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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/71

3:00 p.m., May 2, 1984

W. B. Dale, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	W. B. Tshishimbi
	G. Ercel, Temporary
	X. Blandin
A. Donoso	M. Teijeiro
R. D. Erb	M. K. Bush
	D. C. Templeman, Temporary
	M. B. Chatah, Temporary
	T. Yamashita
J. E. Ismael	
R. K. Joyce	L. Leonard
A. Kafka	C. Robalino
G. Laske	
	N. Coumbis
R. N. Malhotra	A. S. Jayawardena
	E. M. Ainley, Temporary
	T. de Vries
	H.-S. Lee, Temporary
	O. Kabbaj
	A. Camara, Temporary
M. A. Senior	
	K. A. Hansen, Temporary
	T. A. Clark
	D. J. Robinson, Temporary
Zhang Z.	

L. Van Houtven, Secretary
B. J. Owen, Assistant
R. S. Franklin Assistant

Also Present

African Department: R. J. Bhatia, Deputy Director; L. M. Goreux, Deputy Director; N. Abu-zobaa, E. L. Bornemann, F. d'A. Collings, I. A. H. Diogo, M. G. Gilman, J. W. Kratz. Central Banking Department: T. J. T. Balino. Exchange and Trade Relations Department: D. K. Palmer, Associate Director; M. Duran-Downing, M. Guitian, S. Kanesa-Thasan, W. S. Tseng. External Relations Department: H. P. Puentes, Z. Zhang. Fiscal Affairs Department: C. A. Aguirre, E. S. Kreis. Legal Department: S. A. Silard, J. V. Surr. Research Department: R. A. Franks. Treasurer's Department: O. Roncesvalles. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; C. Brachet, M. Caiola, J. C. Di Tata, J. Ferrán, R. Ramaciotti, B. C. Stuart. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: C. J. Batliwalla, J. Delgadillo, L. Ionescu, W. Moerke, G. E. L. Nguyen, J.-C. Obame, Y. Okubo, D. I. S. Shaw, N. Toé. Assistants to Executive Directors: J. R. N. Almeida, I. Angeloni, J. Bulloch, Chen J., M. Eran, C. Flamant, V. Govindarajan, D. Hammann, N. U. Haque, H. Kobayashi, A. Koné, G. W. K. Pickering, E. Portas, M. A. Weitz.

1. IVORY COAST - 1983 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors resumed from the previous meeting (EBM/84/70, 5/2/84) their consideration of the staff report for the 1983 Article IV consultation with Ivory Coast and a request for a stand-by arrangement in an amount equivalent to SDR 82.75 million, together with proposed decisions (EBS/84/81, 4/6/84; and Cor. 1, 4/25/84). They also had before them a staff report on recent economic developments in Ivory Coast (SM/84/81, 4/19/84).

Mr. Hansen stated that he supported the proposed decision, including the amendment suggested by the staff. He did not think that major changes should be made in the letter of intent at the present stage. However, he was ready to consider Mr. Alfidja's request that the last purchase take place after December 31, 1984, instead of after February 28, 1985, if the final review could be conducted before that last drawing was made.

As to the question of a multiyear program, Mr. Hansen said that he concurred with the view that Ivory Coast was facing long-term adjustment problems that should increasingly be dealt with on the basis of longer-term financing than the Fund could provide.

Mr. Zhang remarked that although he supported the program, he had become increasingly doubtful about the reference in the proposed decision to the second tranche of the IBRD's structural adjustment loan (SAL), which in his view should not be linked to the Fund's assistance to Ivory Coast.

The Acting Chairman recalled that during the previous meeting, several Executive Directors had indicated, and the Managing Director had agreed, that the Fund was not following a policy of cross-conditionality vis-à-vis use of its own and the World Bank's resources. The intention was to ensure that the program was fully financed. As the staff representative from the Exchange and Trade Relations Department had suggested, that idea could be conveyed if subparagraphs 2(a) and (b) of the proposed decision referring to arrangements for the release of the SAL and the reduction of Ivory Coast's debt service obligations were replaced by a single subparagraph 2(a) mentioning arrangements "for the financing of the uncovered gap in Ivory Coast's balance of payments in 1984."

Mr. Zhang commented that the implications for future policy would not be altered by the omission of a direct reference to World Bank financing.

The Acting Chairman responded that World Bank financing, whether or not it was mentioned directly, was frequently a significant component in the staff's estimates of the balance of payments financing available to a member. Without Bank support, it would often have been necessary for a member to find financing from another source to fill the gap.

Mr. Erb stated that he had no problem with the wording suggested by the Acting Chairman. It reflected the importance to the program of the World Bank's loan in meeting Ivory Coast's financing requirements, and it had the advantage of not implicitly endorsing the World Bank's advice to Ivory Coast on the introduction of export subsidies, which had troubled him. Another question that he had raised at the previous meeting concerned the relationship of the review to the indicative criteria for the end of December.

The Acting Chairman responded that it would be difficult to convert those indicative criteria into explicit performance criteria unless the final purchase were further postponed. A compromise solution would be for the review mission to visit Ivory Coast in December rather than in October, so as to look at figures for October or even for November before reporting to the Executive Board. The review would have to be completed by the end of February, and the final purchase could then be made early in March.

Mr. Kabbaj said that he was satisfied with paragraph 2(a) of the proposed decision, as amended by the Acting Chairman. However, he recalled the point raised by Mr. Salehkhou on the proposal by the staff for an additional subparagraph introducing a rather unusual reference to arrangements for planned increases in mass transit fares and water charges. Such measures were normally the subject of discussion between the authorities and the staff, and to embody them in a formal decision as a condition for approval of a stand-by arrangement might set a wrong precedent. He asked whether more general language could not be found to refer to those measures, along the lines of the reference to the financing requirements.

The Acting Chairman explained that the expectation had been that the measures would have been taken before the stand-by arrangement was submitted to the Executive Board; thus, no problem would have arisen in specifying them. It might be possible, although not fully satisfactory, to make a more general reference to paragraph 7 of the letter of intent, in which mention was made of the proposal to increase fares and water charges, together with other measures.

The staff representative from the Exchange and Trade Relations Department recalled a previous case in which, in a similar situation, specific reference had been made in a decision to a requirement that certain measures be introduced.

Mr. Erb said that his preference was for making it quite explicit that those measures, which were to have been taken by April 25, should be introduced before the stand-by arrangement could become effective.

Mr. de Vries remarked that the announcement of the measures by the President himself would certainly be explicit. Therefore, it seemed unnecessary to look for indirect ways of referring to them in the proposed decision.

The Acting Chairman, in response to a request by Mr. Alfidja for clarification of the nature of the compromise that had been proposed at the previous meeting by the Chairman, explained that neither the letter of intent nor the text of the stand-by arrangement would be changed; the timing of the purchases would still be governed by the provisions therein. The fourth and final drawing would take place after February 28, 1985. On the side of the management and staff, arrangements would be made for the mission to take place in December rather than in October in order to obtain the latest possible information for the Executive Board's consideration of the second review, for which provision had been made in paragraph 24 of the letter of intent. The proposal to advance the date of the final purchase had not met with sufficient support to be adopted.

Mr. Alfidja thanked those Executive Directors who had supported his proposal, and reiterated his view that Ivory Coast's request for a slight advance in the date of the final purchase had been deserving of consideration, for the reasons explained by the staff and management, namely, the delay in distributing the staff paper on the request for the stand-by arrangement until certain prior actions had been taken. However, the Executive Board had taken a different position.

He would not repeat his views, which were well known, on the way in which the World Bank was handling its loans to member countries that also sought assistance from the Fund, Mr. Alfidja continued. He wished simply to be sure that the Fund had enough leverage with the World Bank to ensure that there was no further delay in implementing Ivory Coast's program under the stand-by arrangement. The authorities had begun to carry out their courageous adjustment measures as early as January 1984, and they merited full support by the Fund.

The Ivory Coast authorities were committed to taking steps to increase bus fares, Mr. Alfidja remarked, but the public announcement of some measures could trigger serious political and social disturbances. The decision to raise fares could not be taken singlehandedly by a minister of cabinet rank; it had to be endorsed by the President of the Republic himself, who had to prepare public opinion, especially at a time when the press and the radio had been discussing the issue. There might have been some change in the domestic environment since January, although he had every indication that the increase in fares had been agreed in principle, and he urged Executive Directors to give the authorities some room for maneuver in the timing of their adoption.

He was also grateful for the support he had received from several Executive Directors for his position on the amount of the stand-by arrangement, Mr. Alfidja went on. Executive Directors had a responsibility to keep themselves informed of the state of mind of their various authorities, even if the reports they heard were critical. As Mr. de Vries had observed, the Fund was not in a position to give advice on certain problems. Ivory Coast had understood the necessity to adjust; but the right balance had to be struck between adjustment and financing, from friendly countries as well as from the Fund. Executive Directors had had

an opportunity to state their positions during the discussion on the criteria for enlarged access earlier in the year. However, like others, he had some difficulty in reconciling his understanding of the outcome of the discussion with that of others concerning the access limit of 50 percent of quota for countries where the Fund's role was to be catalytic. He was not aware of the existence of a specific guideline to that effect; if it did exist, he would question its legality. Certainly, he had difficulty in explaining to the authorities of the countries that had elected him why, despite their need, and irrespective of the issue of conditionality, the Fund was not prepared to offer assistance above 25-50 percent of quota.

Financial support by the Fund of a program dealing with problems of a structural nature had been described as contradictory to the Fund's principles, Mr. Alfidja commented. Although he had not proposed that Ivory Coast should be granted an extended arrangement rather than a stand-by arrangement, it was difficult for him to explain to his authorities the reasons for the Fund's inability to help a member to solve its structural problems by supporting a program under the extended Fund facility, which was designed for that very purpose. The staff itself foresaw the need for Ivory Coast to enter into another stand-by arrangement with the Fund after the current one had expired. He remained unconvinced that Ivory Coast should not have a multiyear arrangement with the Fund, nor did he accept that countries should seek help in solving structural problems only from the World Bank. Of course, no country could enter into an extended arrangement with the Fund unless it first proved its case to the management, which could take it upon itself to propose a stand-by arrangement as the more appropriate vehicle for support. As far as Ivory Coast was concerned, it had recorded high rates of growth in the 1960s and 1970s, and had been cited as a model for development; it still had the potential for the resumption of growth. As he had already said, it was a matter of striking the right balance between the adjustment already under way and its financing in order to avoid the political risks that a sustained adjustment effort would involve if the support of friendly countries and institutions like the Fund and the World Bank were not forthcoming.

Mr. Erb observed that the Executive Board's decisions on the extended Fund facility and on the enlarged access policy laid down precise conditions that were expected to be met at the conclusion of a program supported by the Fund. Ivory Coast had come to the end of its three-year extended arrangement, and was seeking approval of a follow-on stand-by arrangement for one year, with the prospect of a further one-year arrangement not having been foreclosed, as the discussion at the previous meeting showed. The Fund had made a flexible, in many ways perhaps too flexible, interpretation and application of the two decisions on the extended Fund facility and enlarged access policy.

Mr. Alfidja responded that his intention was not so much to question the existence of those two decisions as to attempt to draw a distinction between guidelines and decisions, and the way in which those decisions were to be put into practice. But it was still a difficult and lengthy process to explain the full impact of those decisions to member countries.

Mr. Erb added that he too had had difficulties explaining to his authorities why the Executive Board's decisions had been stretched to the extent of providing resources to Ivory Coast on such a long-term basis.

Mr. Clark recalled that he had found Ivory Coast's adjustment effort to be entirely satisfactory, and he had no problem either with the amount of the stand-by arrangement or with the phasing of the purchases. His difficulty was with the fact that the final set of performance criteria would come only five months after the arrangement became effective. He recognized that delay in the negotiations was partly responsible for that situation and that it was too late to modify the letter of intent. But he would put great emphasis on the final review in verifying that developments in 1984 remained on track.

Mr. de Vries remarked that the decisions to which reference had been made had not been adopted arbitrarily. The Fund, not unlike the World Bank, which was limited in its lending capacity by its ability to attract funds, was also a bank of sorts and could attract deposits under certain circumstances. The hesitancy of members to increase their deposits with the Fund had to do more with its credit policies than with whether or not a member's problems were structural and could not therefore be supported by the Fund for that reason alone. Furthermore, in suggesting that the Fund could not offer much by way of advice to Ivory Coast, he had meant only that other institutions were better equipped, by reason of their expertise, to help the country. Finally, he would be prepared to accept a less explicit formulation of the second paragraph of the proposed decision.

Mr. Alfidja explained that his comments had been general ones, aimed at heightening the awareness of all concerned of the feelings in some countries.

Mr. Blandin observed that despite the proposal to postpone the last review, his chair, like others, continued to believe that Ivory Coast deserved a better phasing of purchases.

Mr. Malhotra joined Mr. Alfidja in perceiving some discontent on the part of low-income, small-quota countries--particularly in Africa--over the way in which the Fund was interpreting its catalytic role. It would be useful for Executive Directors to return to the matter in order to enhance their understanding of what that role implied. From his personal observations, he had found that while the Fund's role as a catalyst had positive elements, to the extent that it ensured the continuation of commercial bank financing to highly indebted countries, it could also be negative when it was interpreted more restrictively, vis-à-vis the Fund's own financing, because there were constraints on the ability of official donors and institutions to increase the amount of their financing for weaker economies. Despite the clear direction of the Interim Committee to the Executive Board to be more mindful of the needs of low-income, small-quota countries the Fund seemed, in the eyes of some, to be erring on the negative rather than on the positive side in playing its catalytic role.

The Acting Chairman recalled that the Managing Director had cited, at the previous meeting, his statement at EBM/83/177 (12/19/83) that he believed that the Executive Board "had achieved broad agreement on the matters set out in EBS/83/270 (12/16/83)," including the three issues requiring decisions, and also the understanding that the broad thrust of the staff paper "Considerations Governing Amount of Access" would provide guidance to the staff. Guidance called, of course, for the exercise of judgment, within a framework of understanding and based on an agreed rationale. In his view, judgment had been appropriately exercised in responding to Ivory Coast's request for Fund support of its program.

As Mr. Malhotra had remarked, the Acting Chairman continued, the word "catalytic" was used loosely to refer to any situation in which the Fund attempted to encourage others to support member countries, either commercial banks or bilateral aid donors. As he recalled the description in the staff paper (EBS/83/233, 10/31/83) of a situation in which the Fund would play a catalytic role, it was one in which a country's difficulties were such that its balance of payments and economy in general were likely to remain in a fragile situation for some years, so that the Fund would not wish to contribute financial support of any great magnitude but would attempt to assist the country in mobilizing financing on terms that were more suitable for solving the structural elements of its problems. He was aware of the discontent with which the Fund's catalytic role was viewed in some quarters; if the Executive Board wished to take up the matter again, it could of course do so. A staff paper on the use of prolonged resources by members was scheduled for discussion in the near future.

Mr. Erb said that he agreed with Mr. Malhotra that the word "catalytic" was used differently in different contexts. The staff had not mentioned the concept at the previous meeting; it had referred instead to the concrete conditions that would have to be met before a judgment was made on the access limits of an individual member in given circumstances. It seemed unnecessary to use the term "catalytic role" at all, especially as the Fund acted as a catalyist in so many different ways.

Mr. Malhotra noted that he had not been present at the previous meeting. He wished to recall that he had expressed reservations on the staff paper in question (EBS/83/233) when it had been discussed in the Executive Board. As several Executive Directors had also recalled, the staff paper had not enjoyed the broad support of the Executive Board, which was why it had been considered necessary not to amend the operative recommendations but to sum up the discussion. The Managing Director had deemed it advisable to qualify the staff paper in the nine points made in his summing up. The perception of several Executive Directors was that not enough weight was being attached to the spirit of those qualifications, and that the staff was generally applying the rigid financing limits set out in its paper that had in fact met with objections. In the view of those Directors, those limits would be counterproductive and lead to more problems than they would resolve. In point of fact, from the little information that was available so far, it appeared that the

financing proposed for various members had been inadequate. A year earlier, access in terms of quota had been between 30 percent and 60 percent for two thirds of the members entering into arrangements with the Fund; at present, that proportion was one third. As Mr. Erb had mentioned, it was necessary to eschew the expression "catalytic role"; but that would not resolve the real problem of the level of financing made available, especially to African countries.

The Fund's image was in question, Mr. Malhotra remarked. The new quotas had gone into effect, the General Arrangements to Borrow had been expanded, and the Fund's financing gap with respect to borrowed resources had been filled. Yet the Fund was still not providing enough financing to meet members' needs; Executive Directors were not fully aware of the extent of the problem in each case, because they were not in full possession of the facts. Members' requests for arrangements with the Fund were first screened by the staff and management before they came to the Executive Board. He himself would not wish to make any value judgment in that respect; he would simply draw attention to the unfortunate perception on the part of some, which it was in the interests of the institution to dispel.

Mr. Kafka said, first, that he agreed with both Mr. Erb and Mr. Malhotra that the Fund should not be described as a catalyst, because it was more than a catalyst; it took an active part in determining the catalytic effect. Second, he again asked the staff whether increased support by the Fund would discourage assistance by private and public cofinancers that would otherwise be available, or whether the balance of payments needs of Ivory Coast would have been more than met.

The staff representative from the African Department replied that the answer was clearly in the negative in both respects.

Mr. Erb remarked that national aid agencies concerned with debt rescheduling tended to deduct the amount of assistance given by the Fund from their calculations of the amount of aid that should flow to a given country. That was a factor for the Fund to bear in mind in indicating how much support it intended to give to a member in the years immediately following the conclusion of a program. The Fund should not deter aid-giving agencies from making a fuller, more realistic assessment of countries' financing requirements, absent Fund support.

The staff representative from the Exchange and Trade Relations Department explained that it would be fully in accord with the Fund's phasing policy, whenever a stand-by arrangement was approved early in the year, for indicative criteria to be applied at the end of the year but not to be associated with any purchase. Under such an arrangement, performance criteria would be applied in March, June, and September, with the latter governing the last purchase to be made in November. The rationale was that the purchases should be made within a period that bore a reasonable relationship to the length of the stand-by arrangement.

The Acting Chairman remarked that the issue raised by Mr. Clark, as he understood it, related to the design of programs, especially if they were supported by a series of successive arrangements with the Fund. In such cases, as the staff representative had explained, the drawings would be contingent on performance criteria for the first three quarters and to indicative criteria for the last quarter ending in December. A problem would arise if any country in need of Fund resources over a number of years consistently failed to meet the indicative criteria for the last quarter before entering into a new arrangement with the Fund at the beginning of the following year. The country's performance toward the end of the year would have to be taken into account in some way in the discussions leading up to the subsequent arrangement.

Another accident of timing that was illustrated by the phasing of Ivory Coast's purchases was that two purchases could be made close together at the beginning of the arrangement, depending on its effective date, the Acting Chairman noted. It might be worthwhile giving consideration to establishing a suitable interval between purchases in future.

The program for Ivory Coast had been designed, as the Deputy Director of the African Department had explained, and to the best of the staff's ability to foresee developments, so as to make it necessary for a substantial portion of the World Bank's structural adjustment loan to be disbursed by June 30, if Ivory Coast were to meet the performance criteria for June and September, the Acting Chairman remarked. Nonetheless, the proposed decision could be redrafted along the general lines that he had indicated earlier.

The Acting Chairman then made the following summing up:

> Directors agreed with the thrust of the appraisal in the staff report for the 1983 Article IV consultation with Ivory Coast. Directors recognized that with the drought, the worsening of the external environment, and the sharp deterioration in the terms of trade, Ivory Coast had had to intensify its adjustment effort at the cost of a severe recession, since real GDP had declined by some 8 percent from 1980 to 1983. Directors noted the structural adjustment that had been achieved since 1980 even though the objectives set for the third year of the extended arrangement with the Fund had not been achieved. Payments arrears of the public sector at the end of 1983 were somewhat larger than at the end of 1980, and the external current account deficit, which exceeded 10 percent of GDP in 1983, was still too high.
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> Directors welcomed the recent increase in the producer prices of coffee, cocoa, cotton, and paddy, together with the increase in the consumer price of imported products, which should stimulate agricultural production and help in limiting cereal imports. Directors also noted the measures taken to reduce the deficit of public enterprises, but stressed the crucial importance of fully and urgently carrying out the rehabilitation of this sector.

Directors commended the authorities for freezing total expenditures of the Central Government--inclusive of civil service salaries and promotions--as well as transfers to public enterprises at the 1983 level, in spite of a 20 percent expected increase in government revenues. The targeted reduction in the fiscal deficit from 9.5 percent of GDP in 1983 to 3.6 percent of GDP in 1984 was welcomed as a major but also a very necessary effort. This, together with the restriction on credit expansion, would bring the 1984 deficits of the public sector and of the external current account slightly below the original extended Fund facility targets set for 1983. It was stressed, however, that such reductions were needed if the deficits were to be financed. The authorities should stand ready, Directors observed, to take additional measures to keep the public sector deficit under control in the event that economic activity and budget revenue were less buoyant than forecast.

If the medium-term outlook was to improve, Directors stressed that Ivory Coast would have to give high priority in its policy formulation to the need to restore and maintain external competitiveness and would need to pursue its adjustment effort relentlessly for several years before the debt service ratio could start declining. At the same time, the hope was expressed that supply-oriented policies would be pursued to reactivate growth and also that the financial assistance and debt relief necessary to support Ivory Coast's comprehensive adjustment effort would be forthcoming.

Finally, Directors welcomed the Ivorian Government's commitment to the rapid elimination of the external payments arrears that had started to appear at the end of 1983.

It is expected that the next Article IV consultation with Ivory Coast will be held on the standard 12-month cycle.

The Executive Board than took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1983 Article XIV consultation with Ivory Coast, in light of the 1983 Article IV consultation with Ivory Coast conducted under Decision No. 5392-(77/63), adopted April 29, 1977 ("Surveillance over Exchange Rate Policies").

2. The Fund notes with satisfaction that Ivory Coast continues to maintain an exchange system that is free of restrictions on payments and transfers for current international transactions.

Decision No. 7689-(84/71), adopted
May 2, 1984

Stand-By Arrangement

1. The Government of Ivory Coast has requested a stand-by arrangement for the period of one year following its effective date for an amount equivalent to SDR 82.75 million.

2. The Fund approves the stand-by arrangement set forth in EBS/84/81, Supplement 2, which shall become effective on the date on which the Fund finds that satisfactory arrangements have been made (a) for the financing of the uncovered gap in Ivory Coast's balance of payments for 1984, and (b) for the planned increases in mass transit fares and water charges.

3. The Fund waives the limitation in Article V, Section 3(b) (iii).

Decision No. 7690-(84/71), adopted
May 2, 1984

2. URUGUAY - 1983 ARTICLE IV CONSULTATION

Executive Directors considered the staff report for the 1983 Article IV consultation with Uruguay (SM/84/70, 4/2/84). They also had before them a report on recent economic developments in Uruguay (SM/84/78, 4/13/84).

Mr. Donoso made the following statement:

Uruguay implemented during 1983 an extremely ambitious adjust ment program under very difficult circumstances. The deficit in the current account of the balance of payments contemplated in the program was the equivalent of 5.8 percent of GDP or US$343 million. However, the external financing available for the public sector was less than expected by some US$125 million. Despite tighter than programmed credit policies, the degree of uncertainty prevailing in the markets caused private capital outflows to exceed the amounts that had been envisaged.

The shortfall with respect to the projected total availability of external financing thus reached US$310 million. For the year as a whole, the overall balance of payments deficit was only US$136 million, well within the program target, with the bulk of the shortfall in external financing being made up for by a greater adjustment in the current account of the balance of payments than called for by the program. Instead of a deficit of US$343 million in the current account, the estimates for 1983 show a deficit of US$69 million, equivalent to only 1.2 percent of GDP.

The low level of confidence stemming from the modification of the exchange rate regime, from the difficult economic situation of other countries in the region, and from delays in the early stages of the implementation of the program accounted in a large measure for the financial constraints faced by the economy. With a rate of inflation in 1983 of 51.5 percent as measured by the increase in the consumer price index or 73.8 percent as measured by the increase in the wholesale price index, currency in circulation increased by only 8 percent during the year while demand deposits increased by 7 percent and quasi-money decreased in nominal terms in spite of real interest rates in excess of 10 percent on the average. To cope with the lack of external financing and low demand for monetary assets, the authorities tightened their public finance policies as contemplated in the program and maintained a very strict monetary policy.

The overall deficit of the nonfinancial public sector went down from 10.1 percent of GDP in 1982 to 4.3 percent of GDP in 1983. Spending by the nonfinancial public sector was reduced by the equivalent of 6.5 percent of GDP in 1983, more than had been planned. A depressed level of economic activity and imports caused revenues to be lower than expected. Although the resulting adjustment became less than was necessary to comply with the end-year targets of the program, it still entailed a considerable strengthening of the public finances. Through credit policies tighter than originally envisaged, the targets for the net domestic assets and for the net foreign reserves of the Central Bank were met by ample margins.

Courageous actions were applied to facilitate the adjustment of the economy at the same time that strict demand management policies were implemented. Real wages in the public sector decreased by 22 percent in real terms during 1983. The combination of exchange rate policies and income policies reduced wages in the private sector by 20 percent in real terms during 1983. Wages in the private sector as measured in U.S. dollars fell from an index of 250 in mid-1982 to 95 percent by December 1983.

The implementation of the program has brought an end to the balance of payments crisis of 1982, but it has been costly in terms of general economic performance. Unemployment went up during 1983. Domestic expenditure is estimated to have decreased by 10 percent in real terms during 1983, with consumption being reduced by 6.8 percent in real terms and investment by almost 30 percent in real terms. Gross domestic product fell by an estimated 4.8 percent in real terms.

The country was able to transfer resources abroad in the equivalent of 4.3 percent of GDP after a deficit in the trade balance including nonfactor services equivalent to 2.9 percent of GDP in 1982. This is a profound adjustment, which has allowed Uruguay to keep the increase in its external debt to a moderate rate. It is

to be stressed that the authorities have managed to implement this adjustment under such difficult circumstances without resorting to any restrictions on exchange transactions on current or on capital account, preserving the quality of the policies that had brought growth to the country before difficulties emerged in 1981 and 1982.

Since mid-1983, there have been encouraging signs of economic recovery, with figures for quarterly GDP showing a turnaround in economic activity. Manufacturing has been leading the recovery, with output of the sector increasing relatively fast since the third quarter of 1983. The production of tradable goods in general is expected to continue showing improvement during 1984. On the financial side, there also have been positive developments with monetary aggregates increasing strongly in real terms during the first months of this year.

The authorities plan to stick to a moderate incomes policy, a flexible exchange rate policy, and strict demand management. They attach great importance to the consolidation of their program of trade liberalization, reliance on market forces for determining prices in the economy, control of inflation, and correction of external imbalances.

It is important to keep the losses of international reserves to a minimum, bring down the rate of inflation, and increase the availability of financing for the private sector. For this purpose, the authorities plan to introduce strong measures to reduce the borrowing requirements of the nonfinancial public sector and to stem the losses of the Central Bank.

To reduce the imbalances in the Central Bank, the authorities already have eliminated the remuneration on legal reserve deposits of the banking system. They plan to curtail drastically financial support to the Mortgage Bank which has now been placed under the direct control of the Treasury. Finally, the mechanism has just been put in place to assist in the recovery of the portfolio of private assets acquired by the Central Bank in 1982 and early 1983.

Mr. Senior, indicating broad agreement with the staff appraisal of recent developments in and prospects for the Uruguayan economy, considered that progress had been made in correcting the major imbalances faced by the economy at the end of 1982. On the external side, the current account deficit had been reduced from 7 percent of GDP in 1982 to 1 percent of GDP in 1983, while the trade account had shifted from a small deficit to a large surplus. Domestically, a substantial correction of the public finances had taken place, as indicated by the decline in the deficit of the nonfinancial public sector from 10.1 percent of GDP to 4.3 percent in the same period. Notwithstanding those favorable developments, economic activity had contracted in real terms by almost 5 percent; and inflation as measured by the consumer price index had been much higher than originally envisaged.

In attempting to explain the "mixed" picture of the recent economic trends in Uruguay, emphasis needed to be placed on the impact of the economic and social conditions prevailing in neighboring countries on the formation of expectations in Uruguay, Mr. Senior continued. The staff had correctly noted that the situation in the region--together with the dynamics of the political process in Uruguay--had been a major cause of uncertainties that, in turn, had made progress toward the adjustment of the imbalances more difficult. In particular, the depressed economic conditions in Argentina and Brazil had adversely affected the production and exports of Uruguay's manufacturing industry and service sectors, which contributed significantly to GDP. However, delays in the implementation of policies, especially in the fiscal and credit fields, were also at the root of the deviations from the original objectives and of the difficulties experienced in restoring confidence. Capital flight and strong inflationary expectations were continuing.

It was clear that the measures adopted in 1983 had not been sufficient fully to correct the fiscal imbalances, Mr. Senior remarked. Additional measures affecting the central administration and the financial needs of the Central Bank would need to be undertaken if progress were to be made toward resolving the fiscal problem. It was encouraging to note that the authorities had recently adopted important measures to address that crucial component of the future adjustment effort; he welcomed the recent adjustment of public enterprise prices, which would strengthen the position of the nonfinancial public sector while having a beneficial allocative effect in the medium term. He also welcomed the authorities' intention to limit wage increases in the public sector and to adjust social security benefits. Those actions were essential structural parts of the fiscal effort and indispensable to the attainment of the inflationary objectives. Together with a moderation of the assistance provided by the Central Bank to the mortgage bank, they were expected to result in a decrease of 3 percent of GDP in the borrowing needs of the nonfinancial public sector in 1984. However, given the limited availability of foreign financing, such a reduction hardly seemed consistent with the objective of reducing inflation to 35 percent in 1984. Hence, he agreed with the staff that additional measures would need to be taken in the fiscal area, perhaps including the introduction of a new tax package along the lines currently being considered by the authorities. The Central Bank position would also need to be corrected as soon as possible by collecting principal and interest on the private loan portfolio acquired in 1983.

Finally, Mr. Senior said, he wished to associate himself with the comments of the staff regarding the policies of wage determination that the authorities intended to follow, the recent flexibility introduced in exchange rate policy, and the authorities' commitment to the maintenance of exchange and trade systems free of restrictions. Those elements of economic management were appropriate and constituted a solid base for the formulation of any future adjustment program to be supported by the use of Fund resources.

Mr. Kafka remarked that the latest staff report seemed distinctly more pessimistic than that for the previous Article IV consultation, and he would be grateful if the staff could elaborate on the reasons for the change in emphasis. The results of the present stand-by arrangement had been basically satisfactory in 1983. Credit policy had been tightened, and real money and quasi-money balances had declined, while real interest rates had been substantially positive. Moreover, the deficit of the non-financial public sector had been more than halved in 1983 to 4.3 percent of GDP, even though revenue collections had fallen short of projections because domestic economic activity and imports had been lower than expected and because year-end ceilings of the public sector deficit had been exceeded. All other performance criteria had been fulfilled by a comfortable margin.

As in previous years, the authorities in 1983 had shown a tremendous determination on the external front, Mr. Kafka said. The real effective exchange rate of the peso had been depreciated, a comfortable trade surplus had been achieved, the balance of payments had improved, and the current account deficit in relation to GDP had shrunk by 6 percentage points. There had also been an important structural change in imports due to the maturation of key investments.

Wage policies had been restrained, with real wages in the public sector declining by no less than 22 percent and real private wages by 10 percent in 1983, Mr. Kafka commented. Real wages in both the public and the private sectors were currently below the level registered in 1978. Labor policies had been flexible in recent years, and the work force had responded well to the difficulties of the economy, increasing its rate of participation by almost 5 percentage points during the past four years. Nevertheless, total employment had continued to decline in 1983, despite some improvement in the final semester, and was currently at the level registered in 1979.

The staff had perhaps been correct in suggesting that most of the present financial difficulties of the Central Bank had come as a result of the purchase of loan portfolios of commercial banks and assistance to the Mortgage Bank, Mr. Kafka commented. What the Fund could do to revitalize capital market confidence in Uruguay was perhaps the key question to be posed during the next discussion with the authorities for the second year of the present stand-by arrangement.

Uruguay seemed to be a good example of a country in which a Fund program had worked reasonably well but had produced less than satisfactory results in terms of output and employment, mainly because of factors beyond the authorities' control, Mr. Kafka observed. While the country had lived up to its obligations, the outcome had been different from what had been projected: real GDP per capita, for example, had declined by a cumulative 15 percent over the past three years, which was a frightening pace.

Finally, on a technical matter, some caution should be exercised on the use of the parallel exchange rate for computing the real effective exchange rate, Mr. Kafka considered. He had never before seen such an

approach in a staff paper, and he was not happy about it. First, he was uncertain how representative the parallel market was in the overall exchange market; second, he was uncertain whether the quality of the data was good enough to merit being used in such calculations.

Mr. Joyce considered that the opportunity to comment on economic developments in Uruguay was particularly appropriate at present, because the authorities and staff had not yet reached understandings on the second year of the stand-by arrangement. He was in broad agreement with the staff report, which presented a mixed assessment of developments in Uruguay over the past year. The task of the authorities had not been an easy one; nonetheless, they had introduced a number of difficult adjustment measures and had made progress in meeting some of the program's objectives, including the overall balance of payments criteria.

The authorities were to be commended for their decision in December 1983 to implement a more flexible exchange rate system and for their continued dedication to maintaining freedom of exchange transactions on both current and capital account, Mr. Joyce said. At the same time, their intention to continue with the program of trade liberalization should help to foster more efficient resource allocation and provide a firmer foundation for future growth. The strategy of maintaining positive real interest rates, while it had not stopped capital flight, had been a necessary condition for restoring confidence and diminishing inflationary expectations. The authorities had also maintained strict control over the setting of public sector wages and had allowed market forces to determine wages in the private sector. Their approach was appropriate, since a deceleration in wage costs was necessary if inflation were to be brought down and the prospects for higher employment in future were to be improved.

Uruguay's basic problem remained the deep-rooted lack of confidence in the economy, reflected in the continued capital flight that was a serious drain on the country's exchange resources, Mr. Joyce said. Despite the Government's pursuit of sound policies in many areas, the public perception was that the overall situation in the Uruguayan economy remained fragile. Inflation had accelerated sharply in 1983 and remained high; real GDP had declined in each of the past three years; investment as a percentage of GDP was still far too low; despite some improvement in the fiscal situation since the beginning of 1983, the deficit of the public sector--including the Central Bank--had remained high for the year as a whole. Economic developments in neighboring countries had weakened the recovery of exports and had had a detrimental impact on confidence in Uruguay during 1983. Uruguay had also suffered from growing protectionism in its traditional overseas markets; furthermore, political uncertainty associated with the prospect of elections in the autumn of 1984 had undoubtedly complicated the adjustment effort.

Given the situation in which Uruguay found itself, it had to be concluded that the authorities' pursuit of the broad goals of the adjustment program continued to be overly cautious, Mr. Joyce commented. Their commitment to the adjustment effort seemed to have waivered, particularly

in the second half of 1983. Performance criteria at the end of 1983 had not been met, and compliance with the criteria for end-September 1983 seemed to have been achieved only through the "leads" and "lags" of certain receipts and expenditures. The authorities had since taken a number of steps to correct the fiscal situation, although no agreement had yet been reached with the Fund. Even the further fiscal measures currently under consideration might not be sufficient, especially in light of the slippages that had occurred in 1983. It was thus important to bring the discussions between the staff and the authorities to a speedy and successful conclusion and, as quickly as possible, to adopt the measures necessary to put the program back on track.

The key to strengthening the adjustment program lay in the fiscal area, Mr. Joyce considered. As Mr. Donoso had pointed out in his opening statement, there had been a substantial reduction in the deficit of the nonfinancial public sector; however, as the staff had noted, that had not been sufficient. It was important to look at the total of fiscal outlays, including those of the Central Bank; from that perspective, the projected reduction in the combined deficit of both the nonfinancial public sector and the Central Bank from 13 percent of GDP in 1983 to 10 percent in 1984 might be too modest. He recognized that a further reduction in the deficit could occur if the tax package currently under consideration were adopted and implemented quickly by the authorities; however, the potential yield of the proposed tax package was estimated to be only 2 percent of GDP, while an adjustment in the combined deficit of about 6-7 percent of GDP seemed necessary. Hence, he agreed with the staff that the need to take additional measures to strengthen the financial controls of the Mortgage Bank and to begin collecting principal and interest on the private loan portfolio of the Central Bank was urgent. He wondered also whether any thought was being given to additional measures to increase tax revenues. Even with the proposed new tax package, the ratio of revenue to GDP would be only slightly more than 18 percent in 1984, or considerably below the outturn of 1983. In view of the increases in tax evasion and the postponement of tax payments in 1983, there might be room for increased tightening of tax administration and collections.

Only through the steady implementation of necessary adjustment measures would international and domestic confidence in the Uruguayan economy be restored, Mr. Joyce noted. Improved confidence was vital if the authorities were to secure access to the financial resources necessary to meet the not inconsiderable challenges that Uruguay would continue to face in the medium term. Quick and determined action by the authorities--particularly to reduce the combined fiscal deficit--was required if the gains already registered under the program were not to be lost.

Mr. Grosche said that it was clear from the staff paper that progress under the 1983 program had been mixed. During the first half of the year, adjustments in external and internal imbalances had been encouraging, but momentum had been lost. For the year as a whole, the fiscal targets had been exceeded, and little progress had been made in reducing the imbalances of the Central Bank. The current period was one of political transition,

which complicated economic management; moreover, prevailing uncertainties and developments in neighboring countries made life difficult for decision makers. Nevertheless, there had also been regrettable delays in the implementation of the program and weaknesses in economic policy. Imbalances remained large, and he shared the staff's view that action must be taken quickly if serious setbacks were to be avoided.

The authorities were to be commended for their continued commitment to the targets of the program, Mr. Grosche remarked. However, he found it disturbing that they had not been in a position to conclude the formulation of policies for 1984. He was beginning to wonder whether it was not already too late to implement policies of the sort that could bring the original program back on track. Further comment by the staff or Mr. Donoso on that matter would be welcome.

The staff had rightly noted that a major reduction in the combined deficits of the nonfinancial public sector and of the Central Bank was essential for cutting inflation and creating better conditions for growth, Mr. Grosche commented. It was satisfying to observe that steps in the right direction had been taken in January 1984. However, considering the large financing gap that remained, additional and more comprehensive measures were needed, the most important of which might be the implementation of the tax package that had been under consideration for some time. He accepted the authorities' view that attainment of the price objectives in 1984 would crucially depend on continued wage moderation. Hence, while he welcomed the authorities' intention not to interfere with wage negotiations in the private sector, he hoped they would carry through on their promise to take a tough stance in the setting of public sector wages as an example for the private sector.

On exchange rate policy, Mr. Grosche observed that the generally positive response of the market since the elimination of the crawling peg system might indicate that that decision had been appropriate. Finally, he commended the authorities for retaining freedom of payments for current and capital transactions, despite the difficult domestic and regional circumstances facing them.

Mr. Templeman considered that the Uruguayan authorities had made progress in 1983 toward restoring equilibrium in the external accounts and in pursuing flexible exchange and interest rate policies. Unfortunately, real GDP growth had been negative, and there had been a serious resurgence of inflation and some slippage against fiscal targets. On the brighter side, signs of recovery of economic activity and employment had emerged in late 1983. He wondered whether those favorable signs continued to be in evidence early in 1984.

The crucial issue at present for the authorities was to complete the policy adjustments begun in 1983 and the negotiations with the Fund concerning the performance criteria and targets for the remainder of the current stand-by arrangement, Mr. Templeman continued. Action was needed mainly in the fiscal field. The staff had mentioned that the historically

low ratio of revenue to GDP in Uruguay would remain low, even if the proposed tax package were enacted. Perhaps a more thorough examination of the tax structure was needed. He noted in passing the authorities' willingness to increase employer and employee social insurance contributions if that should prove necessary to reduce central government transfers. Until 1983, those transfers had risen steadily as a share of GDP, from 2.9 percent in 1979 to 9.4 percent in 1982.

The staff had proposed that the authorities should complete their examination of the financial position of the Mortgage Bank--which had received more than $600 million in assistance from the Central Bank since 1982--in order to determine whether assistance in 1984 could not be further curtailed and whether the Central Bank could begin to collect interest on past assistance and reach agreement on a schedule for repayment of principal, Mr. Templeman continued. The staff had also urged the Central Bank to take prompt measures to begin collecting principal and interest on the private loan portfolio that it had acquired from the commercial banks. It appeared from Mr. Donoso's statement that some steps had recently been taken in both areas; he would appreciate a more detailed explanation of those measures from the staff and a quantification of their impact on the financing requirements of the public sector and the Central Bank.

The sharp resurgence in inflation in 1983 following several years of decline had been particularly disappointing, Mr. Templeman said. It pointed to the need rapidly to phase down the rise in nominal wages in order to avoid a wage/price spiral while fostering growth in employment. In that regard, the unexpected second round of public wage increases in 1983 had not been particularly helpful. On the positive side, he welcomed the authorities' announced intention to intervene less in private sector wage negotiations. There should be a reduced need for further adjustments in administered prices, and there seemed to be significant underutilized productive capacity. Moreover, unit labor costs appeared to have fallen back to more competitive levels internationally in 1982/83, and continued prudent monetary policy should help to contain price rises. Nonetheless, the rapidity of the resurgence of inflation in 1983 was a warning of the need to proceed with great caution.

Commenting on the balance of payments, Mr. Templeman observed that the movement to a policy of flexible exchange rates beginning in late 1982, the substantial real effective depreciation of the peso in 1983, and the existence of positive real interest rates should all help to preserve the strengthening of the balance of payments begun the previous year. However, the balance of payments position remained weak. Exports had stagnated in 1982 and 1983, some recovery of imports would probably be required following the strong import compression of 1981-83, and the trade effects of developments in Argentina and Brazil--together with the upcoming elections in Uruguay--created new uncertainties. Those factors underlined the need to continue to monitor the evolution of the balance of payments carefully and to adapt economic policies promptly, if necessary. The high cost to the balance of payments and to the budget arising from the large-scale

borrowing by the authorities in recent years--following a real effective appreciation of the peso in 1979-82--should be a warning. In particular, the rise in the ratio of total foreign debt to GDP from 22 percent in 1980 to 58 percent in 1983, and the rise in the debt service ratio from the public sector alone from 8 percent to 57 percent in the three-year period, were quite startling. In fact, the data in the staff's two medium-term scenarios illustrated the importance of careful debt management, of providing adequate incentives to private savings, and of export diversification.

Considering the country's recent balance of payments difficulties, the authorities were to be commended for having maintained complete freedom of exchange transactions on both current and capital account and for continuing efforts toward trade liberalization through, inter alia, the narrowing of the range of import duties from 10-75 percent to 10-55 percent in 1983, Mr. Templeman said. He understood that a further narrowing was contemplated and that indirect tax rebates to exporters were to be discontinued. He would welcome comment on when those actions might be taken. Finally, he looked forward to the prompt completion of negotiations with the Fund of new program commitments for the remainder of the existing stand-by period, which was to end in April 1985.

Mr. Robinson observed that, following a difficult two years during which real GDP had fallen by more than 13 percent, there had been some encouraging signs of renewed growth in the Uruguayan economy, particularly among export-oriented industries, and a reduction in unemployment toward the end of the year. He welcomed the sharp reduction in the current account deficit in 1983, but noted that it had been largely due to a cutback in imports. Unfortunately, the capital account had improved by less than had been expected, despite the high level of real interest rates, owing both to strong inflationary expectations and to a lack of confidence. As noted by the staff, that lack of confidence had been the result in part of the growing difficulties the authorities had faced during the year in adhering to the fiscal targets of the program. Those difficulties had become apparent as early as the second quarter of 1983, and, in retrospect, it seemed a pity that the 1983 program had contained no provision for a six-month review, so that those developments could have been brought to the attention of the Executive Board. If agreement on the second year of the program could be reached, a six-month review should be included.

Commenting on specific aspects of the economy and the program, Mr. Robinson observed that key problems arose in fiscal policy. While considerable progress had been made in 1983, especially in reducing current expenditure in the nonfinancial sector, the deficit remained high. And, in the absence of further measures, the staff had projected the overall deficit for 1984 at more than 10 percent of GDP. In view of the limited scope for further external borrowing and the need to avoid further inflationary pressures, the deficit seemed likely to bear heavily on savings--which had stood at only 9 percent of GDP in 1983--and to leave little room for private investment. He had been happy to hear from Mr. Donoso that further measures had been taken to reduce the deficit of the financial sector, which was projected to account for about half of the overall deficit. He would be interested in knowing what effect those measures would have on the deficit for 1984.

The authorities had made substantial progress since 1982 in reducing current expenditures, Mr. Robinson considered. Like Mr. Senior and Mr. Grosche, he welcomed their determined efforts to control public sector wages, which provided an important signal to the private sector. While continued wage restraint would become more difficult as the public sector price increases in January--together with a depreciation of the peso at the turn of the year--worked their way through the economy, it would help to hold down inflation and to sustain the nascent recovery. However, the continuing decline in revenue as a percentage of GDP--and, particularly, the 4 percentage point drop projected for 1984--was worrying. While that decline was in part due to the sharp fall in imports and economic activity, difficulties in tax collection had also played a role, and he wondered whether there was any scope for tightening tax collection procedures.

Given the worrying resurgence in inflation in 1983--and the large increases in wholesale prices that would, presumably, have an effect on consumer prices in 1984--a tight monetary policy would be essential if inflation were to be brought down to 35 percent in 1984, Mr. Robinson commented. Despite the need for some restoration of real balances, a target for monetary growth of 42 percent might prove too accommodating. On the external side, he found the projection for public sector debt service ratios of more than 50 percent over the next four years to be worrying. In view of that projection and the relatively short-term maturities of the 1983 rescheduling, he welcomed the intention of the authorities to reduce their dependence on commercial bank borrowing in 1984. However, rescheduling and new bank financing would probably be required in 1985, which underlined the necessity of maintaining creditor confidence by keeping up the pace of adjustment.

On a technical matter, Mr. Robinson observed that Uruguay's prospects were greatly dependent on those of its neighbors, which had substantial adjustment needs of their own. The situation clearly illustrated a concern that his chair had expressed on a number of occasions, namely, that widespread adjustment in areas with important economic linkages reinforced the need for coordinated program design. In particular, for the 1983 Article IV consultation with Uruguay, it might have been helpful to have had some broader assessments of the prospects for Latin America as a whole. He hoped that, where appropriate, consideration would be given to such assessments in future papers.

The staff representative from the Western Hemisphere Department said that the staff had not intended for the latest papers to seem more pessimistic or optimistic than previous documents. The paper in 1983 had combined a staff report on an Article IV consultation with a request for use of Fund resources. The policies described therein had been firm and thus had offered some substance on which the staff could pass reasonable judgment about the chances of success of the program. The consultation for 1984 had been concluded before agreement had been reached on the program; hence, the judgment of the staff had had to be more guarded.

In computing the real effective exchange rate, the staff representative explained, there had been no intention to suggest that the situation in neighboring countries was ultimately disturbing to Uruguay. However, it was important to bring to the attention of Directors the problems for economic management--especially exchange rate management--that arose from the existence at one time or another of larger differentials between the official and parallel exchange rates for the currencies of neighboring countries, which might account for up to 40 percent of a given country's external trading of goods and services. There had been times in 1983 when there had been a large flow of smuggled goods into Uruguay from neighboring countries as well as some leakage of capital through the current account. The authorities had themselves noted that the existence of those differentials raised serious questions about what, in their view, was an appropriate level for the exchange rate and whether theoretical equilibrium rates for Uruguay should really incorporate the effects of those exchange differentials for certain partner countries.

According to Mr. Joyce, the authorities might have been overly cautious in recognizing the need for additional adjustment in 1984 and in acting on that recognition, the staff representative recalled. The staff had expressed a similar concern, which explained in part why no final agreement had yet been reached on the program for the second year of the arrangement, even though the staff was well aware of the considerable adjustment effort undertaken in 1983. Actually, important measures were under way, and he hoped that they would pave the way for a resumption of discussions in short order. During the previous week, the authorities had adopted a scheme to ensure that part of the private sector portfolio acquired by the Central Bank would be collected, perhaps by allowing for some writeoff of some of the accrued interest and by stretching out the terms of repayments. The formulas were quite complicated, depending upon whether the loans were in local or in foreign currency and whether the portfolios had been acquired in 1983 or 1984. However, for the first time, an important change had taken place in an area that had not been appropriately managed in 1983: the authorities had set up a mechanism under which it should be possible to collect interest on the acquired assets and progressively to collect the principal as well.

Another measure of a managerial or administrative nature that had been adopted in recent weeks had been the action to prevent the Mortgage Bank from having direct access to the Central Bank and to ensure that the Treasury would determine the extent of the transfers it would make to a bank that was spending outside the budget. The staff was not yet in a position to quantify the effect of those measures, although the authorities had attempted recently to determine how much of a reduction in the combined deficit of the Central Bank and the public sector those measures might produce. They were also assessing the potential effect of the tax package that had been under consideration for some time. It was perhaps too early to tell whether the combination of actions in those three areas would be sufficient to reduce the combined deficit of the public sector and the Central Bank in 1984 to an amount consistent with an inflation

rate of 35-40 percent and with approximate balance of payments equilibrium. However, it was clear that the actions already taken or contemplated were in the right direction.

Among the encouraging signs in recent months had been the strengthening in demand for various sorts of money balances, including dollar deposits, and the continuous although moderate upturn in economic activity, the staff representative remarked. The authorities did not yet know the final outcome of real GDP in the first quarter of 1984, but partial indicators pointed to a reasonably large crop of wheat, linseed, oats, and barley, which had benefited considerably from the exchange rate adjustment of 1983. Moreover, power production and consumption had increased by 7-8 percent in the early months of 1984 over the previous year. Sales of cement had increased by 40 percent over the first two months of 1983, and indicators of wholesale and retail sales showed increases as well. Registered imports had also gone up by more than 30 percent during the first quarter of the year. Hence, while it was still too early to draw any firm conclusions, the staff viewed those indicators as a sign that the mild recovery under way since the third quarter of 1983 appeared to have continued thus far into 1984.

In response to a question by Mr. Templeman, the staff representative said that it was unclear when the intended reduction in the spread between the highest and the lowest import duties would take place. Also unclear was the timing of the elimination of the rebates of indirect taxes paid in the production process; however, the staff understood that both actions would probably be part of the package that the authorities were currently considering and that might be adopted in the coming two weeks.

Like Mr. Robinson, the staff was concerned about the possible need to tighten monetary policy, the staff representative commented. Certainly, the improvement in demand for money in late 1983 and early 1984 was welcome; that development should not necessarily be taken as an indicator that the trend would be sustained in the months ahead, particularly given the growing influence of political developments in the formation of public expectations. Thus far, the authorities had adhered to their target of modest growth in M-1, and they had recently adopted a modification in the structure of the legal reserve requirement, which, in principle, aimed at encouraging the growth of term and savings deposits at the expense of M-1.

Finally, with respect to the suggestion that the analysis of developments in Uruguay should perhaps be set in the context of an overall assessment of developments in South America, the staff representative from the Western Hemisphere Department agreed that, for an economy so strongly influenced by developments among its largest neighbors, a broader perspective would probably be useful. However, the staff had felt that Executive Directors had already been fully apprised of developments and prospects in Brazil; at present, the staff was not in a position to pass judgment on the future course of the Argentine economy, even though it was true that what was happening in Argentina and Brazil had an important bearing on developments in Uruguay.

The Deputy Director of the Exchange and Trade Relations Department, commenting on a suggestion that frequent program reviews might be desirable, considered that a balance needed to be struck between quantitative performance criteria--particularly when those covered the full period of a program--and midyear reviews. Provision for too many reviews could undermine the effectiveness of performance criteria in their role as guideposts for policy formulation and might divert the authorities' attention from taking note of departures from the criteria in order to adopt policy measures to keep the program on track. Consideration should also be given to the increase in the number of missions that frequent reviews would call for and that would put an added strain on the already stretched Fund staff. Quantitative performance criteria should serve not only to signal the availability of Fund financing but also to indicate the need for adjustment; one of their main functions was to alert the authorities regarding the change in policies required whenever it became clear that targets would not be met.

The Acting Chairman added that all stand-by arrangements, as a standard item, provided for consultation at the initiative of either the Managing Director or the authorities of the member country concerned. Hence, a review could take place whenever necessary if it became clear that the program was going off track.

Mr. Donoso remarked that some historical elements should be mentioned in explaining the special situation in Uruguay, which had had a very poor growth performance in the 25 years from 1950 to 1975. The normal annual rate of growth in Uruguay in real terms was about 1-2 percent. Given the frequent balance of payments crises, the history of imbalances in the public sector, and the tendency for the authorities to introduce more regulations in closing the economy, it was not surprising that the rate of growth had been so low. In 1975, the authorities had made an effort to change their policies. The public sector deficits had been reduced and eliminated by the end of the decade; an effort had been made to open the economy to external competition, to free prices, and to improve the quality of policies. The response of the economy to those changes had been positive, and, by 1979, the annual rate of growth in Uruguay had reached 6 percent.

It had been at that point that the crisis analyzed in the staff papers had occurred, Mr. Donoso continued. While exchange rate policies had been noted as one explanation for the economy's difficulties, they were in the main due to adverse external circumstances. In an effort to recover from the crisis, the authorities were attempting to maintain the policies that had served them well over the years while applying flexible exchange rate policies and strict incomes policies and continuing to maintain an open economy. There were no constraints on exchange transactions, either on current or on capital account, and the entire set of policies appeared appropriate to bring about a rapid recovery in the economy.

The authorities were in agreement with the staff report and the assessment of the problem with the public finances, Mr. Donoso commented; they were planning to take action to correct the situation. As the staff had noted, a number of measures had already been adopted to resolve the

problem of demand for financial support from the Mortgage Bank. In the main, the authorities were introducing some administrative changes so that the Mortgage Bank would be brought more under the control of the Treasury. The Treasury would not be financing, ex post, the imbalances of the Mortgage Bank, but it would have more direct contact with the Bank and be able to control its expenditures more directly.

An effort was also being made to recover part of the portfolio of private assets purchased by the Central Bank and to begin collecting interest on the assets involved, Mr. Donoso observed. A large portion of the claims on the nontradable goods sector had been denominated in U.S. dollars and had risen sharply in peso terms as a result of the depreciation of the peso, thus making collection against claims difficult. However, an effort was being made to express the claims in Uruguayan pesos and to make them adjustable, according to different indices. The effort was designed to facilitate the repayment of those loans but at the same time to strengthen administrative procedures so as to improve collections. The precise extent to which the measures would act to produce additional resources was unclear, but they would certainly help to resolve the problem.

Commenting personally on the Uruguayan situation in 1983, Mr. Donoso considered that most departures from the program had been on the fiscal side, even though expenditures had been reduced more than expected. The implication was that there was a problem on the revenue side, which was probably due to the recession and uncertainties in the economy and was reflected in the behavior of the demand for monetary aggregates. The result had been capital outflows--in spite of high real interest rates--and a depressed demand for investment from the private sector. Analysis suggested that, despite the high interest rates brought about by a tight monetary policy, capital outflows had continued. He wondered whether stricter management in the public finances would have helped. As he saw it, additional tightening of public expenditures could have freed more resources, which would have led to even more capital outflows unless a stricter demand policy had been applied. In the end, slippages on the fiscal side might have contributed positively to activity in a situation in which most of the effort had to be concentrated on the monetary side because of special circumstances in the country. Given the situation in Uruguay and the difference in behavior from what had been assumed on the monetary side, he wondered whether the authorities' noncompliance with the target had not in some way avoided an even worse recession.

The staff representative from the Western Hemisphere Department replied that it was possible to argue that, as financial resources had grown less than had been projected, considerably less credit had been directed to the private sector; hence, to the extent that the tax burden had turned out to be lower than programmed and the public sector deficit larger than envisaged, especially in the second half of 1983, recessionary conditions had been less adverse than they might otherwise have been. However, the staff had been concerned that the gradual weakening of the fiscal position over the course of the year had helped to undermine private sector confidence further and to accelerate capital flight in the second half of the year. A close look at the behavior of money demand

and the exchange market on a month-to-month basis showed that confidence had been very low until the Fund's Executive Board had approved the program for Uruguay. Confidence had then strengthened until early July, when a combination of factors--including a deteriorating political situation, a seasonal decline in the rate of growth of export earnings, and climatic problems--had been at work. There had been a major decline in both real and nominal money balances until early November, when there had been a change of economic teams. The situation had then begun gradually to improve, even though the fiscal position had been relatively weaker at that time than in the early months of the year. In sum, Mr. Donoso's perceptions were probably borne out by developments between, say, December 1983 and March 1984; however, he doubted that, in the first 11 months of 1983, the Keynesian approach to deficit financing would have been of assistance in preventing a greater decline in real GDP than had actually occurred.

The Acting Chairman made the following summing up:

Executive Directors generally were in agreement with the appraisal in the staff report for the 1983 consultation discussion with Uruguay, and satisfaction was expressed on the timing of the Board discussion.

Directors noted that, despite a sharp decline in economic activity and in per capita incomes over recent years, considerable adjustment had taken place in 1983, in particular in the balance of payments, under the economic program supported by a two-year stand-by arrangement with the Fund. However, the limits on the deficit of the nonfinancial public sector had been exceeded at the end of 1983, the imbalances in the operations of the Central Bank remained large, and inflation had been much higher than expected. Thus, Directors said, the most crucial task of the authorities was to renew the adjustment effort that had begun in late 1982 and to restore confidence in the economy. Directors agreed that, in a number of areas--in particular, the pursuit of a flexible exchange rate policy and trade liberalization--the thrust of existing policies was correct. They welcomed the intention of the authorities to continue with those policies, and they noted with satisfaction the more encouraging recent indicators of economic activity.

Directors observed that the measures taken since early 1983 to reduce the deficit of the public sector were substantial and in the right direction but that far-reaching additional fiscal action would be necessary. They urged the authorities to enact without further delay the tax package that had been under consideration for some time and to take steps to reduce imbalances in the Central Bank and in the state-owned Mortgage Bank. Some concern was expressed whether the tax package and related measures would be sufficient to achieve the program's goals of declining inflation and balance of payments equilibrium. Directors encouraged the authorities to present a program warranting continued Fund assistance under the

payments equilibrium. Directors encouraged the authorities to present a program warranting continued Fund assistance under the existing stand-by arrangement. It was noted that additional fiscal action probably would have to be on the side of revenue, but the authorities were also encouraged to continue with a tight monetary policy and to maintain positive real interest rates.

Directors pointed out that the lasting reduction in inflation and the sustained rise in output and employment that were being sought would require a steady deceleration in the rate of nominal wage adjustments and restraint in social security transfers. They supported the authorities' intention to continue with the policy begun in 1983 of limiting official intervention in the process of private sector wage determination.

In trade and exchange policy, the decision of December 1983 to return to a more flexible exchange rate policy was welcomed by Directors, who also commended the authorities for maintaining complete freedom of exchange transactions on both current and capital account. They noted that an open exchange system was bound to serve Uruguay well. The restoration of confidence was also stressed as a critical condition for Uruguay to improve the capital account so as to ease external constraints.

Reference was made to the rescheduling of Uruguay's external public debt that covered 1983 and 1984 maturities. In future years, beginning in 1985, Directors observed, Uruguay would need to exercise most careful debt management in the effort to meet its large debt repayment obligations.

It is expected that the next Article IV consultation with Uruguay will be held on the standard 12-month cycle.

The Executive Directors then concluded their discussion of the 1983 Article IV consultation with Uruguay.

APPROVED: October 15, 1984

JOSEPH W. LANG, JR.
Acting Secretary