programming became increasingly difficult and monetary control based on credit ceilings less effective. First, as more marketable financial instruments became available and the public's sensitivity to changes in relative asset returns increased, the demand for money became rather unstable, making monetary programming harder.

Secondly, some public sector practices, in particular the direct financing of public enterprises by the Government (through Treasury operations) and the servicing of the external debt of some public entities and enterprises by the public sector, further complicated monetary management.

Thirdly, greater integration with the EC progressively eroded the effectiveness of capital flow controls. In particular, high domestic interest rates and favourable exchange rate expectations in the late 1980s resulted in large and unpredictable net capital inflows, making it more difficult to control liquidity growth.

Finally, with the growth of credit not subject to ceilings, the development of the capital market and, again, integration with the EC (which made it easier to circumvent credit controls), the authorities recognised the need to move to a more market-based implementation of monetary policy in which market-determined interest rates played a greater role.

The major problems underlying a regime of direct monetary control thus were, on the one hand, sometimes unexpected changes in the variables used in the calculation of the credit ceilings – the demand for money, net capital inflows and the public sector borrowing requirement – and, on the other hand, the decreasing usefulness of credit controls. However, moving to a more market-oriented approach was also likely to give rise to important adjustment problems. One important consequence of credit ceilings and sizable public sector deficits was that the banking system held a large share of its assets in the form of short-term, quasi-liquid securities. Under these circumstances, a sudden abolition of the credit ceilings would have led to a sharp expansion of credit and a lowering of interest rates, with undesirable implications for inflation and external equilibrium. Therefore, an appropriate programme for guiding the transition from an administered system to an indirect method of monetary control needed to be put together.

An important step in this transition programme was the introduction in 1985 of negotiable short-term Treasury bills, with maturities of three and six months, subsequently extended to one year, and the issuance in

1987 of fixed rate medium-term Treasury bonds, currently with maturities of up to ten years. These short and medium-term securities provided households with an alternative to bank time deposits. Through the issue of these public securities, the government deficit started to be financed outside the banking system at market interest rates. As other sectors also began to tap the capital market, the process of disintermediation of the banking system accelerated.

Capital inflows encouraged by high domestic interest rates and pre-announced changes in the exchange rate (crawling peg), however, complicated liquidity control. These autonomous capital inflows, which were particularly strong from 1988 onwards, prompted the authorities to make advance repayments on the external public debt. To curtail the liquidity effects of private capital inflows, the authorities also speeded up the easing of exchange controls on residents and increased the cost of companies' foreign borrowing by imposing a compulsory deposit requirement. Further measures taken to tighten monetary policy included increases in interest rates, higher reserve requirements and more binding credit ceilings.

However, the monetary authorities continued to face a dilemma: they were not able to control the level of the interest rate and the exchange rate at the same time, without retaining some controls on international capital movements. Such controls, however, militated against the liberalisation of capital flows, which was an important element in the process of European economic integration.

As monetary policy was thus becoming less and less effective, the authorities decided to take the necessary measures to allow transition to market oriented monetary management, chiefly comprising the gradual abolition of administratively fixed interest rates, the revision of reserve requirements, the absorption of excess liquidity and, at the institutional level, the revision of the central bank statutes.

(i) Gradual abolition of administratively fixed interest rates

Until 1987, interest rates were traditionally set by the Portuguese authorities. The process of gradual liberalisation of interest rates started in January 1987, when the interest rate ceiling on demand deposits of individuals was removed. This left only two deposit rates (the minimum rate for six-month time deposits and the rate on deposits made under a special "housing-savings regime") and two lending rates (the maximum rate for loans of up to six months and the rate for loans based on the housing-savings regime) administratively fixed.

In March 1987, the Portuguese authorities retained just one interest rate ceiling on lending operations, and in September 1988 this administratively fixed rate was also freed, with the exception of the rate on housing credit and on loans based on the housing-savings regime. The maximum interest rate applicable to these loans was abolished in March 1989. On the same occasion, maximum interest rates on demand deposits were introduced at a level equal to one-third of the minimum rate payable on six-month time deposits. This measure was aimed at giving those retail banks with a reasonable network of branches greater stability, so as to enable them to face the price competition from other, mostly newer banks.

In May 1992, the minimum rate payable on six-month time deposits ceased to be administratively fixed, and the rate payable on demand deposits was also freed. By that date, therefore, the gradual process of liberalisation of interest rates on banking operations was completed. Since then, all rates have become market-determined.

(ii) Revision of reserve requirements

Before the first revision of the system of legal reserve requirements in March 1989, different ratios were applied for demand deposits (15%), time deposits from 30 to 180 days (12%), those from 180 days up to one year (3%) and those of over 1 year (1%). At that time, a uniform reserve coefficient of 17% was introduced and reserve requirements related to time deposits with maturities of more than six months began to be remunerated. In addition to tightening the stance of monetary policy (the average ratio increased), the introduction of a uniform coefficient was aimed at facilitating monetary programming and control, given that the substitutability of monetary liabilities with different reserve coefficients affected the banks' demand for reserves.

In May 1990, a second step in the revision of the system of reserve requirements was taken. Under the new regime, all financial institutions whose core business involved the creation of monetary liabilities – including investment, leasing and factoring companies – became subject to the compulsory reserve requirements. At the same time, the basis for calculating the required reserves was widened to encompass all instruments included in the broad monetary aggregate L^- (liquid assets held by non-financial residents) as well as emigrant deposits. In the case of banks, which constitute the bulk of the financial system, reserve requirements were determined on the basis of weekly averages of daily figures and the regime became almost contemporaneous, i.e. only a three-day lag was set between banks' liabilities accounting periods[5] and their reserve maintenance periods.[6]

In February 1991, reserve requirements, which previously had been remunerated at different levels, became remunerated according to a formula,[7] which assured, at the margin, the same rate of remuneration for all reserves. The rates of remuneration of reserves were set quarterly (on the 4th of January, April, July and October) at values close to market rates to avoid disintermediation and delocalisation of deposits.

In November 1994, the authorities further reformed the system of minimum reserve requirements, in line with other European countries. The compulsory reserve coefficient was reduced from 17% (partially remunerated) to 2% (non-remunerated), thus releasing a huge amount of liquidity (about 13% of GDP), which was absorbed via the issue of central bank certificates of deposit with maturities ranging from two to ten years. These certificates could be used as collateral in repo-transactions or as contributions to the Deposit Guarantee Fund established in December 1994.

(iii) Absorption of excess liquidity

An important part of the transition to indirect monetary control was the agreement reached in December 1990 between the Government, the

[5] "Weeks" from the 1st to the 8th, from the 9th to the 15th, from the 16th to the 22nd and from the 23rd until the end of the month.

[6] "Weeks" from the 4th to the 11th, from the 12th to the 18th, from the 19th to the 25th and from the 26th up to the 3rd of the following month.

[7] The formula was:

$RR_t=[8\%*Bl_0+17\%*(Bl_t-Bl_0)]*n/365*Tj_t\%$

where:

RRt = amount of interest paid on reserve requirements in respect of the maintenance period t,

Bl_t = average eligible liabilities over the relevant computation period t,

Bl_0 = average eligible liabilities over the period 1st December 1990 to 3rd January 1991,

n = number of days of the computation period t,

Tj = rate of remuneration of reserve requirements.

Bank of Portugal and the banks on the launching of a large operation aimed at mopping up the excess liquidity, amounting more than 12% of GDP, that the banks held on deposit at the central bank. This operation – which took place between December 1990 and March 1991 – consisted in the issuance of government bonds to be acquired by the banks against their deposits previously held with the Bank of Portugal. The proceeds from the sale were used to cancel public debt held in the Bank of Portugal's portfolio and to prepay part of the general government external debt.

(iv) Reform of the central bank charter

A new Organic Law governing the operations of the Bank of Portugal was promulgated in October 1990. This law conferred a greater degree of autonomy on the central bank by explicitly prohibiting it from financing the state, other than through the underwriting of Treasury bills subject to negotiated conditions. It also strengthened the Bank Portugal's responsibilities and competencies in the area of prudential supervision.

The implementation of these reforms allowed the changeover from a system of direct quantitative limits on credit, in place since 1977, to one of indirect monetary control via open market operations. Following the suspension of formal credit ceilings in March 1990 and of credit growth recommendations at the end of 1990, monetary policy has focused on the setting of the cash reserves for the banking system to control liquidity growth, in accordance with the monetary programming framework presented in the Annex.

Since the beginning of 1991, intervention by the Bank of Portugal in the money market, within the reserve maintenance period, has taken four forms: regular intervention, fine-tuning repos, a late credit facility and an overnight credit facility. The first type of intervention determines the key rates for the system, that is, the interest rates which set indicative limits for the very short-term rates in the money market. In contrast with past practice, the Bank of Portugal has ceased to intervene daily, thus allowing interest rates to be more market-determined. Indeed, *regular intervention* takes place only on the first working day of each maintenance period and comprises operations of both supply and absorption of liquidity up to the first working day of the following period.

However, the Bank of Portugal can also resort to *fine-tuning repos* whenever it deems it necessary to stabilise the market during the reserve maintenance period, in particular when the overnight money market rate is diverging too far from the indicative band. The maturities of these occasional operations are set on a case-by-case basis. Usually, operations mature within the period in which they are undertaken or mature at the start of the subsequent period.

As was the case in September 1992 in response to ERM turmoil, the Bank of Portugal can on occasion suspend its regular forms of intervention and resort to liquidity auctions at market-determined interest rates. The purpose is to allow domestic interest rates to rise and so penalise speculation against the escudo.

The *late credit facility* is an exceptional facility for providing liquidity on the last working day of the reserve maintenance period when the market is closed and compliance with the reserve requirements needs to be ensured. This credit facility is overnight and bears a penalty rate, which is the higher of: either the rate of provision of liquidity on the last regular auction plus 1 percentage point, or the highest rate on interbank money market transactions of the same day for maturities of up to five days plus 1 percentage point.

A *daily facility*, which allows banks subject to reserve requirements to raise funds overnight (up to a limit for the whole banking system of Esc. 100 billion), was created in June 1993. The maximum limit for each institution is established according to their respective reserve requirements, and the interest rates for these operations are pre-announced and may be changed each day.

The different types of intervention associated with reserve maintenance periods were initially undertaken in the form of repurchase agreements using Treasury bills, but since mid-1991 operations aimed at absorbing liquidity have been carried out mainly with central bank monetary certificates, the longest maturity of which was extended for this purpose from 7 to 14 days. Apart from the short-term intervention operations focused on reserve maintenance periods, the Bank of Portugal has also conducted liquidity-draining operations at longer maturities, given the existence of a structural liquidity surplus associated with the strong capital inflows mentioned above.

These intervention operations have been carried out either through the sale of central bank intervention bills (chiefly at maturities of one month and six months), or through the issue of Treasury bills (at three months, six months or 12 months) for monetary purposes. In the latter case, the proceeds of the issues have been deposited in a specific Treasury account with the Bank of Portugal and have been remunerated so that the operation is neutral for the Treasury.

On 6th April 1992, the escudo joined the ERM with a wide fluctuation band of ±6 per cent and in December of the same year Portugal lifted all remaining capital controls (see the next section). Given this new institutional set-up, the Bank of Portugal stopped specifying a target for liquidity growth in 1993. Keeping the exchange rate stable has become the key intermediate target of monetary policy, to be achieved mainly through open market operations.

3. Liberalisation of capital movements

Exchange rate policy, together with capital controls on external transactions, have played an important role in Portugal since the mid-1970s. Given the difficulties faced by the Portuguese economy following the revolution of April 1974 and up until the accession to the EC in 1986, the exchange control regime (which covered most external current and capital account transactions) helped to contain or reduce the difficulties of the external sector. During this period of financing difficulties stemming from persistent and wide current account deficits, exchange controls were mainly imposed on transactions that gave rise to outflows. In essence, they aimed at guaranteeing that foreign exchange reserves were maintained at an adequate level and, at the same time, at preventing or hindering capital flight.

Apart from the quantitative restrictions on imports of some commodities necessitated in the context of an escudo subject to a programmed rate of depreciation (crawling peg), measures were also imposed with the objective of dampening speculation against the Portuguese currency, including the imposition of maximum terms for advance payments for imports and a penalty exchange rate to be applied to export payments made after the legal time limit.

The accession to the EC in 1986 marked the beginning of a programme of capital account liberalisation, initially in the framework of the single market and subsequently within the context of EMU, with a timetable agreed at the time of Portugal's accession and revised in 1988 (Directive 88/361/EEC of 24th July 1988).

The liberalisation strategy defined in the Treaty of Accession gave priority to external transactions closely aligned with the fundamental principles set forth in the Treaty of Rome (free movement of goods, persons and services and the right of establishment). It included the following steps:

(i) the immediate and unconditional liberalisation of international trade and invisibles transactions on the current account (other than travel expenditure and the provision of banking and financial services) as well as of those capital transactions which ensured the proper functioning of the common market (e.g. short and medium-term credits related to current transactions in which a resident participates) or assisted the revival of the Portuguese capital market (purchases by non-residents of quoted domestic securities);
(ii) the determination of transitional periods during which capital operations (mainly capital inflows) would be progressively liberalised;
(iii) the postponement of the terms agreed for the liberalisation of those capital transactions which might complicate monetary and exchange rate policies, in particular flows showing high sensitivity to interest rate differentials vis-à-vis the rest of the world.

The Portuguese authorities adopted the principle of liberalising capital movements on a gradual and "erga omnes" basis, giving priority in the period 1986–88 to those capital transactions most directly linked to international trade in goods and services and to the right of establishment. On a number of occasions, liberalisation measures were introduced ahead of the schedule agreed at EC level, most notably Portuguese investment overseas (including direct investment, real estate investment and portfolio investment).

The foreign exchange restrictions which were maintained or whose reintroduction proved necessary in 1990 and 1991 were basically targeted at those capital inflows which were most sensitive to interest rate differentials or changes therein. Indeed, from mid-1990 onwards, exchange restrictions were applied more selectively and judiciously to short-term capital movements (inflows) and non-trade-related external borrowing. The huge capital inflows then recorded, induced by sizable interest rate differentials as well as by expectations of some appreciation of the escudo, complicated the management of monetary policy. Consequently, to curb the inflows and ensure a significant degree of autonomy required for effective monetary policy, a set of measures was implemented, comprising:

(i) the prohibition of forward transactions (sales and acquisitions) in escudos against foreign currencies with non-residents (except for hedging purposes) in June (purchases) and October (sales) 1990;
(ii) the introduction of a compulsory non-remunerated deposit of 40% of the countervalue in escudos of external borrowing in July 1990;
(iii) the imposition of a compulsory non-remunerated deposit of 40% of balances on escudo-denominated accounts held by non-residents with resident credit institutions in February 1991;
(iv) the subjection of repurchase agreements against domestic securities to prior authorisation by the Bank of Portugal in February 1991;
(v) the subjection of non-residents' purchases of floating rate Portuguese securities (indexed to money market rates) to prior authorisation by the Bank of Portugal in July 1991.

As noted before, these restrictions were temporary. The process of liberalisation continued with the abolition in August 1991 of the limits on the maximum maturity of forward foreign exchange transactions. In December of the same year, the maximum term of foreign-currency-denominated accounts held by non-residents with resident credit institutions and restrictions on such accounts held abroad by residents were lifted, and residents were freely allowed to hold foreign-currency-denominated accounts in Portugal.

Between March and July 1992, the compulsory deposit requirement on external financial borrowing was progressively cut from 40% to 25% and was abolished altogether in September of that year. At the same time, the full liberalisation of medium and long-term external borrowing was completed.

The escudo joined the ERM in April 1992, ahead of the complete liberalisation of capital movements (in particular the liberalisation of transactions of a short-term, monetary nature), which took place in the course of the second half of the year. In August 1992, resident purchases of non-listed, foreign-currency-denominated bonds and of foreign money market securities were freed. Also liberalised were financial loans to non-residents, with the exception of those denominated in escudos with a maturity of one year or less. In November 1992, all restrictions on non-resident purchases of Portuguese floating rate bonds and other similar securities, as well as on short-term external financial borrowing, were lifted. Finally, in December 1992, it was decided to free all remaining transactions with non-residents falling within the authority of the Bank of Portugal, in particular the remuneration of escudo accounts held by non-residents, accounts held abroad by residents, non-resident purchases of Portuguese money market securities, short-term escudo-denominated loans made available to non-residents, forward foreign exchange transactions, futures and options. Since December 1992, capital movements have thus been completely free, subject to the relevant EC regulations, specifically those laid down by the Treaty of Rome and Directive 88/361/EEC.

4. Exchange rate policy and the foreign exchange market

Over the period 1978–85, the Portuguese authorities' exchange rate policy was based on a crawling-peg regime, aimed at offsetting the inflation differential between Portugal and its main trading partners. The purpose of this policy was to improve, or at least to maintain, external competitiveness.

Following a temporary suspension between November 1985 and April 1986, the crawling-peg regime was reinstated, but until December 1988 a less accommodative stance was adopted in that the rate of devaluation was progressively reduced in line with quarterly inflation targets. As from 1989, there was a gradual de facto move from this partly non-accommodative policy to a policy of progressively shadowing the EMS, which Portugal officially joined on 1st October 1990.

At that date, exchange rate policy changed formally: a composite index of the leading currencies participating in the ERM (weighted by Portuguese foreign trade) was constructed and was adopted as a reference medium-term objective for exchange rate policy. The escudo was allowed to fluctuate according to market pressures within a set, non-published range. To guarantee the smooth functioning of the market, scope was given to the Bank of Portugal to intervene on an ad hoc basis. This showed the clear commitment of the Portuguese authorities to participation in the ERM. In April 1992 Portugal indeed entered the ERM.

Up to 1985, the foreign exchange market was centred on the Bank of Portugal. Credit institutions were allowed to hold a maximum amount of foreign currencies as working balances, based on their escudo liabilities to clients. Except in the case of banknotes or coins, foreign currency conversions could only be carried out with the Bank of Portugal. The Bank also determined the exchange rates to be used in transactions between the banks and the general public.

In the Treaty of Accession to the European Community (signed in June 1985), Portugal committed itself to taking the necessary steps to align the functioning of its foreign exchange market with that of the other EC countries. The escudo therefore began to be quoted as of July 1985 in a foreign market, Paris being selected for this purpose. In order to regulate the escudo market abroad and reduce the gap between the rates on external markets and the Lisbon rates, a protocol was signed with the Bank of France in March 1986, which stipulated that the latter could intervene on behalf of the Bank of Portugal in the Paris fixing session.

The first stage in the introduction of an exchange market in Portugal took place in October 1985, when a spot interbank exchange market started operating. Next, the banks' clients were allowed to choose between the rates negotiated among institutions or the rates resulting from the fixing session. These foreign exchange transactions with clients had to have a counterpart in escudos and to be related to goods, services or capital transactions with non-residents.

As of May 1986, credit institutions' scope for operating in the foreign exchange market was extended to cover arbitrage operations in foreign currencies among themselves and with other banks domiciled abroad. Credit institutions were also authorised to open or take among themselves deposits in foreign currency at up to one year.

These developments paved the way for the creation in February 1987 of a forward exchange market with a structure similar to that of the spot exchange market, except for the intervening role of the Bank of Portugal. Banks could carry out forward operations with the Bank of Portugal, but only at the latter's initiative. Unlike in the spot market, no official exchange rates were set for forward operations.

In addition to credit institutions, resident exporters or importers of goods, services or (legally authorised) capital were allowed to deal in the forward exchange market, with the rates being freely negotiated among the parties. The maximum term of the operations was initially set at six months, but was extended to one year in March 1988 and completely liberalised in August 1991.

Purchases and sales of one foreign currency against another were legally confined to credit institutions operating in the Portuguese market. Banks were free to act within the positions allocated to them. In practice, each bank was allocated a ceiling on open (short and long) positions in foreign exchange, which in turn was related to the maximum daily exchange risk – spot position plus forward position – which each bank could incur.

The development of the forward exchange market was an important innovation in the Portuguese financial system. Besides providing a useful financial hedging instrument to economic agents with significant external trading and investment interests, it also established a closer link between the foreign exchange market and the domestic money market via the interbank market.

On the basis of studies undertaken with the participation and cooperation of credit institutions on how to change the procedure for the determination of the official exchange rate, banks were invited to attend the fixing sessions from 1st October 1987. This development represented an important step towards the liberalisation of the exchange market. Gradually, the process of determining exchange rates on the basis of supply and demand was extended to all segments of the market. As official exchange rates ceased to be administratively fixed, the Bank of Portugal started to intervene in the market in order to stabilise the exchange rate at a level consistent with the stance of its exchange rate policy.

In March 1989, banks ceased to be subject to limits on their spot positions, having only to comply with the regulations on their overall foreign exchange position. At the same time, spot purchases/sales of foreign currency against escudos by resident credit institutions from/to any non-residents were authorised. These steps, together with the authorisation of payments to non-residents in escudos in December 1988, generated exceptional turnover growth in the spot and forward exchange market (in particular, in the swap market) and led to the stabilisation of external spot quotations for the escudo, more in line with domestic quotes.

On 1st October 1990, a number of rules governing the fixing sessions were modified. In particular, all currencies began to be quoted directly against the escudo and the Bank of Portugal ceased to guarantee quotations. Until then, the US dollar had been the first and only currency to be quoted against the escudo.

On 1st September 1991, fixing sessions, which had been a regular daily event over the previous four years and had been conducted in the presence of market operators, ceased to be held. Notwithstanding the contribution of the fixing sessions to the development of the foreign exchange market, their gradual loss of importance relative to activity in the interbank market made them dispensable, much in line with the practice in several other European countries. The determination of indicative official exchange rates, purely for reference purposes, began to be made on the basis of a procedure involving daily consultation of the interbank foreign exchange market by the Bank of Portugal.

The formal change in the stance of exchange rate policy in October 1990 led to an appreciation of the escudo and to a process which culminated in the entry of the escudo into the ERM in April 1992 and in the full liberalisation of capital movements in December of that year, as described in the previous section.

5. The capital market

The Portuguese capital market, still in its infancy and with a high speculative component, was deeply affected by the closing of the stock exchanges in 1974. It took until January 1976 for the Lisbon Stock Exchange to reopen, although only for bond transactions. Trading of shares on the Lisbon floor resumed in February 1977, while dealings on the Oporto Stock Exchange began anew in January 1981.

Between 1975 and 1981 only Treasury bonds were issued. In 1981, public enterprises began issuing bonds through public subscriptions, while capital increases of leading companies, which had been nationalised in the wake of the April 1974 revolution, were carried out through budget appropriations. As a result, turnover on the stock exchanges continued to be rather depressed – and almost exclusively based on Treasury bonds – for quite a long period of time following their reopening.

As already noted, the opening of the Portuguese banking system to the domestic and foreign private sector in February 1984 was one of the first steps in the process towards a liberal financial system. An identical trend towards greater freedom was also recorded with regard to the capital market. In order to foster the growth of the securities market, the Government decided:

(i) to grant tax incentives for investment in the capital market, both for securities holders and issuing companies, in 1985;

(ii) to create an entity – the Securities Market General Supervisor – with powers to supervise brokers and other securities market participants in October 1987;
(iii) at the same time, to reorganise the Stock Exchange National Council, whose main duty it was to inform and advise the Minister of Finance on subjects relevant to the securities market;
(iv) to adapt the listing requirements for securities on the Portuguese stock exchanges to EC rules in July 1988.

However, it was only in 1991, when the Capital Market Code was enacted, that major changes were implemented in the legal, institutional and operating framework of the Portuguese securities market. The main underlying principles of the Capital Market Code were the globalisation of the supply and demand in the securities market, on the one hand, and the progressive liberalisation of the primary and secondary market, on the other. These principles became reflected in:

(i) the privatisation of the stock exchanges;
(ii) a new structure for the stock market;
(iii) the implementation of a nationwide clearing and settlement system, supported by a Central Securities Depository, similarly of national scope.

As a result, the management and functioning of the stock exchanges have now become the responsibility of private non-profit associations composed of brokers and dealers (member associates) and banks (non-member associates).

According to the Capital Market Code, each stock exchange must have a *market with official quotations* for companies complying with the specific market-listing criteria, as well as a *second market* for small and medium-sized companies, in which funds can be obtained on less strict admission terms. In addition a *market without quotations (unlisted market)* can be established for the remaining companies which fulfil the general stock market admission criteria. In June 1994, a *special market for trading blocks* was created, intended for trading and registration of large lots of bonds or similar securities. This overall market structure characterises the Lisbon Stock Exchange, but not the Oporto Stock Exchange. In fact, in the wake of a market specialisation agreement signed between the associations of the two Portuguese stock exchanges in June 1994, all spot market transactions have tended to be concentrated in Lisbon while the Oporto Stock Exchange became responsible for the launching of the options and futures markets which happened in the first half of 1996.

Annex

Monetary programming used by the Bank of Portugal in the period between the abolition of credit ceilings and the entry of the escudo into the ERM

In the early 1990s the Bank of Portugal's interventions in the money market were broadly based on the following monetary programming framework:

1. Target for money demand/monetary aggregate L^-, excluding liabilities of non-monetary financial institutions.
2. Liabilities included in L^- not subject to reserve requirements (e.g. currency in circulation).
3. Liabilities subject to reserve requirements not included in L^- (e.g. deposits of emigrants).
4. (= 1 – 2 + 3) Base of incidence of the reserve requirements of monetary institutions.
5. Coefficient of operational (compulsory plus estimated voluntary) reserves.
6. (= 4 x 5) Demand for reserves of monetary institutions.
7. Ad hoc estimate of the reserve requirements of non-monetary financial institutions.
8. *(= 6 + 7) Target for the reserve requirements of the financial system.*
9. Currency in circulation (plus cash in vaults).[8]
10. Net foreign assets of the Bank of Portugal.
11. Net credit to the administrative sector by the Bank of Portugal.
12. Other items of the balance sheet of the Bank of Portugal, net (liabilities minus assets).
13. *(= 8 + 9 – 10 – 11 + 12) Intervention in the money market (+ = supply of liquidity; – = absorption of liquidity).*

[8] For operational reasons, the reserve requirements comprise only deposits with the Bank of Portugal.