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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

Portugal: Caetano's Economic Policies

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
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INTELLIGENCE MEMORANDUM

Portugal: Caetano's Economic Policies

Introduction

1. Dr. Salazar's relinquishment of power two years ago, and his death in July 1970, set the stage for change under Portugal's new leader, Dr. Marcello Caetano. Although there has been little political relief in the short period since his accession, Dr. Caetano's economic policies are promising. A significant facet of Portugal's new economic outlook has been an inclination toward a stronger European orientation -- that is, association with the European Community (EC).

2. This memorandum reviews the economic problems inherited by Dr. Caetano, describes Portugal's moves toward economic modernization, and assesses the probable effects of the dissolution of the European Free Trade Association (EFTA) 1/ on Lisbon's future international economic orientation as well as the likely implications these events will have for the government's colonial policies.

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1. The European Free Trade Association (EFTA) consists of nine member countries: Austria, Denmark, Finland, Iceland, Norway, Portugal, Sweden, Switzerland, and the United Kingdom. A free trade area, which is the underlying concept for the EFTA, differs from a customs union in that it does not provide for a common external structure of tariffs for trade with non-members.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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Summary and Conclusions

3. For many years of Salazar's reign, Portugal enjoyed political stability and moderate economic growth. However, fiscal conservatism, widespread government controls, and maintenance of a protective environment for many industries held economic development below its potential and below the achievements of most other countries in southern Europe. Portugal's entry into the European Free Trade Association in 1960 stimulated the economy, but the rising burden of a war in Africa combined with growing emigration had the opposite effect.

4. Caetano, since his accession to power in late 1968, has publicly emphasized the need for economic modernization. To this end he has begun to dismantle Portugal's longstanding industrial licensing control system, provided new incentives for foreign investment in technologically advanced industries, increased expenditures on education, and promoted domestic investment by offering fiscal incentives and initiating reforms of the financial markets. However, he has not reduced Portugal's commitments in the overseas territories.

5. In the next few years, Caetano will probably proceed cautiously toward further economic liberalization in order to avoid alienating the conservative military and financial power structure on which his political life depends. Nevertheless, he should be able to bring about considerably higher economic growth rates than the past average of 5%. Portugal's continued backwardness in many economic areas presents opportunities for relatively rapid improvement. Improved incentives and the more expansionary fiscal policies being launched should raise investment. And, with foreign exchange reserves very large, there is little risk that more rapid expansion of investment and production will soon lead to balance-of-payments difficulties. Should the United Kingdom, Denmark, and Norway be admitted to the European Community (EC), Portugal's need to reach an accord with the EC will become urgent. Although Lisbon desires an association agreement with the EC, so long as it rigidly upholds its present colonial policy in Africa, it will most likely have to settle for a preferential agreement of the type extended to Spain.

Discussion

Background

General

6. During the 40 years of economic tutelage under Dr. Salazar, Portugal 2/ remained one of Western Europe's poorest and least developed countries. In the post-war period, gross national product (GNP) grew at an average annual rate of 5% (see Table 1). Although per capita GNP equalled

Table 1

Comparison of Average Annual Growth of GNP for Selected Countries

Percent

Country	1951-60	1961-65	1966-70
Greece	6.2	8.0	7.0
Turkey	5.6	4.3	6.8
Spain	5.0	8.6	6.1
Portugal	*4.5*	*6.4*	*5.5*

that of Spain as recently as 1960, it is now the lowest in Europe, excluding Turkey (see Table 2), and significant structural impediments to growth persist.

7. The relatively poor performance of the economy under Salazar in great measure resulted from his economic policies. These included a preoccupation with balanced budgets and tight money, intended to assure the stability of the escudo; a corporative system that accorded little opportunity to potentially enterprising individuals outside the privileged class; and, until the 1960s, a rather mercantilist attitude regarding relations with the outside world that led to the accumulation of large gold and foreign exchange reserves.

2. Hereafter refers to metropolitan Portugal, which includes the Azores and Madiera Islands.

Table 2

Comparisons of Development of Selected West European Countries in 1969

Country	GNP a/ per Capita (US $)	Electric Power per Capita (Kilowatt Hours)	Literacy (Percent)	Telephones per Thousand Persons
Turkey	370	115	55	N.A.
Portugal	*570*	*630*	*65*	*65*
Spain	870	1,380	90	99 b/
Greece	940	775	82	65 c/
Ireland	1,180	1,554	98	94 d/
Italy	1,550	2,155	94	143 d/
Austria	1,680	3,640	98	169
Finland	1,960	3,500	99	71
United Kingdom	1,970	4,270	98-99	233
Netherlands	2,190	2,570	98	228
Belgium	2,360	2,860	97	198
France	2,590	2,580	96	150
West Germany	2,700	3,407	99	186
Norway	2,810	15,000	99	270
Denmark	2,850	2,400	99	309
Switzerland	2,960	4,210	98	434
Sweden	3,590	7,000	99	518

a. National currencies were converted at the official rate of exchange.
b. 1967.
c. 1966.
d. 1968.

8. Budgetary policies were seldom designed to stimulate economic growth and development. Portugal was successful in balancing its budget until the early 1960s, when it was forced to borrow 15% to 20% of total expenditures to meet rising military outlays.

9. The government exercises an inordinate amount of control over the private sector by making all important decisions from the national down to the company level through a corporative network Salazar established in the mid-1930s. 3/ Each Portugese industry is represented by a corporation, comprising a guild that all employers are obliged to join and a labor association with compulsory membership for all employees. The extensive powers of these corporations -- including decisions regarding investment outlays, production levels, and new plant locations -- are, in turn, subject to close government supervision. The corporations' authority to prohibit the entry of new firms has sheltered existing industry from domestic competition, and high tariffs have protected them from foreign competition. A relatively small number of financial holding companies own most of Portugal's productive and distributive capacity.

10. Large gold and foreign exchange reserves were accumulated during Salazar's reign, notwithstanding the needs for investment capital. These reserves were sufficient to pay for 20 months of imports as recently as 1959, and since have been consistently equivalent to more than a year's imports. They were generated by a continuing series of balance-of-payments surpluses achieved by the Portugese escudo area. 4/ Because of a large deficit

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3. In Spain, prior to the 1960s, Franco employed a large network of quasi-government agencies toward the same ends as those served by Portugal's corporations.

4. Including, with metropolitan Portugal, the overseas provinces of Angola, Cape Verde, Macao, Mozambique, Portuguese Guinea, Portuguese Timor, the Principe Islands, and Sao Tome. The escudo area is both a semi-free trade area and a semi-integrated monetary system. The official stock of gold and foreign exchange, earned through non-escudo area transactions of both the metropole and the overseas provinces, are centralized in Lisbon with no distinctions made among their contributors.

on trade account, metropolitan Portugal's balance of payments with non-escudo countries was, until 1966, usually in deficit. This deficit, however, was more than offset by a favorable balance with the overseas provinces. More recently, Portugal's overall balance with non-escudo countries has been in surplus. Remittances from abroad, tourist receipts for the metropole, and expanded exports to EFTA countries account for much of the improvement (see Table 3).

11. Salazar's dedication to stability entailed a heavy price. The Portugese economy was adversely affected by insufficient investment, a paucity of skilled workers, and inadequate management. A still primitive although important agricultural sector -- which accounted for 18% of GDP in 1969 (see Table 4) -- expanded at an annual rate of only about 1% in the 1955-68 period. The manufacturing sector, although growing 7.5% annually, has had to be sheltered from import competition.

Insufficient Investment

12. Although the rate of fixed capital formation has gradually increased, it is still low for a southern European country. Fixed capital formation averaged less than 18% of GNP in 1958-68 compared with more than 22% in Greece or Spain, countries at an equivalent stage of development. Portugal's relatively low rate of capital formation is attributable to both a paucity of investment opportunities and inadequately developed institutions for channeling domestic savings to potential investors.

13. The lack of investment opportunities is due to structural shortcomings in both agriculture and industry. An archaic landownership system has limited the potential for higher agricultural profitability. Two-thirds of the farm population is concentrated on subsistence farms in the north where holdings are too small to permit efficient use of land, machinery, and manpower. In the south, the predominant system of *latifundia*, which are owned by absentee landlords and operated by tenant farmers, provides little incentive for soil improvement or new methods. Investment in industry has been affected by the low degree of competition among firms and the attendant lack of entrepreneurial

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Table 3

Balance of Payments of the Escudo Area a/

Million US $

	1964	1965	1966	1967	1968	1969
Current account	17	-37	38	114	44	55
Metropolitan Portugal	-111	-128	-40	30	-38	43
Trade balance	-214	-297	-340	-333	-383	-389
Tourism	68	82	178	186	135	92
Private remittances	79	108	158	209	263	392
Other invisibles	-44	-21	-36	-32	-53	-52
Overseas provinces	128	91	78	84	83	12
Capital account	91	103	102	84	89	15
Metropolitan Portugal	93	109	109	95	95	-20
Overseas provinces	-2	-6	-7	-11	-6	35
Net errors and omissions	-1	2	-5	11	13	10
Overall balance	*107*	*68*	*135*	*203*	*146*	*80*

a. Because of rounding, components may not add to the totals shown.

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Table 4

Gross Domestic Product
and Employment by Sector

	GDP in 1969		
	Million US $	Percent of Total [a]	Employment in 1967 (Percent)
Agriculture, forestry, and fishing	862.9	17.7	34.7
Manufacturing and mining	1,869.6	38.3	25.6
Construction	198.0	4.1	8.5
Services	1,950.6	40.0	31.2
Total	*4,881.1*	*100.0*	*100.0*

a. Because of rounding, components may not add to the totals shown.

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initiative and also by an industrial attitude that is still, although to a diminishing degree, excessively oriented to Portugal's small domestic market.

14. Viewed from the supply side, inadequate credit mechanisms have existed to support a much higher level of investment. Portugal's money and capital markets are too underdeveloped to mobilize large amounts of private savings. The government, although an important source of medium- and long-term credits, has been unwilling to fill the gap completely. Several opportunities for converting added income into investible funds have remained unexploited because of this. For example, little of the increased income generated by the expanded markets within EFTA in the 1960s was invested and the large increases in emigrant remittances are largely used to increase consumption.

Scarcity of Skilled Workers

15. The low educational levels of and technical training available to labor have hampered economic development, particularly in industry. Only 60% of the eligible students receive as much as six years of schooling. About 35% of the population is still illiterate. As a result, many employers have been unable to fill vacancies requiring skill and experience qualifications.

16. This shortage of skilled workers and technicians has been exacerbated by a consistently large net emigration during the 1950s and 1960s. Emigration, spurred more recently by attractive wages in other European countries and by a four-year stint in the military service -- usually in Africa -- that all young men are required to serve, reached a peak of nearly 120,000 in 1966 -- a level equal to the natural increase in the labor force (see Table 5). The flow, initially encouraged by the government because of worker remittances and domestic unemployment, became a serious concern in the late 1960s as skilled labor became relatively scarce. Many of the emigrants left the industrial sector where they had learned useful skills, and industry had to replace them with newly arrived unskilled workers migrating from the farms. All told, because of emigration and increases in the armed forces, the civilian labor force has not increased in a decade.

Table 5

Portuguese Emigration a/

Year	Number of Emigrants (Net) b/	Civilian Labor Force
1945-49 (annual average)	4,583	N.A.
1950-54 (annual average)	34,887	N.A.
1955-59 (annual average)	30,224	N.A.
1960	30,458	3,130,000
1961	31,740	3,060,000
1962	31,870	3,080,000
1963	37,349	3,100,000
1964	53,886	3,100,000
1965	87,488	3,070,000
1966	118,519	3,070,000
1967	90,949	3,070,000
1968	79,067	3,090,000
1969	69,153	N.A.

a. Including only those workers and relatives who emigrate legally. There have been, in addition, substantial numbers of illegal emigrants. These probably average at least 5,000 per year.
b. The number of emigrants who have returned to Portugal each year have been netted from the total numbers of annual emigrants.

17. The increased demand for skilled workers and the high rate of emigration have combined to cause an accelerated rise in wages since the early 1960s. The resulting increases in labor costs, added to exisiting supply bottlenecks and a rising demand trend, have exacerbated inflationary pressures. Consumer prices rose at an annual rate of about 6.5% during 1960-70 following a prolonged period of stability.

<u>The Costs of Colonialism</u> 5/

18. The economic burden to Portugal of maintaining its African territories of Angola, Mozambique, and Portugese Guinea has been considerable since a major rebellion erupted in Angola in 1961. Financial and managerial resources have had to be diverted from crticial domestic economic problems and projects. Portugal's regular military forces have almost tripled in size since 1959 and about two-thirds of the 210,000 men are tied down in Africa. Although effectively providing security for most of the heavily populated areas, the army has made little headway in ending ten years of fighting. Lisbon's military expenditures rose sharply during the 1960s following the outbreak of hostilities in Africa and, as a result, now average about 7% of the country's GNP (see Table 6). Of these military expenditures, 60% have been absorbed by Portugal's military requirements in Africa. Moreover, with the civilian labor force nearly stable and GNP rising steadily in Portugal, labor productivity has been growing rapidly and unemployment has been progressively absorbed. This means that the real cost of maintaining and expanding the armed forces has increased -- military service is less and less a refuge for underemployed rural labor and more and more of a diversion of labor from needed civilian uses.

19. Portugal also has been contributing heavily to economic development in Angola and Mozambique, hoping both to encourage additional white settlement through increased investment in infrastructure and mineral resources and to demonstrate to the black inhabitants that their economic welfare is enhanced under Portugese rule. During the second half of

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Table 6

Portugal's Military Expenditures

Year	Military Expenditures (Thousand US $)	Percent of Total Expenditures	Percent of GNP	Approximate Number of Military Personnel a/
1959	98,080	28.9	4.3	75,000
1960	105,140	26.7	4.2	79,400
1961	171,190	36.6	6.4	84,000
1962	199,780	38.7	6.9	116,500
1963	199,090	36.5	6.4	134,100
1964	224,390	37.5	6.6	139,800
1965	232,350	36.5	6.2	160,500
1966	257,140	37.3	6.3	178,600
1967	333,050	41.0	7.2	197,500
1968	371,910	42.4	7.4	198,200
1969	374,920	39.3	6.9	210,000

a. Regular military, excluding the National Republican Guard and Fiscal Guard, which together have numbered from 12,000 to 15,000 personnel.

the 1960s, Lisbon made more than $125 million in official long-term loans (net) to its three African provinces, contributed between one-fourth and one-third of that amount in grants, and guaranteed substantial amounts of private loan commitments.

International Exposure and EFTA

20. Portugal's entry into EFTA in 1960 was Salazar's most notable economic accomplishment. The consequent growth in trade has been very important to Portugal because its domestic economy provides neither the market nor the technical capabilities required to sustain economic expansion. EFTA extended special privileges to Portugal because of its less developed status. Thus Lisbon has been permitted to postpone tariff cuts for many of its imported industrial products until 1980, yet since 1967 Portugal has benefited fully from the abolition of import tariffs by other EFTA members.

21. During the 1960s Portugal's exports grew nearly 11% annually (see Table 7) compared with slightly more than a 1% annual increase during 1952-60. Moreover, the composition and direction of Portugese exports changed. Traditional exports -- cotton textiles, cork, wine, and olive oil -- while increasing in absolute terms, declined in importance compared with new manufacturing exports -- chemicals, light machinery, and a wider variety of consumer goods such as processed foods. For example, as total exports expanded at a rate of 9.3% annually during 1966-69, exports of wood and cork increased at an annual rate of 1.7%, cotton textiles at 5.8%, and wine at 8.4%; but exports of metals and metal products increased 14.0%, machinery and transportation equipment 31%, and canned tomatoes 13.9%. Exports to the Portuguese territories declined from 29% of total exports in 1959 to 25% in 1969, as exports to EFTA countries increased to 35% of the total. The export expansion, in turn, stimulated a sharp increase in the annual growth rate of Portugal's GNP from an average of 4.5% during the 1950s to about 6% during the 1960s. Greater and more diversified industrial production accounted for most of the improvement.

Table 7

Growth of Portugal's Exports

Thousand US $

Year	Total Exports	Total Imports	Exports to Territories	Exports to EFTA	Exports to EC
1957	288,314	501,639	75,566	123,520	
1958	288,652	480,329	79,211	124,496	
1959	290,485	475,859	83,988	120,508	
1960	327,239	545,576	83,688	143,947	
1961	326,014	656,095	75,687	70,615	70,874
1962	369,803	585,375	83,160	74,888	86,026
1963	418,232	656,218	99,424	91,708	91,742
1964	515,853	776,345	128,920	129,902	106,847
1965	576,440	923,574	144,001	158,091	119,513
1966	619,537	1,022,833	145,986	179,260	120,499
1967	701,432	1,059,221	171,041	240,511	116,740
1968	762,315	1,177,664	190,454	261,561	126,804
1969	822,567	1,230,709	208,617	285,849	149,310
1970 a/	793,064	1,297,031	198,466	280,982	144,075

a. *January-November.*

22. Since joining EFTA, Portugal has welcomed foreign investment to reduce production costs and improve its international competitive position. Foreign investment -- equally divided between direct and portfolio investment -- rose from $7.5 million in 1962 to about $40 million in 1968. Accounting for only 4% of fixed capital formation in 1960, foreign investment now contributes nearly 20% of fixed investment. Because of low wage rates, most foreign capital has been attracted to labor-intensive industries, particularly food processing, textiles, and electronic equipment assembly, directed mainly to exports.

23. Another outgrowth of the increased contact with the outside world has been the substantial influx of tourists. The number of foreign tourists has expanded rapidly during the past decade, attaining a peak of nearly 2.8 million in 1969, compared with only 350,000 in 1960. Tourism ranks third to merchandise exports and emigrant remittances as a source of foreign exchange -- $92 million in 1969 (see Table 3).

Caetano's New Policies

A Changing of the Guard

24. When Caetano was selected as the new prime minister in September 1968, he too had to win approval of the same powerful group of families with vested interests in land, industry, and the military that had formed an alliance with Salazar. Accordingly, he has been at least tacitly committed to uphold some of the basic ideas that characterized the Salazar era.

25. It is significant that, in light of the inherent constraints of his office, Caetano has adopted -- albeit cautiously -- a more progressive brand of economic policy than his predecessor. From the outset he placed considerable emphasis on greater professionalism in public administration and modern economic techniques and decision-making. He has appointed a number of young "technocrats" to key ministerial posts, some of whom were formerly members of the opposition to Salazar and all of whom are strong advocates of industrial modernization and more progressive economic policies.

New Government Initiatives for Economic Structural Reform

26. The Law of Means (the annual economic policy guidelines) for 1970 and 1971, the first to be drafted entirely by Caetano's economic advisors, have established distinctly new policy directions. The two most noteworthy characteristics reflected in these annual statements have been: first, that the government is dedicated to rapid growth and development, in contrast to Salazar's paramount preoccupation with stability; and second, that unprecedented responsibilities are assumed by the government for planning and stimulating this growth. For example, much more extensive use has been made of expansionary fiscal and monetary policies under Caetano than ever before.

27. As in 1970, the Law of Means for 1971 notes especially the pressing need for increased fixed capital formation through both public and private investment. Public investment needs join the requirements for the defense of the African territories as a top-priority claim on the budget, a position that had been exclusively reserved to the latter throughout the previous decade. Expenditures on the development of Portugal's economic and human resources as a share of the total government expenditures increased somewhat from 37% in 1969 to about 44% planned for 1971. In absolute terms, however, the increase is more impressive: $353 million and $485 million, respectively. The need for social and economic infrastructure, such as expansion of the country's educational facilities, is growing more urgent. By extending the period of compulsory schooling for all students from six to eight years, Caetano expects eventually to improve the skill levels of Portuguese workers, with an attendant boost in labor productivity. The regime is also demonstrating serious concern with past neglect of agriculture by sharply increasing annual allocations for projects such as irrigation, land improvement, and rural roads.

28. Nonetheless, Caetano is looking primarily to increased private investment, with less interference by the government, to foster development. He is especially promoting industrialization as the

main pillar of the country's economic future. Priority is being given to developing "modern" growth industries, mainly engineering and chemicals, and to revitalizing the badly under-capitalized textile industry, long a mainstay of the manufacturing sector. Fiscal incentives are being emphasized in these industries to stimulate a higher rate of investment and to improve their competitiveness. The more important are tax incentives to encourage mergers and a reduction or abolition of customs duties on imported capital machinery and raw materials. Caetano, unlike his predecessor, appears willing to draw upon the country's large and growing stock of international reserves in order to advance industrial development (see Table 8).

29. The most significant and far-reaching step taken to foster economic initiative and growth has been to reform the *condicionamento industrial*. This obsolete industrial licensing system that severely restricted the establishment of new industrial enterprises has now been reduced in scope. A number of industry categories subject to government license were eliminated in February 1971. This first stage reform exempts about 60% of Portugal's manufacturing industries, and eventually only strategic industries are expected to remain subject to the system. At that time, only 5% to 10% of the manufacturing sector will be covered.

30. Reforms are being sought in agriculture that will encourage more investment in modern techniques and equipment. Caetano is attempting, primarily by fiscal incentives, to consolidate small land holdings in the north into more economically sized units. However, the gestation period for accomplishing this objective appears to be considerable. Cooperatives that encourage more efficient use of farm machinery are being promoted.

31. Another major concern of Lisbon is to generate more medium- and long-term capital. Companies have too often relied on short-term bank credits to meet their capital needs. Under Salazar, commercial banks were premitted to extend loans with maturities exceeding 180 days only up to an amount equivalent to the banks' equity and reserves. Caetano's decision to authorize the banks to finance loans with maturities greater than six months -- and to

Table 8

International Reserves Held by Portugal

Million US $

	1965	1966	1967	1968	1969	1970
Gold	576	643	699	856	876	902
Foreign exchange	347	415	515	487	550	544
IMF gold tranche position	15	19	19	19	19	19
Total	*938*	*1,077*	*1,233*	*1,362*	*1,445*	*1,465*

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grant special export credits and insurance -- should partially fill the gap. Furthermore, more long-term capital has been made available by raising the ceilings on the deposit rates of the government-owned *Caixa-Geral* -- Portugal's most important savings bank -- and the National Development Bank and by creating a third major long-term credit institution, the semi-public Portuguese Finance Corporation.

Foreign Capital and Technical Know-How

32. Foreign investment for the first time has been included in the government's development strategy, although it had been previously considered beneficial. Lisbon offers favorable fiscal incentives to firms deemed helpful contributors to national needs -- that is, those that are able to transfer technical, managerial, and marketing know-how to Portuguese nationals or those that are made in collaboration with Portuguese investors. Caetano perceives the role of foreign direct investment to be vitally important to Portugal.

33. Portugal also is seeking a substantial increase in foreign official aid, especially from the United States. An International Bank for Reconstruction and Development (IBRD) team visited Portugal during March and April 1971 to discuss possible development aid. Lisbon, however, is not optimistic about the outcome, because of its recent failures to obtain loans from the IBRD or its affiliated agencies, mainly because of Afro-Asian opposition. Lisbon is pinning its foreign aid hopes largely on an increase in US official assistance as a *quid pro quo* for continued US military use of the Azores. In the latter half of the 1960s, such aid averaged $10 million annually (spread rather evenly among PL-480, Export-Import Bank credits, and military aid). However, the two governments have not yet been able to arrive at mutually satisfactory terms for a new agreement. 6/

6. *The last formal Azores base agreement expired in 1962, and since then the United States remains there on an ad hoc basis. As a result of talks initiated by Lisbon last fall, Portugal and the United States agreed that this base arrangement be continued at least temporarily and* [footnote continued on p. 20]

Price Stabilization

34. Caetano has had to struggle against inflationary tendencies. The new administration, however, has taken a distinctly different tact from its predecessor in resisting higher prices. Salazar dwelt on restrictive measures to check demand forces, while Caetano is convinced that increased supply with minimum restraints on demand is a preferable solution. He has stressed higher productivity, more efficient internal distribution, and increased imports. He hopes thereby to offset price and wage increments, with selective monetary restrictions employed to divert resources from consumption into investment. Returns for 1970 indicate moderate success in dampening inflation, as the rate of price increase declined from almost 9% in 1969 to about 6% in 1970.

Ties with the EC

35. A main force underlying the move toward economic reorganization and industrial modernization is Lisbon's growing belief that Portugal's economic future is inevitably bound up with the markets of Europe. From the formation of EFTA in 1960 through the end of the decade, Portugal increased its exports to other members more than threefold, causing the EFTA share of Portuguese exports to rise from 22% in 1961 to more than 35% in 1969. But if the United Kingdom, Norway, Ireland, and Denmark are admitted to the European Communities (EC), EFTA will be disbanded.

36. Because of this, Lisbon is anxious to reach an accord with the EC. The Portuguese position, as stated before the EC Commission on 22 November 1970 is ultimately to obtain association status, presumably of the type enjoyed by Greece and Turkey.

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that the United States would provide increased economic aid to Portugal, essentially through PL-480 aid and other assistance to be agreed upon. In March of this year the United States offered $5 million in PL-480 aid per year -- about twice the recent annual average -- in addition to two surplus oceanographic research vessels and an unspecified amount of Export-Import Bank credits. Lisbon, however, is balking at what it maintains is an inadequate package.

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Asserting that the present state of Portugal's economic development, as well as its constitution, does not permit full membership, Portugal has requested special provisions that would prepare Portuguese industry and agriculture for eventual economic union. Recognizing the EC's present sensitivity to any arrangements with Portugal that imply closer political ties, Lisbon is asking only for commercial concessions in the initial phase. Nevertheless, Portugal has rejected the possibility of a preferential trade agreement of the Spain-EC type, which provides for tariffs reductions for selected exports. Portugal already enjoys extremely liberalized export advantages with the EFTA member countries that it does not wish to relinquish under any new arrangement.

Portugal in Africa

37. Caetano has become almost as intransigent on the colonial issue as was Salazar. All factions in the present power structure are convinced of the importance of maintaining the overseas territories. These feelings are nurtured by emotional memories of Portugal's imperial past and the more practical knowledge that the African territories -- particularly Angola -- are beginning to yield higher economic dividends after years of considerable investment of Portuguese money and lives. Lisbon's determination to retain the African territories was dramatically demonstrated in November 1970 by the Portuguese-supported military forays into Guinea, in part aimed at the destruction of terrorists camps located there. These incursions were launched in spite of the worldwide disapproval it was bound to, and did, evoke.

38. The prospect that the African territories may become more valuable to Portugal is based primarily on the discovery of large oil and iron deposits in Angola and, to a lesser extent, on the extensive Cabora-Bassa development program for the Zambezi Valley in Mozambique. The 120-million-ton iron ore reserve at Cassange will probably place Angola among the world's largest iron ore exporters, and the two billion barrels of low-sulfur oil reserves in Cabinda has provided Angola with another major new export, which should lead all its exports within a few years. The construction of an ambitious hydroelectric installation at Cabora-Bassa -- the first phase is

scheduled for completion in 1975 -- will give Mozambique one of Africa's largest sources of power. Moreover the power export potential to neighboring countries is considerable. Lisbon hopes that the agricultural and mineral development permitted by the dam will ultimately attract an additional million Portuguese emigres to the northwest region of Mozambique. However, it is doubtful that Lisbon can induce anything like that number to settle in this area. For this and other reasons, the full potential of Cabora-Bassa will probably not be realized. 7/

39. The other African territories -- Cape Verde Islands, Portuguese Guinea, Sao Tome, and the Principe Islands -- because of their small size and lack of resources, will probably always be a drain on the Portuguese economy. Lisbon, however, is unwilling to give them up for fear that this would strengthen the cause of the insurgents in Angola and Mozambique.

Prospects

40. Although Caetano appears to believe that the Portuguese people should be given a greater measure of freedom and influence n government, there is little likelihood that this will proceed at more than a small and grudging step at a time. He must move circumspectly lest he imperil his own position by provoking the financial and military establishments that still comprise much of the power structure. Caetano has taken a more liberal approach on the economic front that could yield important results beyond the immediate confines of economics. He counts on a reorganization of major European markets as a convincing justification for pushing forward more progressive economic policies. Yet the repeal in October 1970 of a progressive labor law, enacted just a year earlier to give workers more rights through collective bargaining, aroused concern that the government's program for economic liberalization was being stifled. This act was prompted by the need to combat growing inflationary pressures generally attributed to excessive wage increases.

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41. The government's new expansionary fiscal measures -- including increased public investment in agriculture and tax and tariff incentives for investment in industry -- and some structural reforms should have a salutary effect during the early 1970s. The reform of the *condicionamento industrial*, however, an especially important reform, may take some time to make itself felt. As a result of these new policies, the strong upswing of gross fixed investment in 1970 should accelerate to an annual growth rate of about 9% over the next five years. On this basis, Portugal may achieve an annual real growth rate for GNP during this period of approximately 7%. Industry will continue as the most rapidly growing sector, although agricultural growth will also accelerate. The highest growth areas of the industrial sector will probably be those manufacturing paper, chemicals, and machinery. Expanded irrigation and a shift from low-yielding grains to animal and horticultural products for which there is a fast-rising demand should foster a moderate agricultural growth.

42. Both increased concentration of resources in large-scale industries and the greater exposure of private firms to competition will likely result in higher economic productivity. Still, the government must reconcile the need to achieve greater economies of scale, through mergers when advisable, with its determination to resist the dead hand of the existing oligarchy over the economy. Beyond this, shortages of skilled labor and entrepreneurial talent will continue to be the principal growth constraints in industry. Strong resistance to measures directed toward the consolidation of land holdings in the north will prevent even greater agricultural growth.

43. A deteriorating trade balance, reflecting the growing imports of capital goods and raw materials that accompany expanding investment, will weaken Portugal's balance of payments over the short run. Indeed, imports for the first 11 months of 1970 rose by more than 20%. The long-term effects of intensified investment activity, however, should help Portuguese products become more competitive on world markets. Moreover, Lisbon is looking toward higher earnings from the tourist trade to bolster the balance of payments. The completion

of the Salazar Bridge over the Tagus River has opened up access to a yet unexploited stretch of scenic coastal area practically on Lisbon's door-step.

44. Caetano's anti-inflationary policies are already showing some results, and more progress can be expected. There is some risk that the gathering momentum of the labor union movement in Portugal may aggravate inflationary problems, but thus far Caetano has not hesitated to come down hard on the unions when he felt that their demands were excessive. The stabilization measures under Caetano have the important advantages over earlier methods of permitting concurrent rapid real growth. Moreover, increased economic prosperity and higher wages in Portugal should gradually dampen the heavy stream of emigrant workers.

45. Even as it seeks associate membership in the EC, Portugal can anticipate persistent demands to renounce its colonial policies. When Spain applied for associate status with the EC, because of the non-democratic nature of the Spanish regime, the most Madrid could exact from the EC Commission was the preferential trade agreement now in effect. If Lisbon remains resolute concerning its African provinces, it too may be forced to settle for some form of preferential trade agreement, although possibly a more favorable one than that extended to Spain because of Lisbon's historical ties with EFTA. Any agreement, furthermore, would cover metropolitan Portugal only.

46. The retention of its African provinces is held by the Portuguese to be a non-negotiable right, but some small movement from this rigid stance is evident. On 2 December 1970, Caetano proposed that the National Assembly, as one of several constitutional reforms, extend greater autonomy to the overseas territories. The new "autonomous regions" under Portugal would be given more administrative and fiscal authority, especially to undertake local development programs; but the Metropole would retain control over the regions' foreign policies, defense, and the appointment of regional governors. In the long run, the administration may believe that it can gradually prepare Angola and Mozambique, both

economically and politically, to be multiracial states, perhaps independent, but with close ties with Portugal. Together, the Metropole and its former colonies would form a commonwealth of independent, Portuguese-speaking states, an arrangement that could be accommodated to Portugal's increasing orientation to Europe.

47. Caetano's efforts to modernize Portugal are constrained by the conservative financial and military interests that continue to dominate the power structure. If he should lose their support, not only would the government's ambitions for liberalization of the economy be thwarted, but much of what has already been accomplished could be undone. In sum, the prospects for achieving economic modernization are more favorable than for political change.