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EBS/83/43

CONFIDENTIAL

February 25, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Uruguay - Staff Report for the 1982 Article IV Consultation and Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1982 Article IV consultation with Uruguay and a request from Uruguay for a stand-by arrangement equivalent to SDR 378 million. A draft decision appears on page 29.

This subject will be brought to the agenda for discussion on a date to be announced.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

URUGUAY

Staff Report on the 1982 Article IV Consultation and Request for Stand-By Arrangement 1/

Prepared by the Western Hemisphere and Exchange and Trade Relations Departments

(In consultation with the Fiscal Affairs, Legal, and Treasurer's Departments)

Approved by Eduardo Wiesner and Manuel Guitian

February 24, 1983

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1/ In accordance with suggestions made by Executive Directors concerning the documentation for Board discussion on country matters (EBM/81/52, April 9, 1981), this paper combines in one document material for the Article IV consultation and the presentation of a program to be supported by the use of Fund resources.

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I. Introduction

The 1982 Article IV consultation discussions with Uruguay were conducted in Montevideo in the periods December 13-21, 1982 and January 4-11, 1983. Discussions on a request for a two-year stand-by arrangement in support of the authorities' economic program took place at the same time. The representatives of Uruguay in these discussions included the Ministers of Economy and Finance, Agriculture and Livestock, Industry and Energy, Labor and Planning; the President of the Central Bank; the presidents of the Mortgage Bank and of the Bank of the Republic; the chief executives of the largest public enterprises; and other senior officials. The head of the mission was received by the President of the Republic. The staff representatives were Messrs. Brachet (Head-WHD), Braz (WHD), Clement (ETR), Feltenstein (FAD), Kreis (WHD), and Ms. Toso (Secretary-WHD). The mission was assisted by Mr. Duran-Downing, the Fund resident representative in Montevideo.

In a letter dated February 1, 1983 (Attachment II), the Minister of Economy and Finance and the President of the Central Bank of Uruguay request access to Fund resources for the equivalent of SDR 378 million (300 per cent of Uruguay's quota of SDR 126 million) in the framework of a two-year stand-by arrangement. Of the amount requested under the arrangement, SDR 94.5 million would come from ordinary resources and SDR 283.5 million from borrowed resources. A waiver of the limitation in Article V, Section 3(b)(iii) of the Articles of Agreement is required.

Uruguay's request is for the support of a program that is described in the attached letter and Memorandum of Understanding and is analyzed in this report. Under the requested stand-by arrangement, up to SDR 189 million, or 150 per cent of quota, would be available before April 1, 1984 with the following phasing: purchases shall not exceed SDR 47.25 million until August 20, 1983; SDR 94.5 million until November 20, 1983; and SDR 151.2 million until February 20, 1984.

Uruguay has had 12 stand-by arrangements from the Fund, the latest of which was in the first credit tranche and expired on July 14, 1982. Uruguay purchased its reserve tranche in May 1982 and its first credit tranche under this arrangement in July 1982. In August 1982, Uruguay also purchased SDR 55.3 million, or 45 per cent of quota, under the compensatory financing facility. The purchase was made with respect to a shortfall in merchandise export earnings for the year ended September 1982. At that time export data were available only through April 1982 and export earnings were estimated for the five-month period May-September 1982. Actual data for this period became available in January 1983, at which time it was established that Uruguay had been overcompensated to the extent of SDR 11.2 million. In accordance with the representations Uruguay had made at the time of its request for a CFF purchase in August 1982, the amount corresponding to overcompensation was repurchased on February 24, 1983. As of February 24, 1983, the Fund's holdings of new Uruguayan pesos stood at 160 per cent of quota, and 125 per cent of quota excluding holdings under the compensatory financing facility.

Full use of the requested stand-by arrangement would raise the Fund's holdings of new Uruguayan pesos to 460 per cent of quota upon expiration of the arrangement (425 per cent of quota excluding purchases under the compensatory financing facility) (Table 1).

Uruguay is a participant in the Special Drawing Rights Department and has received allocations totaling SDR 50 million. Current holdings are 3.4 per cent of net cumulative allocations. Further information on Uruguay's relations with the Fund is presented in Appendix I.

The 1981 Article IV consultation discussions with Uruguay were held in April-May 1981 and completed by the Executive Board on July 15, 1981. Discussions with the Uruguayan authorities on the 1982 Article IV consultation and on an economic program that could be supported by the Fund with a multiyear arrangement were initiated in March 1982; they stretched over an extended period during which there were important changes in Uruguay's underlying economic conditions and the emphasis of policies was shifted to cope with developments. The March mission was followed by a visit by Uruguayan officials to Washington in April 1982 and by another round of discussions in Montevideo in May 1982. Discussions were resumed at the time of the Annual Meetings in Toronto and in informal contacts in Montevideo and Washington in October 1982. In mid-November, an Uruguayan delegation visited headquarters for further discussions, setting the stage for the staff missions of mid-December 1982 and early January 1983 that conducted the 1982 Article IV consultation discussions and concluded the negotiations on the program in support of which the stand-by arrangement is being requested.

II. Background

During much of the period after the Second World War, Uruguay's economic policies were characterized by import substitution, a growing public sector, heavy state intervention in price and wage determination, and extensive controls on current and capital external transactions. These policies were, in general, accompanied by weak demand management, which resulted in high inflation and recurrent balance of payments difficulties in a setting of negligible real GDP growth. Policies were altered radically in the mid-1970s as increasing reliance was placed on market mechanisms to allocate resources, while domestic financial policies were geared to strengthening the balance of payments, reducing inflation, and encouraging saving and investment. These policies involved the lifting of most domestic price controls and the introduction of flexible management of the exchange rate, the liberalization of the exchange and financial systems, a gradual reduction of the public sector

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Table 1. Uruguay: Projection of the IMF Position 1/

	Outstand-ing Feb. 23, 1983	Operations in First Year of Program: Apr. 1983	Aug.-Oct. 1983	Nov. 1983-Jan. 1984	Feb.-Mar. 1984	Total	Operations in Second Year of Program
		(In millions of SDRs)					
Tranche policy							
Purchases	31.5	47.2	47.3	56.7	37.8	189.0	189.0
Ordinary resources	31.5	14.3	21.5	25.8	17.2	78.8	15.7
First credit tranche	31.5	--	--	--	--	--	--
Stand-by arrangement	--	14.3	21.5	25.8	17.2	78.8	15.7
Enlarged access	--	32.9	25.8	30.9	20.6	110.2	173.3
Repurchases	--	--	--	--	--	--	--
Compensatory Financing Facility	44.1	--	--	--	--	--	--
Total holdings (end of period)	201.6	248.8	296.1	352.8	390.6	390.6	579.6
Total holdings excluding CFF purchase (end of period)	157.5	204.7	258.0	308.7	346.5	346.5	535.5
		(In per cent of quota)					
Purchases							
Compensatory Financing Facility	35.0	--	--	--	--	--	--
Other	25.0	37.5	37.5	45.0	30.0	150.0	150.0
Total holdings (end of period)	160.0	197.5	235.0	280.0	310.0	310.0	460.0
Total holdings excluding CFF purchase (end of period)	125.0	163.5	200.0	245.0	275.0	275.0	425.0

Source: International Monetary Fund.

1/ Partials may not add up to totals because of rounding.

deficit, and a tightening of credit expansion by the monetary authorities. The Fund granted a series of stand-by arrangements in support of these policies, which were instrumental in the achievement of balance of payments surpluses during 1976-78 and in a marked recovery of economic activity.

Progress in controlling inflation, however, was uneven, with average price increases remaining at around 50 per cent a year during this period. To bring inflation more nearly in line with that abroad and foster greater efficiency in industry through increased foreign competition, the instrumentation of economic policies was modified significantly in the last quarter of 1978. The policy shift centered on the announcement of a schedule of daily exchange rates several months in advance that implied a progressive deceleration over time of the rate of depreciation of the peso, and on a gradual opening of the goods and capital markets to foreign competition.

It was believed that these measures would help change expectations about inflation. In the goods market, there would be pressures for a convergence of domestic and international prices for tradables, inducing a shift of domestic demand from nontradables to tradables, and thus contributing to a decleration of inflation. In the financial market, interest rates were expected to converge with foreign rates, adjusted for the announced rate of depreciation of the peso and for the country risk premium. As part of this general strategy, an import liberalization program was announced, whereby most remaining quantitative import restrictions were to be eliminated and the protection enjoyed by domestic industry was to be reduced over a seven-year period. Import duties were to be reduced to a maximum of 35 per cent by January 1, 1985, through a 16 per cent annual reduction in the difference between existing tariff rates (which in late 1978 ranged up to 150 per cent) and the 35 per cent rate. At the same time, most limitations and impediments to international capital flows were removed. In order not to interfere with the process of price convergence that was being sought, public sector financial operations were to be in approximate equilibrium, and the Central Bank was to refrain from expanding its domestic credit on any significant scale.

This liberalization of the economy worked well in fostering the growth of real GDP, which averaged 6 per cent a year in 1979-80 (Table 2), and in bringing unemployment to its lowest level in many years. It also encouraged private capital inflows, which not only financed one of the highest levels of private capital formation of the last 35 years (Chart 1) but also assisted in keeping the overall balance of payments in surplus. Where progress was most elusive was in regard to inflation; the rate of increase of consumer prices doubled to 83 per cent during 1979, and remained in excess of 40 per cent during 1980 (Chart 2).

Table 2. Uruguay: Selected Economic Indicators

(Percentage changes at annual rates)

	1978	1979	1980	1981	Est. 1982	Projected 1983	Projected 1984
Gross domestic product							
In current market prices	52.7	78.0	69.6	30.4	7.3	39.9	21.2
In constant 1978 prices	5.3	6.2	5.8	-1.1	-8.5	1.0	4.0
GDP deflator	45.1	67.7	60.4	31.8	17.3	38.5	16.5
Prices and exchange rate 1/							
Consumer prices	46.1	83.1	42.8	29.4	20.5	...	...
Wholesale prices	59.6	77.1	28.6	14.9	33.5	...	...
Wholesale prices of domestic manufactures	49.3	82.7	32.9	18.1	37.9	...	...
Exchange rate 2/	30.4	20.0	18.4	15.7	146.4	...	...

Sources: Central Bank of Uruguay; and Fund staff estimates.

1/ Percentage change during 12 months to end of period.
2/ In terms of pesos per U.S. dollar.

To some extent the high rate of inflation could be attributed to the sharp increase in Argentine tourism and investment expenditure in Uruguay owing to the real appreciation of the Argentine peso. But a number of domestic factors also were at work. The elimination of legal reserve requirements in the first half of 1979 resulted in a large one-time increase in domestic credit that gave rise to substantial price pressures. Integration with foreign goods markets also took longer to achieve than the authorities had hoped. Given the high initial levels of import duties, the pace at which import restraints were being relaxed was of little consequence for prices in 1979-80, while the failure to do away with the system of minimum import prices (aforos) had the effect of maintaining a redundantly high degree of protection from foreign competition. A factor that was important in sustaining inflation was the indexing of wages and social security benefits to past price or wage increases (Chart 3). Given the deceleration in the rate of currency depreciation allowed for in the announced exchange rate schedule, unit labor costs in U.S. dollar terms rose to levels that had increasingly adverse repercussions on the competitiveness of the Uruguayan economy (Chart 4).

The rate of price increase abated noticeably from mid-1981, but the peso continued to appreciate in real terms because of the even faster deceleration in the rate of depreciation of the currency. In an attempt to correct the overvaluation of the currency, the pace of exchange depreciation was accelerated somewhat in 1982, but in real effective terms the peso appreciated further (Chart 5) because of the general strengthening of the U.S. dollar (to which the peso was pegged) and of sharp real exchange rate corrections in neighboring countries. The effect on output of the loss of competitiveness of domestic industries was aggravated further by the weakening of world demand.

As a result of the conditions that prevailed in the period from mid-1981, profitability in the tradable goods sector was eroded, bankruptcies multiplied, and a number of banks experienced severe financial difficulties. Also, tax collections plummeted in real terms which, given the indexing of wages and social security benefits to past inflation, resulted in the emergence of a large deficit in the public finances in 1982.1/ Accordingly, the Central Bank, already faced with the need to assist banks with problems was forced to extend credit on a large scale to the nonfinancial public sector. Pressure on its resources was further intensified by a surge in the borrowing needs of the Mortgage Bank; following the collapse in the first half of 1981 of the real estate investment boom in Uruguay that had been fostered by Argentine investors, this bank, under government prodding, had stepped up sharply its lending program to take up the slack in private construction activity.

The resumption of deficit financing by the Central Bank greatly weakened confidence; this led initially to a rise in domestic interest rates and from early 1982 to a shift, within the Uruguayan financial system, from local currency denominated financial assets to U.S. dollar-denominated assets. As confidence continued to wane, shifts in the composition of financial holdings gave way to mounting capital flight and to a decline in both peso- and dollar-denominated domestic assets in Uruguay.

The deterioration in Uruguay's economic and financial position is illustrated clearly by the main indicators of economic performance. Real GDP growth slowed in the first half of 1981, turned negative for the year as a whole, and output is estimated to have declined by

1/ Under the one-year stand-by arrangement in the first credit tranche approved by the Executive Board in July 1981, targets had been set for December 31, 1981 and the authorities were to reach understandings with the Fund on their policies and objectives for the second half of the period of the arrangement by no later than January 31, 1982. Following the sudden deterioration in Uruguay's fiscal and balance of payments situation in the latter part of 1981, the authorities requested instead that a mission travel to Montevideo in March 1982 to negotiate a multiyear arrangement giving Uruguay access to the upper credit tranches. As of December 31, 1981, the target for net domestic assets of the Central Bank was amply met, while the cash operations of the Treasury registered a deficit of NUr$110 million--equivalent to 0.1 per cent of GDP--compared with a target of equilibrium.

8-1/2 per cent in 1982. Manufacturing output dropped by 4-1/2 per cent in 1981 and by more than 17 per cent in 1982. In reflection of the severity of the recession, unemployment rose from 5.8 per cent in the first half of 1981 to an estimated 12 per cent in the second half of 1982.

As a cause of the country's economic troubles and a consequence of the deepening economic recession, the public sector's financial position moved from a surplus in 1980 to deficits equivalent to 2-1/3 per cent of GDP in 1981 and 12-1/3 per cent of GDP in 1982 (Table 3 and Chart 6). The deficit of the Central Administration (Treasury)--including transfers between the Central Administration and the rest of the public sector--reached 0.9 per cent and 9 per cent of GDP, respectively, in 1981 and 1982.1/

Because of an increased recourse by the public sector to foreign borrowing in 1981, Central Bank credit expansion in that year was kept about in line with the growth of its resources, and net official international reserves rose marginally. In the first 11 months of 1982, however, and notwithstanding increasingly large public sector reliance on external sources of finance, Central Bank credit grew by the equivalent of 83 per cent of the stock of currency issue at the end of 1981. At the same time, the weakening of confidence provoked by this very rise in claims on the Bank's resources caused currency issue to shrink by 8-1/2 per cent and Uruguay's net official international reserves (excluding exchange gains on account of gold sales) fell by US$635 million during the first 11 months of 1982.

The balance of payments current account deficit narrowed in 1981 despite a deterioration in the terms of trade; there was an increase in the volume of meat exports as the beef cycle entered a liquidation phase and, with the onset of recession, there was a 15 per cent reduction in import volumes. At the same time, the near doubling of foreign borrowing by the nonfinancial public sector and heavy use of short-term foreign loans by the state-owned Mortgage Bank approximately offset a marked decline in private capital inflows (Table 4 and Chart 7).2/

In contrast, the international reserve loss in 1982 mirrored a deterioration in both the current and capital account. The trade deficit narrowed noticeably, with the recession leading to a 30 per cent decline in the value of imports which more than offset a drop in export earnings. However, the decline in tourism receipts from Argentina and Brazil and the sharp increase in interest payments on the external debt caused

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1/ Although the Treasury accounts for no more than 55 per cent of total public sector spending, its financial position is the most easily and widely followed in Uruguay and, as a result, it plays a central role in the formation of the price and exchange rate expectations of the general public.

2/ For a review of external debt developments, see Section V in the accompanying report on recent economic developments.

Table 3. Uruguay: Summary of Public Sector Operations

(As per cent of GDP)

	1978	1979	1980	1981	Est. 1982	Proj. 1983	Proj. 1984
General government							
Revenue 1/	23.9	22.7	21.9	23.9	21.2	24.4	23.7
Current expenditure 1/	21.9	19.6	19.3	22.6	27.2	23.7	21.7
Current account surplus or deficit (-) 1/	2.0	3.1	2.6	1.3	-6.0	0.7	2.0
Consolidated public enterprises current account surplus or deficit (-) 1/	2.3	1.9	3.0	2.4	0.6	1.5	2.1
Consolidated public sector savings	4.3	5.0	5.6	3.7	-5.4	2.2	4.1
Capital expenditure 2/	4.8	5.2	5.1	6.0	6.9	5.2	5.2
Consolidated public sector overall surplus or deficit (-)	-0.5	-0.2	0.5	-2.3	-12.3	-3.0	-1.1
Central Administration 3/	-0.8	0.1	-0.4	-0.9	-9.0	-1.9	-0.7
Autonomous agencies 4/	--	--	--	--	--	--	--
Social security	0.7	0.7	0.7	-0.5	-0.2	--	--
Local governments 5/	--	0.1	0.1	--	0.1	--	--
State enterprises	-0.4	-1.1	0.1	-0.9	-3.2	-1.0	-0.4
Financing	0.5	0.2	-0.5	2.3	12.3	3.0	1.1
Dollar-denominated bonds and bills 6/	0.5	-0.5	-0.2	--	0.8	--	...
Other internal financing (net)	-1.1	-1.1	-1.8	0.4	9.4	1.4	...
Other external financing (net)	1.1	1.8	1.5	1.9	2.1	1.6	...

Sources: Office of the Comptroller General, Ministry of Economy and Finance; Secretariat of Planning and Coordination; Central Bank of Uruguay; and Fund staff estimates.

1/ Includes transfers between the general government and the public enterprises.
2/ Net of capital receipts.
3/ Includes transfers to other public sector entities.
4/ National Colonization Institute only.
5/ Montevideo only.
6/ Breakdown between resident and nonresident holders of bonds and bills is not available.

Table 4. Uruguay: Summary Balance of Payments, 1978-84

(In millions of U.S. dollars)

	1978	1979	1980	1981	Est. 1982	Proj. 1983	Proj. 1984
Current account	-127.0	-316.8	-627.3	-478.3	-594.2	-342.9	-282.4
Trade balance	-80.2	-411.5	-629.2	-488.5	-162.2	-0.7	50.0
Exports, f.o.b.	686.1	788.1	1,058.5	1,215.4	961.3	1,159.3	1,330.0
Imports, c.i.f.	-766.3	-1,199.6	-1,687.7	-1,703.9	-1,123.5	-1,160.0	-1,280.0
Nonfactor services (net)	22.9	145.4	93.6	74.3	-202.5	15.0	43.0
Factor services (net)	-76.8	-57.8	-100.4	-73.8	-239.9	-368.2	-386.9
Transfers (net)	7.1	7.1	8.7	9.7	10.4	11.0	11.5
Capital account	290.5	368.4	797.7	479.3	-205.3	242.9	282.4
Public sector total	20.3	76.2	169.8	308.2	731.1	455.3	100.0
Public sector long-term	23.3	83.4	160.3	223.5	323.4	885.3	...
Nonfinancial	53.4	99.2	166.1	207.8	55.8	295.5	...
Central administration 1/	5.1	2.4	39.2	82.7	13.0	63.0	...
Public enterprises	35.1	96.1	79.4	142.4	71.2	236.6	...
Other 2/	13.2	0.7	47.5	-17.3	-28.4	-4.1	...
Financial	-30.1	-15.8	-5.8	15.7	267.6	589.8	...
Central Bank 3/	--	1.3	15.0	16.3	269.6	249.0	...
BROU	-29.7	-16.7	-20.5	-0.2	-1.6	56.2	...
BHU	-0.4	-0.4	-0.3	-0.4	-0.4	284.6	...
Public sector short-term	-3.0	-7.2	9.5	84.7	407.7	-430.0	...
Private sector total	270.2	292.2	627.9	171.1	-936.4	-212.4	182.4
Commercial banks	-30.3	127.6	293.0	103.6	--	...	...
Short-term	-114.1	37.3	96.3	-273.6	185.7	...	...
Long-term 4/	83.8	90.3	196.7	377.2	-185.7	...	...
Private nonfinancial	300.5	164.6	334.9	67.5	-936.4	...	...
Direct investment	128.8	215.5	289.3	48.6	10.0	...	...
Other 5/	171.7	-50.9	45.6	18.9	-946.4	...	...
SDR allocation	--	11.0	11.0	10.9	--	--	--
Overall balance	163.5	62.6	181.4	11.9	-799.5	-100.0	--
Valuation adjustment 6/	--	--	-59.7	13.1	214.9	--	--
Official reserve movement (increase -)	-163.5	-62.6	-121.7	-25.0	584.6	100.0	--
Memorandum items							
Current account/GDP 7/	-2.9	-5.9	-9.7	-6.8	-8.7	-4.7	-3.6
Overall balance/GDP 7/	3.7	1.1	2.8	0.2	-11.7	-1.4	--

Sources: Central Bank of Uruguay; and Fund staff estimates.

1/ Excludes foreign currency denominated Treasury notes and bonds.
2/ Local governments, suppliers' credits to other public sector, and government bonds.
3/ Medium- and long-term liabilities only.
4/ Mostly changes in foreign currency denominated deposits in the domestic banking system.
5/ Includes private suppliers' credits and errors and omissions.
6/ Includes an adjustment to allow for the difference between the price at which gold was bought and sold, and the price at which it is valued for reserve purposes (SDR 35 per ounce).
7/ U.S. dollar GDP has been estimated using an exchange rate for the Uruguayan peso that would keep the Uruguayan peso/U.S. dollar exchange rate constant in real terms at the 1976 level.

the current account deficit to widen from 6-3/4 per cent of GDP in 1981 to the equivalent of 8-2/3 per cent of GDP in 1982. With private capital outflows equivalent to 13-2/3 per cent of GDP, well in excess of unprecedently large inflows of official capital, the overall balance of payments deficit approached US$800 million in 1982. Public external debt rose to an estimated US$2.1 billion, or over 30 per cent of GDP.1/

Faced with such abrupt economic deterioration and loss of confidence, and with evidence that the attempts at corrective action in February, June and October of 1982 had failed, the authorities moved swiftly in late 1982 to change policies. The market-oriented, outward-looking thrust of the existing economic strategy was reaffirmed, but measures were taken to strengthen domestic demand policy and to facilitate adjustment of the balance of payments. On November 26, 1982 the Central Bank announced its withdrawal from the exchange market and that the determination of the external value of the peso was to be left to the free play of market forces. In subsequent weeks, measures were adopted in the areas of incomes, fiscal, monetary and trade policies, as part of a comprehensive adjustment and recovery program.

III. The Adjustment and Recovery Program

The objectives of the program are to reduce the external payments imbalance; to achieve a deceleration of inflation once the spurt of corrective price adjustments now underway has worked its way through the economy; and to lay the basis for a recovery of economic activity.

1. Resource allocation policy

Central to the authorities' program has been the abandonment of the practice of announcing the path of the exchange rate several months in advance in favor of a float of the peso. The authorities noted that their efforts in 1982 to restore competitiveness to the Uruguayan economy through a faster rate of depreciation of the peso--from 1.17 per cent a month in the first quarter of the year to 1.35 per cent a month in the second quarter, 1.89 per cent a month in July-August and 2.2 per cent a month from last September 2/--had been nullified by the appreciation

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1/ Throughout this paper, ratios of external flows to GDP have been computed by estimating a dollar GDP for Uruguay on the basis of an exchange rate for the Uruguayan peso in terms of the U.S. dollar that remains constant in real terms at its level of 1976. Because of the sharply divergent movements between this notional exchange rate and the actual exchange rate, these ratios differ significantly from those derived by converting external flows to pesos on the basis of actual average exchange rates, such as the ratios presented in the table appended to Attachment II.

2/ A 10 per cent import surcharge/export subsidy scheme was introduced in early June 1982 as a means of advancing the effect of the acceleration in the rate of depreciation in September.

of the U.S. dollar and the large real depreciation of the Argentine peso. They also noted that this course of action had had the effect of raising real interest rates to such levels (45 per cent in early November) as to produce very large output and employment losses.

In opting for allowing the peso to float, the authorities took the view that, given the low level of confidence that prevailed toward the end of 1982 and the inconclusive experience of other countries with attempts to move the exchange rate to a predetermined level, it would be safer for a time to let the peso float and find its equilibrium level once domestic adjustment policies were in place. They thought that this might not occur until the second quarter of 1983 because of the lagged impact of some of the corrective measures adopted at the time the peso was floated. From then on, they might opt for a float, with a measure of Central Bank intervention to ensure orderly market developments, or for a crawling peg system. In any event, the authorities stressed their intention to maintain flexibility in the management of the exchange rate and indicated that they would be guided in their choice of an exchange rate system by the need to preserve the competitiveness of the Uruguayan economy and to achieve a significant reduction of the overall balance of payments deficit in 1983 and equilibrium in 1984.

The exchange market reopened on November 29, with the peso depreciating initially from NUr$13.80 per U.S. dollar to NUr$20.00 per U.S. dollar and then oscillating until early January in the range of NUr$25-40 per U.S. dollar. The extreme volatility of the exchange rate was traceable in part to initial uncertainties associated with the change of exchange rate regime and to heavy Central Bank financing of the Treasury and of the Mortgage Bank in December. It also reflected delays in determining the rate of the emergency export taxes announced on the day of the float and the level of the export tax credits that were to replace previous export rebates and subsidies. Also, the Central Bank reintroduced legal reserve requirements (which had been discontinued in 1979) and resumed open market sales only after a lag of several weeks. Eventually, once the new policies became known with greater precision and the Central Bank began regulating liquidity in early January, the peso strengthened in the exchange market. By mid-January the exchange rate was moving in the relatively narrow range of NUr$25-27 per U.S. dollar and in real effective terms was roughly at its level of 1976.

The authorities explained that the exchange rate action of late November was aimed primarily at correcting the cost-price distortions that had developed over the previous three years. At the same time, they were determined to take advantage of the attendant improvement in the relative position of the tradable goods sector to push ahead with the liberalization of the trade system initiated in late 1978.1/ Effective January 1, 1983, the highest import duty rate was lowered from 75 per cent to 55 per cent, which in effect advanced by one year the implementation of the program of import duty reduction launched five years earlier. With a few exceptions import duties ranging from 10-35 per cent were left unchanged, but the number of basic categories of import duty rates was reduced from 11 to 5, representing a major simplification of the system.

As a further indication to the market of their determination to keep fostering efficiency in domestic industry, the authorities also eliminated the minimum import prices (aforos) maintained by the Bank of the Republic and indicated that from then on import reference prices would only be maintained or established as an antidumping device. The authorities also took advantage of the floating of the peso to terminate the 10 per cent import surcharge/export subsidy scheme that had been introduced in June 1982. The subsidized export prefinancing scheme introduced in September 1982 also was terminated.2/ With these measures, the authorities hoped that the market would soon become convinced that the basic thrust of the policies implemented since the mid-1970s was being continued.

The authorities noted that their concern for improving resource allocation also was evidenced by their approach to pricing policy. Despite the bout of corrective inflation that was anticipated in the wake of the float of the peso, they had resisted pressures for imposing price controls. In addition, they had decided to adjust prices and tariffs for goods and services produced and marketed by the public sector by between 25-50 per cent, with the highest increases concentrated in fuel prices. Their intention was to continue with such adjustments if circumstances dictated and, in any event, to raise domestic fuel prices further in April and October 1983 as part of the plan of fiscal adjustment. In general, public sector pricing policies would be governed by the need to not only cover costs but also to allow the enterprises to make significant contributions to the financing of their investment programs.

1/ Uruguay maintains no multiple currency practices or restrictions on payments and transfers for current international transactions subject to Fund approval under Article VIII. For a description of the Uruguayan exchange system, see Appendix I to the accompanying report on recent economic developments.

2/ For an analysis of these assists to the tradable goods sectors, which in effect aimed at shielding the private sector from the overvaluation of the peso, see Sections III and V, in the accompanying report on recent economic developments. It should be noted, however, that the unwinding of the export prefinancing scheme, which involved a forward exchange sales commitment on the part of the Central Bank, likely will involve a substantial loss of net official international reserves in the first half of 1983.

The authorities remarked that public investment in recent years had not always been governed by strict criteria of efficiency, and this had resulted in a waste of resources and high social costs. A recent review of the mechanisms for allocating funds for public investment had led to the conclusion that the definition and preparation of the investment program and the procedure for ensuring compatibility with resource availabilities still left much to be desired, notwithstanding the progress that had been made in extending budgetary control over the execution of investment plans. Accordingly, the authorities intended to establish soon--with the assistance of international development institutions--a procedure that would help in identifying, preparing, and following up investment projects; in ranking them according to development priorities; and in making sure that feasibility and engineering studies, and final project design work, were undertaken at a pace sufficient to generate a steady stream of projects. The financial requirements of the projects emerging from the pipeline were to be determined for a period covering several years, and medium-term development budgets consistent with the country's financial constraints were to be established. The authorities expected that all projects incorporated in the 1985 budget would be subjected to this review and approval procedure. In the meantime, priority would be given to completing projects already underway or awaiting approval with a high prospective rate of economic return.

2. Wage policy

The authorities viewed the cost-price distortions that had arisen from the growing inconsistency between exchange rate and wage developments during 1979-81 as a major cause of the difficulties experienced in the last 18 months.

To avoid pressures on the exchange rate from the side of wages once the initial overvaluation of the peso had been corrected, the authorities were of the view that the Government should cease to intervene in the process of wage determination. Although an across-the-board wage raise could not be avoided when the currency was floated, the increase--effective from January 1, 1983 for wages and payable in two stages (January and April 1983) for social security benefits--had been kept to 15 per cent. Henceforth, the determination of remuneration levels in the private sector is to be left to each firm in the light of its own financial position and of the labor market situation in general. The authorities thus would limit themselves to adjusting from time to time the minimum wage--which in accordance with international conventions must be set by law--without setting this de facto wage floor at a level that might cause actual salaries to move on a path inconsistent with the intended deceleration of inflation. More generally, the authorities observed that any lasting improvement in labor market conditions would only result from productivity increases and the revival of economic activity.

It was recognized that wage trends in the private sector likely would be influenced by movements in public sector remunerations. The authorities stressed their determination to exercise prudence in the setting of public sector wages and they indicated that across-the-board wage raises for public sector employees would be ruled out for the time being. Instead, the wage bill would be managed in the light of overall spending priorities and in accord with the need to achieve a substantial reduction in the overall deficit of the nonfinancial public sector. Adjustments in social security benefits also would be moderate and of such magnitude as could be financed out of direct contributions by employees and employers, without requiring assistance from the Treasury in excess of that now being provided.

3. Fiscal policy

The adjustment effort depends crucially on the achievement of a major improvement in the public finances. The current account of the nonfinancial public sector is to shift from a deficit equivalent to 5-1/2 per cent of GDP in 1982 to a surplus of 2-1/3 per cent of GDP in 1983 and a surplus of 4 per cent of GDP in 1984. This turnaround, together with a reduction of capital outlays from 7 per cent of GDP last year to 5-1/4 per cent of GDP in both 1983 and 1984, should help to lower the borrowing requirements of the nonfinancial public sector from 12-1/3 per cent of GDP in 1982 to 3 per cent of GDP in 1983 and to around 1 per cent of GDP in 1984.

General government revenue relative to GDP is projected to rise to about 24-1/2 per cent in 1983 before declining slightly to 23-3/4 per cent in 1984, compared with a ratio of 21-1/4 per cent in 1982. The recovery of government revenue is to come from a variety of measures, many of which seek to capture part of the windfall income gains resulting from the recent exchange rate adjustment. Of most significance is the introduction of a tax ranging from 5-15 per cent on traditional exports 1/ and the elimination of export subsidies which are netted out of revenues. (These now have been replaced, in accordance with GATT rules and at a much smaller fiscal cost, by a refund to exporters of indirect taxes paid during the production process.)

In addition, there are to be adjustments for inflation of the tax base for purposes of computation of corporate income and property tax liabilities. The wealth tax has been increased by 25 per cent and the effective rate of the real estate tax has been doubled. Most excise taxes have been raised by 10 per cent, while the minimum rate of the value-added tax--applicable principally to foodstuffs and medicines--has been raised from 8 per cent to 12 per cent and the coverage of this tax has been extended to interest on bank loans and to professional services. The 2 per cent levy on wages eliminated in 1980 has been

1/ These export taxes may be discontinued after 1983 as they are merely a substitute for the tax on farm income (IMAGRO) which is collected with a one-year lag and therefore was not likely to be affected in a major way in 1983 by the exchange rate action at the end of 1982.

reinstated, and the rate of the corporate income tax has been raised by 5 percentage points to 30 per cent. All of these measures taken together are expected to yield the equivalent of NUr$4.5 billion, or 2-1/2 per cent of GDP in 1983.

On the expenditure side, the limitation of the post-devaluation adjustment in wages and social security benefits (noted in subsection 2 above) should be instrumental in facilitating a reduction in general government current spending from 27-1/4 per cent of GDP in 1982 to an estimated 23-2/3 per cent of GDP in 1983 (and 21-2/3 per cent of GDP in 1984), despite a sizable increase in interest payments on the internal and external debt. Other current outlays, which account for less than 11 per cent of the total, will not be permitted to increase by more than 7 per cent in nominal terms which would imply a sharp contraction in real terms. As a result of these measures, general government savings (including receipts from and transfers to the public enterprises) should shift from a negative 6 per cent of GDP in 1982 to a positive 2/3 per cent of GDP in 1983.

The improvement in the operating surplus (after tax payments and transfer receipts) of the public enterprises--from 1/2 of 1 per cent of GDP in 1982 to 1-1/2 per cent of GDP in 1983--is predicated on the 25-50 per cent adjustment in tariffs and prices decreed in late 1982; also (as indicated in subsection 1 above) public sector prices are to be managed flexibly so that enterprises not only cover costs but also contribute to financing part of their investment program.

With the completion in 1982 of the Palmar hydropower plant--the largest public investment project in Uruguay in recent years--and of the state airlines' modernization program, Uruguay's relatively low level of public sector capital formation would have been about halved in 1983. There is an urgent need, however, to moderize the telecommunications network, upgrade power distribution and port facilities, and increase investment in health, education, and transport. Capital spending in these areas is to be raised somewhat in 1983-84--an effort that the authorities hope will be of some assistance in alleviating unemployment--although overall investment spending will drop by more than 1-1/2 percentage points of GDP to about the average ratio of the 1976-80 period.

The performance criterion for fiscal policy is a set of cumulative quarterly limits on the overall borrowing needs of the nonfinancial public sector, supported by a set of sublimits on the overall borrowing of the Central Administration (Treasury). 1/ In the case of the overall

1/ Borrowing needs are to be measured in both cases as the sum of net external borrowing, net borrowing from the domestic financial system and the net increase in holdings of Treasury bills and bonds by the nonbank private sector, to the exclusion of those Treasury bills issued by the Central Bank for purposes of open market operations. The introduction of the sublimit on the Treasury was requested by the authorities because of the importance of the Central Administration balance for expectations and to assist the authorities in controlling expenditure.

nonfinancial public sector, the limits have been set at NUr$2.2 billion in the 3 months through March 31, 1983, at NUr$3.3 billion in the 6 months through June 30, 1983, at NUr$4.6 billion in the 9 months through September 30, 1983, at NUr$5.5 billion in the 12 months through December 31, 1983, and at NUr$6.2 billion in the 15 months through March 31, 1984. The limits for the Treasury deficit have been fixed at NUr$1.4 billion in the 3 months through March 31, 1983, at NUr$2.5 billion in the 6 months through June 30, 1983, at NUr$3.2 billion in the 9 months through September 30, 1983, at NUr$3.5 billion in the 12 months through December 31, 1983, and at NUr$3.8 billion in the 15 months through March 31, 1984. Given the need to limit the growth of Uruguay's public external debt and the continued need for sizable external financing of the official banks in 1983 (see subsections 4 and 5 below), the program only counts on US$95 million in net external financing to the nonfinancial public sector (US$63 million to the Treasury), about one third of which would be in the form of suppliers' credits and loans from official development institutions already in the pipeline. Accordingly, in 1983 about one half of the financing requirements of the nonfinancial public sector, and more than one half of the Treasury's, is expected to be covered from domestic sources.

4. Monetary policy

The magnitude and speed of the fiscal adjustment have been dictated to a large extent by the substantial claims on Central Bank resources from other sources that are in prospect for 1983.

Largest among these claims is the continued heavy, albeit declining, financing requirements of the Mortgage Bank. The Mortgage Bank saw its borrowing requirements increase to the equivalent of 5-1/2 per cent of GDP in 1982 in reflection of (1) the deterioration in the competitiveness of its own financial instruments (readjustable mortgage obligations) at a time interest rates on peso-denominated term deposits surged because of a weakening of domestic confidence; (2) the suspension from 1980 of Treasury transfers from a special levy on wages, and (3) greatly stepped up lending from mid-1981. These financing needs were covered by a combination of foreign borrowing and Central Bank advances, at great cost in terms of increases in external debt and of pressure on the balance of payments. In 1983, these borrowing needs are projected at 3 per cent of GDP before falling off sharply in 1984, when the recent scaling down of the Bank's construction program begins to take effect and the Bank starts collecting rents on housing built in 1982-83.

Another source of pressure on the Central Bank will be the unwinding of the export prefinancing scheme introduced in September 1982 and discontinued after the float of the peso; the forward exchange sales contracts that are involved are expected to cost the Central Bank some US$120 million in the first half of 1983. Substantial Central Bank credit expansion (a large part of which is in foreign exchange) also is expected in 1983 from (1) repayments to the Bank of the Republic and to local private commercial banks of short-term loans made in late 1982 to the Treasury and to the Mortgage Bank, and (2) interest payments on behalf of borrowers on a five-year refinancing loan granted by domestic commercial banks, in September 1982, to allay the burden on agricultural and industrial firms of the domestic debts contracted in the previous two years.1/

To meet these prospective credit demands and at the same time ensure that the price and balance of payments targets of the program are being achieved, the Central Bank will have to make active use of legal reserve requirements and open market operations. On January 5, 1983, the authorities established a basic 10 per cent legal reserve requirement and a 50 per cent marginal requirement on bank deposit liabilities denominated in local currency. Legal reserve requirements on foreign currency denominated deposits have not been reintroduced yet for fear of intensifying deposit withdrawals by nonresidents; by the end of January 1983 these withdrawals had reached the equivalent of 27 per cent of the stock of such deposits on the eve of the float. The decline in these deposits now has tapered off and, once confidence has been strengthened and dollar deposits start growing again, the authorities intend to subject dollar deposits to the same type of reserve requirements as apply to peso-denominated deposits. In early January, open market operations were resumed by way of daily auctions of Treasury bills with maturities ranging from 90 to 180 days.

The authorities expect that during the program period currency issue will rise somewhat ahead of the increase in prices as the exchange rate action in late November should result in a marked reduction in uncertainty about exchange rate policy. It may be noted that currency issue had declined in absolute terms from end-1981 through the end of November 1982.

The performance criterion for monetary policy is a set of ceilings on the net domestic assets of the Central Bank, defined as the difference between the Bank's currency issue and its net international reserve position, i.e., including liabilities to banks and other financial intermediaries and the net product of its sale of Treasury bills as an offset to domestic credit operations. In this definition, the net domestic asset test captures all facets of credit expansion by the Central Bank.

Given the simultaneous objectives of limiting the balance of payments deficit and of keeping inflation under control, the growth of net domestic assets has been constrained to the rate of increase in the currency issue, with a maximum increase consistent with the inflation objective, plus the targeted deficit in the balance of payments. As explained in subsection 5 below, the target for the deficit of the balance of payments has been made adjustable up to a limit for a possible shortfall in official foreign borrowing from the level envisaged

1/ For a review of these schemes, see Section III in the accompanying report on recent economic developments.

in the program and the net domestic asset test is to be adjustable upward for an equivalent amount. The quarterly ceilings on net domestic assets take into account seasonal variations in the demand for currency and the balance of payments.

5. Balance of payments and external debt policies

a. Balance of payments

The program envisages a reduction in the overall balance of payments deficit from US$800 million in 1982 to US$100 million in 1983 and in the 15-month period through end-March 1984; the deficit is to be adjusted to as much as US$180 million in 1983 and US$200 million in the 15-month period through March 31, 1984--approximately the maximum that the Fund could finance under the requested arrangement--should net official external borrowing fall short of the projected level. Any shortfall in such borrowing in excess of US$80 million in 1983 and of US$100 million in the 15-month period through March 1984 would have to be made up for by a greater domestic adjustment effort. The objectives for the balance of payments reflect the need to restore domestic and foreign confidence in Uruguay so that the country can maintain freedom of exchange transactions on both current and capital account--which the authorities believe served Uruguay well in the years through 1981--and strengthen its external creditworthiness. Some two thirds of the US$700 million improvement in the overall balance of payments targeted for 1983 reflects an expected turnaround in the capital account, while the remainder is to come from a narrowing of the current account deficit.

The authorities are counting on the recent exchange rate adjustment to help produce a small surplus on goods and nonfactor services account. Merchandise imports are expected to grow only marginally, with a prospective small decline in the oil import bill being more than offset by modest increases in imports of other intermediate goods and of capital goods as the recession comes to a halt. At the same time, the value of exports is projected to advance by over 20 per cent in U.S. dollar terms, reflecting a broad-based response of most export categories to the exchange rate adjustment and the recovery of foreign markets from which certain nontraditional exports had been barred because of the export subsidies previously in existence in Uruguay. Overall, the trade balance is expected to be in equilibrium in 1983. Nonfactor services, especially tourism, also are expected to move from a large deficit in 1982 to a small surplus this year, a development consistent with the traditional behavior of these accounts until 1981. Despite a marked increase in net factor income payments, the current account deficit should shrink from almost US$600 million, or 8-2/3 per cent of GDP in 1982, to somewhat less than US$350 million, or 4-2/3 per cent of GDP, this year.

One of the objectives of the new exchange rate policy is to stem private capital outflows, which had reached close to US$1 billion in 1982. However, the authorities are faced with a situation wherein a number of contractual obligations acquired last year by the Central Bank, such as the export prefinancing scheme and the payment of interest on the September 1982 domestic debt consolidation loan, are denominated in foreign currency and in effect are claims by residents on official foreign exchange holdings.1/ There is a risk of unsettling the exchange market if the Central Bank were to acquire in the market the foreign exchange needed to meet these obligations. The authorities have thought it preferable, therefore, to finance these claims out of the Central Bank reserves, which could cause the overall balance of payments to remain in deficit in 1983. Keeping the deficit to US$100 million will require net official capital inflows of almost US$460 million this year; as was indicated above, however, the program provides for an adjustment in the targeted deficit of up to US$80 million in 1983 (and US$100 million for the 15-month period through March 1984) should net official external borrowing fall short of the amount projected.

b. External debt policies

The projected external current account deficit is only two thirds the size recorded in 1982, but it is uncertain whether Uruguay will be able to obtain balance of payments financing on the scale sought in 1983, and thus provision has been made for the aforementioned adjustment of the balance of payments target. One reason why the full amount of foreign borrowing that is projected may not become available is the general cautiousness of the international financial market in the wake of the debt servicing difficulties experienced by a number of large debtor countries. Another reason is that Uruguay's official external debt--which until 1981 was one of the lowest in the area whether measured in relation to national income or to exports of goods and services--grew by almost 60 per cent in 1982. Yet a third reason is that a substantial part of net official external financing in 1982 was at terms of less than one-year maturity; Uruguay will have to seek a consolidation of these short-term external obligations in medium-term loans in 1983, which may affect Uruguay's ability to raise new money.

At the same time, however, the authorities noted that Uruguay's official external debt barely exceeded 30 per cent of GDP, a ratio that was not high by the standards of countries at a similar level of income per capita. Also, all external obligations were being met and it was not intended to renegotiate payments falling due on medium-term debts. Moreover, the foreign borrowing programed for 1983 was intended to tide Uruguay over the early stages of its stabilization effort, and with the major adjustment of the public finances that was being undertaken and the curtailment of the lending program of the Mortgage Bank, net reliance by the public sector on foreign loans would fall to no more than US$100 million in 1984.

1/ More than 60 per cent of domestic financial intermediation in 1982 was in foreign currency denominated instruments.

The interest cost of the external debt, which had risen from 5-1/4 per cent of exports of goods and nonfactor services on the average during 1978-81 to 15-1/2 per cent in 1982, would rise to an estimated 16-17 per cent in 1983-84 (Table 5).1/ However, the authorities viewed these as unavoidable peaks in a profile of debt service payments that had been kept to very prudent levels until a year ago and to which they intended to return progressively as financial difficulties were overcome and economic growth resumed.

The authorities remarked that to some extent the US$460 million of official foreign borrowing programed for the current year was being inflated artificially by the postponement from late 1982 to early 1983 of up to US$250 million in medium-term borrowing operations as the counterpart (in a ratio of 2.5 to 1) of US$100 million worth of domestic "portfolio purchases" by the Central Bank from banks operating in Uruguay.2/ An additional US$35 million, in the main to the nonfinancial public sector, already was in the pipeline, and discussions had been initiated with the World Bank on a possible quick disbursement loan of up to US$60 million. Under present assumptions, Uruguay's need for net new money from the international capital market therefore would be in the range of US$110-170 million, plus any possible shortfall in receipts from the "portfolio purchases" operation.

The performance criterion for external debt policy is a set of cumulative limits on the net external borrowing of the entire public sector, to the exclusion of the short-term foreign liabilities of the Central Bank. The limits as of the end of December 1983 (US$460 million) and March 1984 (US$485 million) are binding but, because of Uruguay's likely inability to control the timing of disbursements on foreign commercial bank loans, the limits for the first three quarters of the program period are only indicative. However, should actual net cumulative disbursements of foreign loans as of these first three testing dates exceed the indicative amounts, the limits on the balance of payments deficit and the net domestic asset test would be adjusted downward for the full amount of the excess. Moreover, given the sharp increase in short-term obligations (including foreign currency denominated 180-day Treasury notes) in 1982, the program includes a sublimit of US$50 million on the net increase in the stock of official short-term debt during the period through March 31, 1984. This sublimit is to be

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1/ Measured as the ratio of total interest and amortization payments (including short term) to exports of goods and nonfactor services, the debt service burden rose from an estimated 11 per cent on the average during 1978-81 to 32-1/2 per cent in 1982; under the assumptions of the program, the debt service ratio would amount to almost 80 per cent in 1983 (31 per cent excluding amortization of short-term debt that is assumed to be consolidated in a seven-year loan in 1983).

2/ For a review of the history and mechanisms of these "portfolio purchases" (compras de cartera) see Section III, in the accompanying report on recent economic developments.

Table 5. Uruguay: Public Sector Debt Profile Projections, 1978-87

(In millions of U.S. dollars)

	1978	1979	1980	1981	Est. 1982	Projections 1/ 1983	1984	1985	1986	1987
Public sector debt outstanding 2/	768.2	851.0	1,062.0	1,337.2	2,111.2	2,646.5	2,413.4	2,007.2	1,587.6	1,213.4
Long and medium term	756.0	845.2	1,046.7	1,255.8	1,588.3	2,553.6	2,320.5	1,914.3	1,494.7	1,120.5
Short term	12.2	5.8	15.3	81.4	522.9	92.9	92.9	92.9	92.9	92.9
Public sector debt service 2/										
Long term	138.8	129.1	130.9	146.4	279.7	329.7	474.5	636.7	627.9	536.2
Interest	43.5	54.7	80.2	103.0	180.5	197.2	241.4	230.5	208.3	162.0
Principal	95.3	74.4	50.7	43.4	99.2	132.5	233.1	406.2	419.6	374.2
Short term	—	—	—	9.9	113.1	851.2 2/	104.1	104.1	104.1	104.1
Interest	—	—	—	0.7	7.2	30.4	11.2	11.2	11.2	11.2
Principal	—	—	—	9.2	105.9	820.8	92.9	92.9	92.9	92.9
Total 2/	138.8	129.1	130.9	156.3	392.8	1,180.9	578.6	740.8	732.0	640.3
Interest	43.5	54.7	80.2	103.7	187.7	227.6	252.6	241.7	219.5	173.2
Principal	95.3	74.4	50.7	52.6	205.1	953.3	326.0	499.1	512.5	467.1
Exports of goods and nonfactor services	931.3	1,248.4	1,526.0	1,666.5	1,218.8	1,509.3	1,731.0	1,904.1	2,094.5	2,304.0
Debt service ratio										
Excluding IMF debt service	14.9	10.3	8.6	9.4	32.2	78.2 3/	33.4	38.9	34.9	27.8
Long-term	14.9	10.3	8.6	8.8	22.9	21.8	27.4	33.4	29.9	23.3
Short-term	—	—	—	0.6	9.3	56.4	6.0	5.5	5.0	4.5
Including IMF debt service 4/	14.9	10.3	8.6	9.4	32.4	79.9	35.8	41.8	39.1	31.4
Long-term	14.9	10.3	8.6	8.8	23.1	23.5	29.8	36.3	34.1	26.9
Short-term	—	—	—	0.6	9.3	56.4	6.0	5.5	5.0	4.5
Interest/XGNFX										
Excluding IMF debt	4.7	4.4	5.3	6.2	15.4	15.1	14.6	12.7	10.5	7.5
Including IMF debt 4/	4.2	4.4	5.3	6.2	15.5	16.0	17.0	15.0	12.6	9.4
Interest/GDP 5/										
Excluding IMF debt	1.0	1.0	1.2	1.5	2.8	3.2	3.7	2.8	2.4	1.7
Including IMF debt 4/	1.0	1.0	1.2	1.5	2.8	3.3	3.8	3.4	2.9	2.2

Sources: Central Bank of Uruguay; and Fund staff estimates.

1/ For purposes of these calculations, US$430.0 million in short-term debts outstanding at the end of 1982 is projected to be consolidated in 1983 in a seven-year loan, with a two-year grace and at an interest rate of 12 per cent.

2/ Debt profile on the basis of projected outstanding debt as of end 1982 and US$80 million in Central Bank short-term liabilities to be consolidated at medium term in 1983, excluding debt outstanding with IMF.

3/ Total debt service ratio in 1983 excluding short-term debt amortization of principal that is to be consolidated at medium term in 1983, but including amortization of foreign currency denominated Treasury notes (which however are projected to be renewed in full) would be equal to 30.9 per cent.

4/ CFF and credit tranche purchases (1982), and purchases under a proposed two-year stand-by arrangement.

5/ For purposes of this calculation, U.S. dollar GDP has been estimated using an exchange rate for the Uruguayan peso that would keep the Uruguayan peso/U.S. dollar exchange rate constant in real terms at the 1976 level.

adjusted downward, including to negative values, should the authorities be able to refinance at terms of more than one year part or all of the official short-term debt outstanding at the end of 1982.

6. Prospects for output and prices

Although the authorities expect the exchange rate adjustment to provide substantial relief to the tradable goods sector, confidence was eroded severely in the past 18 months, and they believe that the process of economic reactivation will be slow. It is likely that the private sector will want to see evidence that the authorities are steadfast in their pursuit of appropriate policies--thus ensuring both relative stability in the exchange market and a lasting improvement in the competitiveness of the economy--before production plans are stepped up and investment in new productive facilities are resumed on a significant scale. In addition, the foreign currency indebtedness of businesses to the domestic banking system expanded considerably during 1981-82, as the growth of banks' deposit liabilities increasingly was in foreign currency denominated instruments and real interest rates on local currency loans reached such levels as to discourage debtors from borrowing in pesos; firms, therefore, will need time to absorb the exchange losses arising from the recent exchange rate action and, even with improved cash flows, are unlikely to see their profitability restored until late 1983 or early 1984.

Accordingly, private investment is expected to advance little in 1983 and most probably will be limited to reconstituting inventories depleted in the last two years. Public sector fixed capital formation is to fall by almost 14 per cent in real terms because, as was noted above, increased spending in traditional areas would not compensate for the drop in investment at PALMAR and by the state airlines. Consumption demand also should contract as a result of the curtailment in real terms of current government outlays and the expected drop in real wages.

In contrast, it is expected that the adoption of external policies geared to improving substantially the competitiveness of the tradable goods sector--both through the exchange rate change and the lowering of effective protection--will result in an increase of around 10 per cent in the volume of exports and in a marked rise in tourism receipts. This recovery should be sufficient to stem any further decline in output in the first half of 1983 and to provide for a growth rate of about 1 per cent for the year as a whole. A more robust revival of economic activity would be expected in the second year of the program.

The authorities are convinced that control over inflation is an absolute prerequisite for investment to pick up and the economic recovery to become self-sustaining. The program anticipates a substantial spurt of corrective inflation in the aftermath of the float of the peso and of the attendant adjustments in public sector tariffs and prices. But the program seeks to achieve a substantial deceleration in the rate of price increase in subsequent months so that average inflation in 1983 be kept to around 40 per cent, and to 16-17 per cent in 1984. Attainment of this objective is dependent on the implementation of the restrictive financial policies described above, supported by appropriate incomes, commercial and exchange rate policies.

If the present program proves to be successful, toward the end of 1984 or the beginning of 1985 the Uruguayan economy should be characterized by low inflation, improved private sector confidence, and a much strengthened balance of payments position--with an expanded external sector. With the sustained application of present policies, a gradual turnaround in private sector attitudes can be expected, which should result in a return to the generally strong economic performance of the period 1975-80. Of course, continued attention will have to be paid to keeping the external current account deficit to a level consistent with Uruguay's debt servicing capacity, an objective that should prove feasible if the fiscal adjustment proceeds in accordance with the authorities' present intentions. The extent of the improvement in the domestic economy will depend in good measure on external factors--the timing and strength of the world recovery, international interest rate levels and the behavior of Uruguay's terms of trade. But, assuming moderately favorable developments in these areas, it should be possible for the Uruguayan economy to resume relatively rapid rates of growth in coming years.

7. Performance criteria 1/

The program contains as performance criteria: (1) a quarterly balance of payments test limiting the deficit to US$100 million in the first year of the program (while allowing for seasonal variations), adjustable to up to US$200 million in the event of a shortfall in net official external borrowing in relation to the programed level (paragraph 2 of the Memorandum of Understanding); (2) quarterly cumulative limits on the global borrowing requirements of the nonfinancial public sector and of the Treasury, covering net borrowing from the domestic financial system, net placement of government paper outside this system to the exclusion of Treasury bills issued for purposes of open market operations, and net external borrowing (paragraph 3 of the Memorandum of Understanding); (3) a ceiling on the increase in the total disbursed external debt of the public sector, as well as a sublimit on the growth of official external debt with maturity of less than one year (paragraph 4 of the Memorandum of Understanding); (4) a set of ceilings limiting the expansion of the net domestic assets of the Central Bank to the growth of its currency issue, constrained to absolute amounts consistent with the inflation target, plus the targeted balance of payments deficits, and adjustable by up to NUr$2.6 billion for any shortfall in net external official borrowing in relation to the programed level (paragraph 5 of the Memorandum of Understanding); and (5) the usual provisions regarding the exchange and import system (paragraph 4 of the stand-by arrangement).

1/ Quantitative performance criteria are presented in Table 6. These performance criteria are referred to in paragraph 4 of the stand-by arrangement.

Table 6. Uruguay: Stand-by Arrangement, Quantitative Performance Criteria for the Period Through March 1984

	1983			1984
	Jan.-June	July-Sept.	Oct.-Dec.	Jan.-March
(In billions of new Uruguayan pesos)				
Cumulative global deficit of the nonfinancial public sector	3.3	4.6	5.5	6.2
Cumulative global deficit of the Treasury	2.5	3.2	3.5	3.8
Cumulative net domestic assets of the Central Bank: change in banknote issue since December 31, 1982 plus indicated peso amounts 1/	2.34	3.9	2.6	2.6
With an upper limit of 1/	3.45	4.25	5.34	5.69
(In millions of U.S. dollars)				
Cumulative change in the net international reserves of the Central Bank of Uruguay 2/	-90	-150	-100	-100
Cumulative change since December 31, 1982 in disbursed external debt of the public sector 3/	345	410	460	485
Maximum increment since December 31, 1982 of outstanding stock of public sector debts with maturities of less than 1 year 4/	...	...	...	50

Sources: Ministry of Economy and Finance; Secretariat of Planning and Coordination; Central Bank of Uruguay; and Fund staff estimates.

1/ In case of a shortfall in actual as compared with projected disbursements of foreign loans by the public sector, this limit will be adjusted by the amount of the shortfall up to a limit of NUr$1,040 million through the end of the first half of 1983; NUr$1,560 million through the end of the third quarter of 1983; NUr$2,080 million through the end of 1983; and NUr$2,600 million through the end of the first quarter of 1984. Should net official foreign borrowing in the first three quarters of 1983 exceed the amount indicated in the public sector external debt targets, the cumulative limits for the net domestic credit of the Central Bank will be adjusted downward by the equivalent of the excess.

2/ In case of a shortfall in actual as compared to projected disbursements of foreign loans by the public sector, this limit will be adjusted upward by the amount of this shortfall, with a limit of US$40 million through the end of the first half of 1983; US$60 million through the end of the third quarter of 1983; US$80 million through the end of 1983; and US$100 million through the end of the first quarter of 1984. Should net official foreign borrowing exceed in the first three quarters of 1983 the amount indicated in the public sector external debt targets, the cumulative limits for the decline in net official international reserves will be adjusted downward by the full amount of the excess.

3/ Only the limits for the end of 1983 and the first quarter of 1984 have been made performance criteria. For other quarters see footnotes 1/ and 2/.

4/ Excludes Central Bank short-term foreign liabilities but includes U.S. dollar-denominated Treasury bills. This limit will be adjusted downward for any substitution of medium-term external debts for existing short-term debts over the course of the program.

IV. Staff Appraisal

Uruguay's economic and financial situation, one of the strongest in Latin America from 1976 to early 1981, took a sharp turn for the worse in the past two years. Real GDP growth came to a halt in 1981, and output is estimated to have declined by 8-1/2 per cent in 1982. As a result, unemployment, which had declined steadily in the six years through 1981, surged to an estimated 15 per cent in the fourth quarter of last year.

The financial position of the public sector moved from a surplus in 1980 to a deficit in excess of 12 per cent of GDP in 1982. In two years, official external debt about doubled in relation to GDP, and there was a sharp increase in Central Bank credit expansion. With currency issue declining in absolute terms throughout most of 1982 because of the rapid erosion of domestic confidence, the loss of net official international reserves in 1982 more than erased the gains of the previous six years.

In attempting to trace the causes of this abrupt deterioration, external developments (especially the rapid changes from early 1981 in the circumstances of neighboring countries) cannot be ignored. But the cost/price distortions arising from the growing inconsistency between incomes and exchange rate policy, and the effects of these distortions on the evolution of the public finances, and on competitiveness and production, came to play the central role in altering Uruguay's economic performance.

The authorities thus are to be commended for the determination they have displayed in launching in late 1982 a bold effort to correct these distortions and to adjust policies, while maintaining the basic objectives of fostering economic efficiency and improving resource allocation through reliance on market mechanisms.

The floating of the peso with a minimum of initial intervention, together with the authorities' commitment to continue with a flexible exchange rate policy, should go a long way in restoring the competitiveness of the economy and setting the stage for a gradual recovery of economic activity. The accelerated implementation of the trade liberalization program also is appropriate, inasmuch as a reduction of effective protection should provide an important assist to the growth of the export sector. The staff would like to commend the authorities for the fact that, despite the present difficult economic situation, Uruguay maintains no multiple currency practices or restrictions on payments and transfers for current international transactions and for capital transfers; the staff also welcomes the intention of the authorities to retain this system.

The authorities rightly have taken the view that beyond the initial readjustment of relative prices, incomes and demand management policies should be geared to a prompt deceleration of the rate of price increase and to the attainment of approximate stability in the exchange market. The recent decision to limit increases in wages and social security benefits clearly goes in the right direction, aimed as it is at ending the practice of indexing on past inflation in effect through late 1981, and at relating movements in remunerations and benefits to productivity gains and output growth with minimal government intervention. Holding the line on wages, especially in the early stages of the program, undoubtedly will be difficult, but the staff believes that the present thrust of incomes policy is the one that holds out the best hope for real labor income gains and, most importantly, for a progressive reduction of unemployment.

The key element of the program is a major adjustment of the public finances. A reduction in the borrowing requirements of the nonfinancial public sector from 12-1/3 per cent of GDP in 1982 to 3 per cent of GDP in the first year of the program and to around 1 per cent of GDP in 1984 is ambitious, but the staff believes that this reduction is feasible. There is scope for a restoration of the tax burden to around its level of recent years as activity picks up and the exchange rate action results in large income and/or capital gains in which the public sector can share. Moreover, a marked drop of expenditure relative to GDP is in prospect as a consequence of the recent decisions on wages and social security benefits and of the completion of large investment programs in 1982. Of course, some of the new revenue measures will have only a one-time effect; others, such as the export taxes, are bound to have a detrimental impact on resource allocation and ought to be replaced by other revenue sources at the earliest possible date. It would be reasonable to hope however, that as the recovery gains strength the elasticity of Uruguay's tax system would be sufficient to produce a substantial rise in revenues. At the same time, the abandonment of indexing of important categories of budget outlays ought to assist the authorities in keeping spending in line with available resources.

The speed and magnitude of the adjustment in the public finances have been dictated by the continued large--albeit declining--claims on resources from other sources that are in prospect in the first year of the program. Central Bank commitments undertaken last year with the domestic private sector will cost some US$200 million, or 3 per cent of GDP, in 1983; also, despite the recent scaling down of its investment program, the Mortgage Bank will incur borrowing requirements equivalent to an estimated 3 per cent of GDP. These demands on Central Bank resources will greatly reduce the authorities' room for manoeuvre in conducting monetary policy in 1983 and will require utmost flexibility in the use of legal reserve requirements and in the conduct of open market operations. Such flexibility will be particularly necessary if the recovery of confidence should be slow and the growth of domestic financial assets falls short of the rate envisaged in the program.

More specifically, the authorities may well find it necessary in the near future to subject domestic bank deposit liabilities denominated in foreign currency to legal reserve requirements on the same terms and conditions as apply to local currency deposits. The staff also would want to urge the authorities to keep the lending program of the Mortgage Bank under continuous scrutiny in the months ahead, and to review the possibility of allowing the Bank to offer new financial instruments to the public to reduce the need for Central Bank assistance to less than that presently contemplated.

With the set of policies that has been developed, the authorities expect a substantial improvement in the goods and nonfactor services account of the balance of payments. This improvement, however, is projected to be offset to some extent by the increase in net factor income payments abroad, in reflection of the heavy official reliance on external sources of finance in 1982. The current account deficit thus is likely to be around US$350 million in 1983, some 3 percentage points of GDP less than last year. Private sector capital outflows should abate noticeably as a result of the change in exchange rate policy, although some private capital outflows remain in prospect. Accordingly, to keep the overall balance of payments deficit to US$100 million in 1983, the public sector needs to arrange net external borrowing of US$460 million.

Of this amount, US$285 million seems assured under the "portfolio purchases" scheme and from the prospective net disbursements of loans already in the pipeline. It is possible that a quick disbursement loan could be extended by the World Bank, an avenue which the staff would press the authorities to explore, but the remainder will have to be obtained from the international financial market. The authorities also would be required to roll-over--or preferably replace with medium-term loans--some US$520 million in short-term debts. Under this set of assumptions, the debt service ratio is likely to rise to around 40 per cent of exports of goods and nonfactor services in 1985-86, before it begins to fall off.

The prospective borrowing requirements and debt service burden are high, but the staff would tend to concur with the authorities' view that the domestic adjustment effort that is being envisaged is as large as might reasonably be attempted in the short run. At the same time, there is some uncertainty whether, because of prevailing conditions in the international financial market, the authorities will be able to obtain the full amount of balance of payments support being sought. Accordingly, should net official external borrowing fall short of the anticipated level, the program allows for a partial adjustment of the balance of payments target (and of the net domestic asset test) up to the maximum that Fund financing could cover during the first 12 months of the program.

The magnitude of Uruguay's external borrowing requirements in 1983 underlines the severity of the imbalances that have plagued the economy in the past two years and, even though major corrective measures were adopted at the start of the program, it points to the need for an adjustment period of more than one year. However, Uruguay's public sector is approaching the limit of its reliance on external savings, which signals the importance of the authorities' adhering closely to their program and of reducing sharply Uruguay's resort to foreign resources in 1984 and beyond. The staff considers that the program is strong enough, especially in its crucial fiscal component, to attain the requisite adjustment and it believes that the program fully deserves Fund support under a two-year stand-by arrangement for the maximum amount available to Uruguay under existing policies.

The following draft decision is proposed for adoption by the Executive Board:

Stand-By Arrangement

1. The Government of Uruguay has requested a stand-by arrangement for the period April , 1983 to April , 1985 for an amount equivalent to SDR 378 million.

2. The Fund approves the stand-by arrangement attached to EBS/83/43 as revised by EBS/83/43, Correction 2.

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

Table 7. Uruguay: Main Indicators

	Actual/Prel. 1981	Est. 1982	Proj. 1983	Proj. 1984
(Annual percentage changes, unless otherwise specified)				
National income and prices				
GDP at constant prices	-1.1	-8.5	1.0	4.0
GDP deflator	31.8	17.3	38.5	16.5
Consumer prices 1/	34.0	19.0	38.5	16.5
External sector (in millions of U.S. dollars)				
Exports, f.o.b.	14.9	-20.9	20.6	14.7
Imports, c.i.f.	-6.7	-30.3	3.2	10.3
Non-oil imports, c.i.f.	-11.6	-40.0	9.5	10.4
Export volume	15.1	17.5	10.0	8.4
Import volume	-14.2	-28.4	-10.5	4.6
Terms of trade (deterioration -)	-8.3	-1.9	-4.2	--
Nominal effective exchange rate (depreciation -) 1/	-18.3	-28.4	...	...
Real effective exchange rate (depreciation -) 1/	12.6	10.1	...	...
General government 2/				
Revenue and grants	42.5	-3.1	58.4	17.2
Total expenditure	52.0	30.0	20.3	12.0
Money and credit				
Domestic credit 3/	38.5	25.5	27.9	...
Public sector 3/	4.4	18.7	4.0	...
Private sector 3/	38.3	8.8	14.0	...
Money and quasi-money (M2) 4/	27.5	9.8	32.1	...
Velocity (GDP relative to M2)	3.60	3.52	3.73	...
Money and quasi-money (M3) 5/	43.3	0.2	17.5	...
Velocity (GDP relative to M3)	2.00	2.14	1.81	...
Interest rate (annual rate, six-month savings deposit)	49.8	65.0	...	...
(In per cent of GDP)				
Public sector saving 2/	3.7	-5.4	2.2	4.1
Public sector deficit (-) 2/	-2.3	12.3	-3.0	-1.1
Central administration deficit (-) 2/	-0.9	-9.0	-1.9	-0.7
Domestic bank financing	0.1	8.1	1.0	...
Foreign financing 6/	0.8	0.9	0.9	...
Gross domestic investment	15.6	13.2	12.6	13.8
Gross domestic savings	11.4	7.2	7.7	9.9
Current account deficit (BOP) 7/	6.8	8.7	4.7	3.6
External public debt (medium and long term) inclusive of use of Fund credit 7/	19.1	32.6 8/	40.3 8/	37.3
Debt service ratio (in per cent of exports of goods and services)	9.4	32.4	30.9	36.0
Interest payments (in per cent of exports of goods and services)	6.2	15.5	16.0	17.1
(In millions of U.S. dollars)				
Overall balance of payments deficit (-)	12	-800	-100	--
Gross official reserves (months of imports)	4.3	2.6	3.5	5.0
External payments arrears	--	--	--	--

Sources: Ministry of Economy and Finance; Secretariat of Planning and Coordination; Central Bank of Uruguay; and Fund staff estimates.

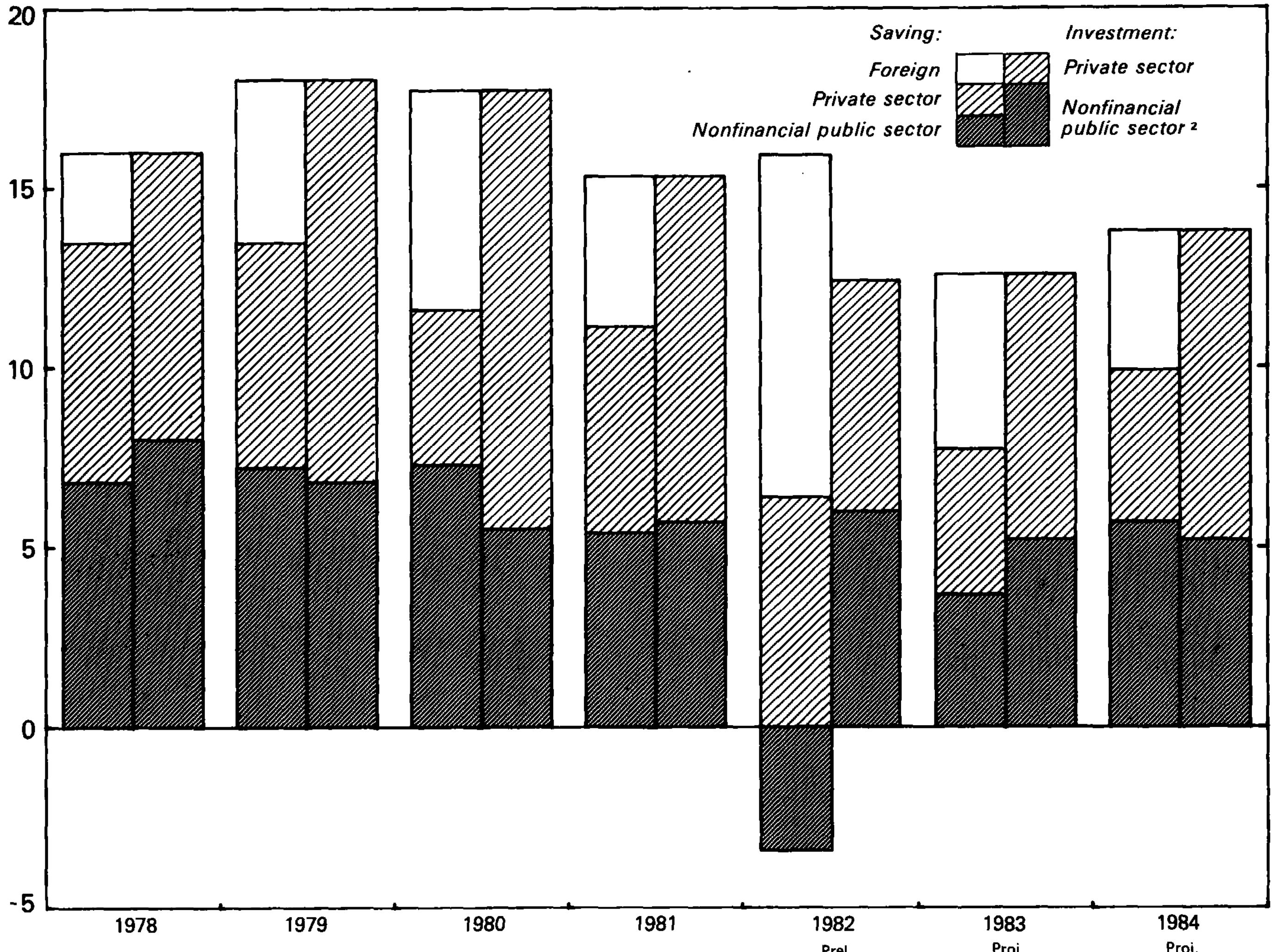
1/ Annual average.
2/ Includes foreign financed expenditure which is not registered in the central administration operations as officially reported.
3/ In relation to the stock of liabilities to the private sector at the beginning of the period.
4/ Includes only deposits and liabilities to the private sector in local currency.
5/ Includes foreign currency deposits valued at the annual average exchange rate of each year.
6/ Including dollar-denominated bills sold to residents and nonresidents.
7/ For the purpose of these ratios, U.S. dollar GDP has been estimated using an exchange rate for the Uruguayan peso that would keep the Uruguayan peso/U.S. dollar exchange rate constant in real terms at its average 1976 level.
8/ Includes short-term debt contracted in 1981 and 1982 but converted to medium term in 1983.

CHART 1

URUGUAY

SAVING AND INVESTMENT[1]

(Per cent of GDP)



Sources: *Central Bank of Uruguay; and Fund staff estimates.*

[1] National Accounts basis.

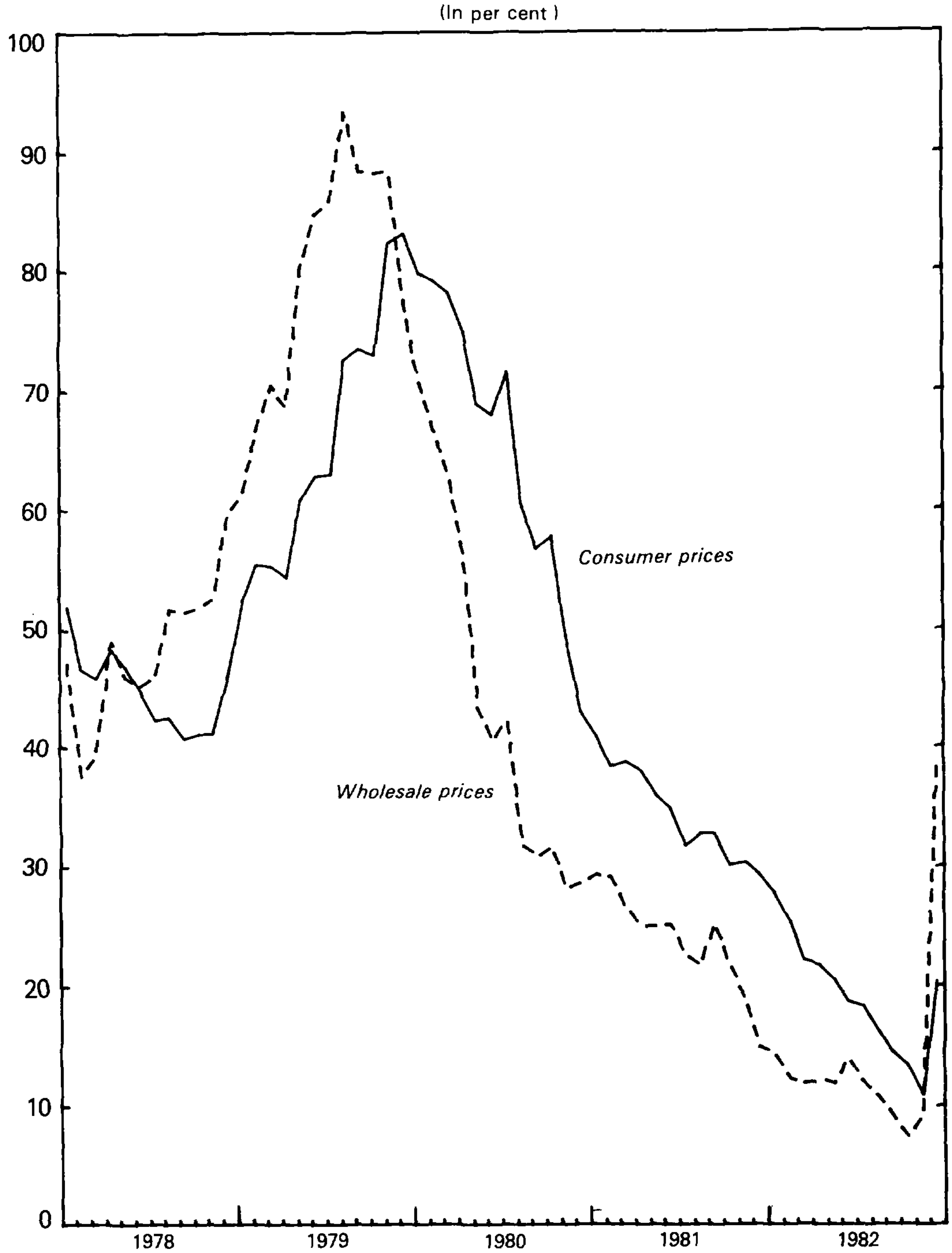
[2] Adjusted to include outlays on Salto Grande binational hydroelectric project through 1983.

CHART 2

URUGUAY

12-MONTH INFLATION RATE

(In per cent)



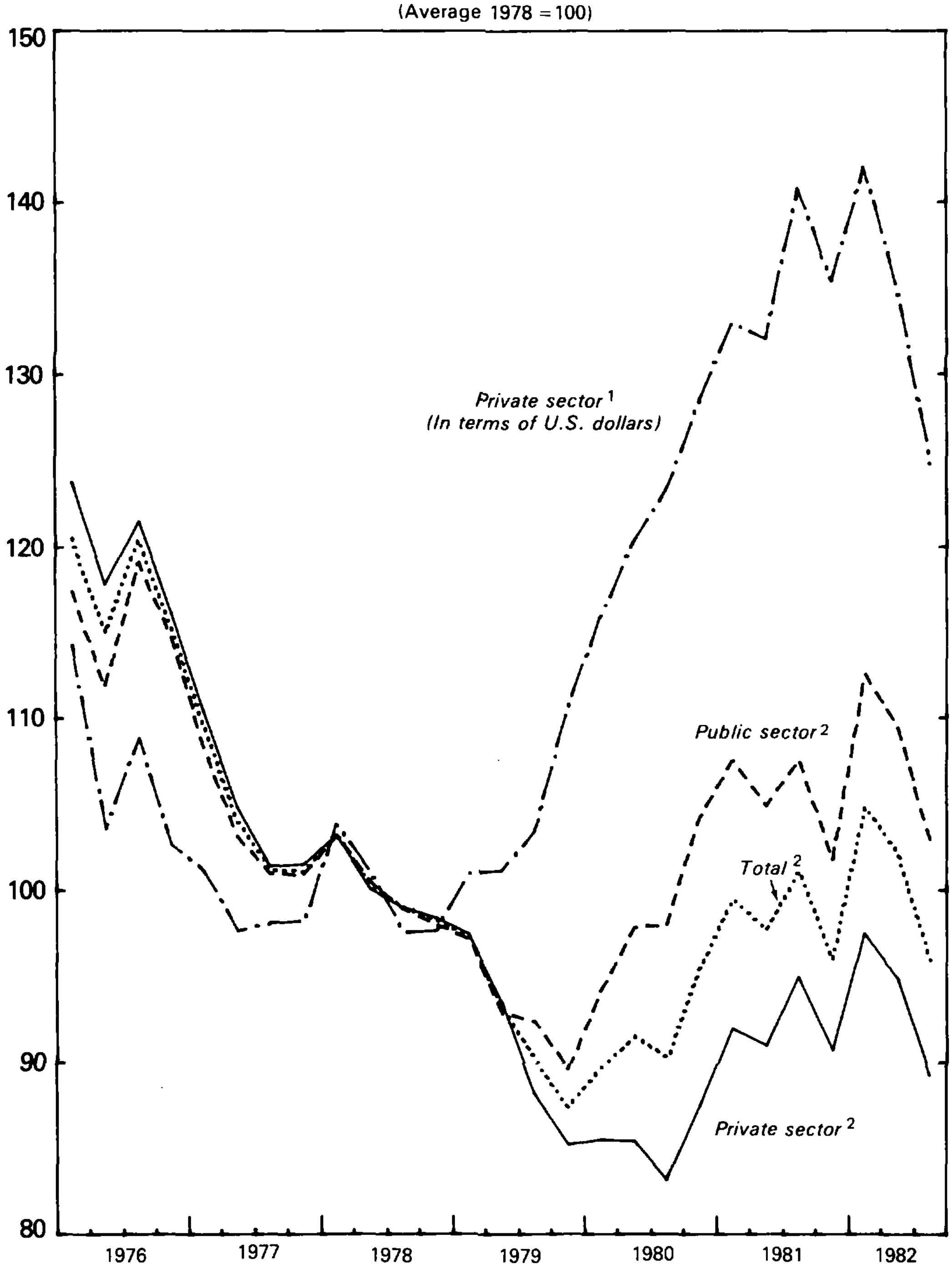
Source: Central Bank of Uruguay.

CHART 3

URUGUAY

PRIVATE AND PUBLIC SECTOR REAL WAGES

(Average 1978 = 100)



Sources: Directorate of Statistics and Census; Central Bank of Uruguay; and Fund staff estimates.

[1]Nominal wages converted to U. S. dollars and deflated by U.S. consumer price index.

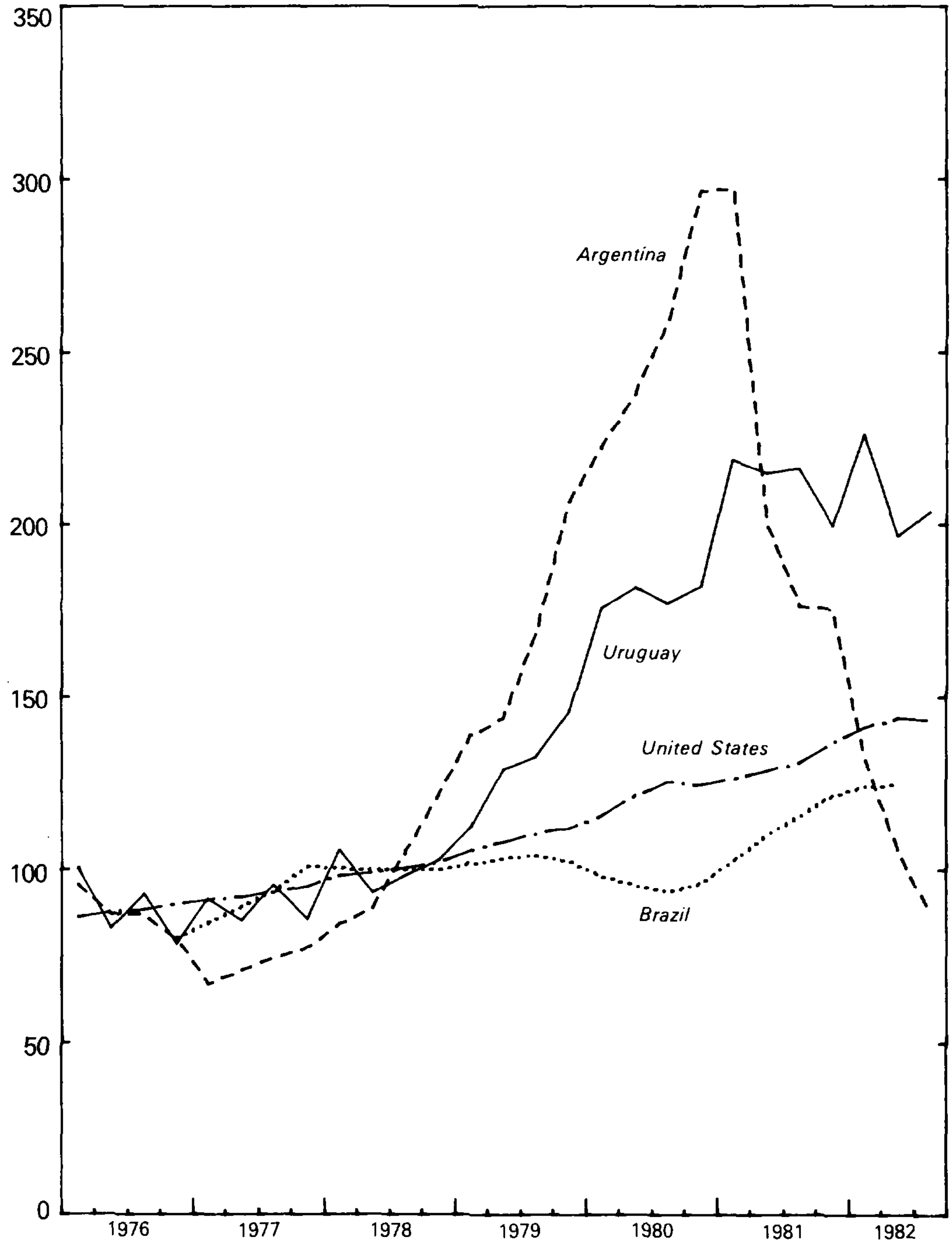
[2]Nominal wages deflated by the consumer price index.

CHART 4

URUGUAY

UNIT LABOR COSTS IN MANUFACTURING[1]

(Average 1978 = 100)



Sources: Central Bank of Uruguay; National Institute of Statistics (Argentina), Brazilian Institute of Geography and Statistics; and IMF Data Fund.

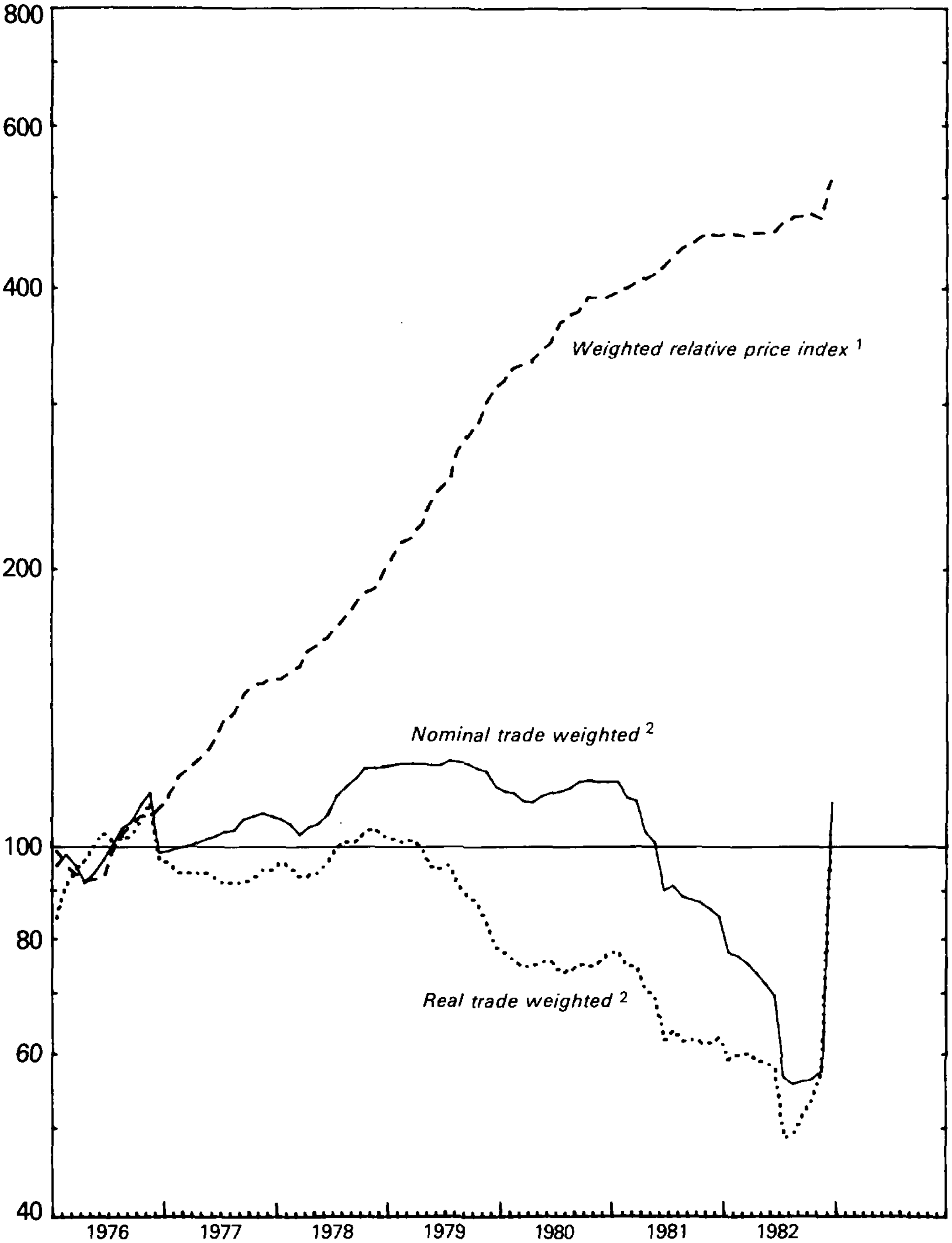
[1]Measured in terms of U.S. dollars.

CHART 5

URUGUAY

EFFECTIVE EXCHANGE RATE, 1976-82

(1976 = 100)



Sources: Central Bank of Uruguay; and IMF, *International Financial Statistics* and *Direction of Trade.*

[1] Index of wholesale prices in Uruguay relative to the index of wholesale prices in Uruguay's major trading partners (weighted average).

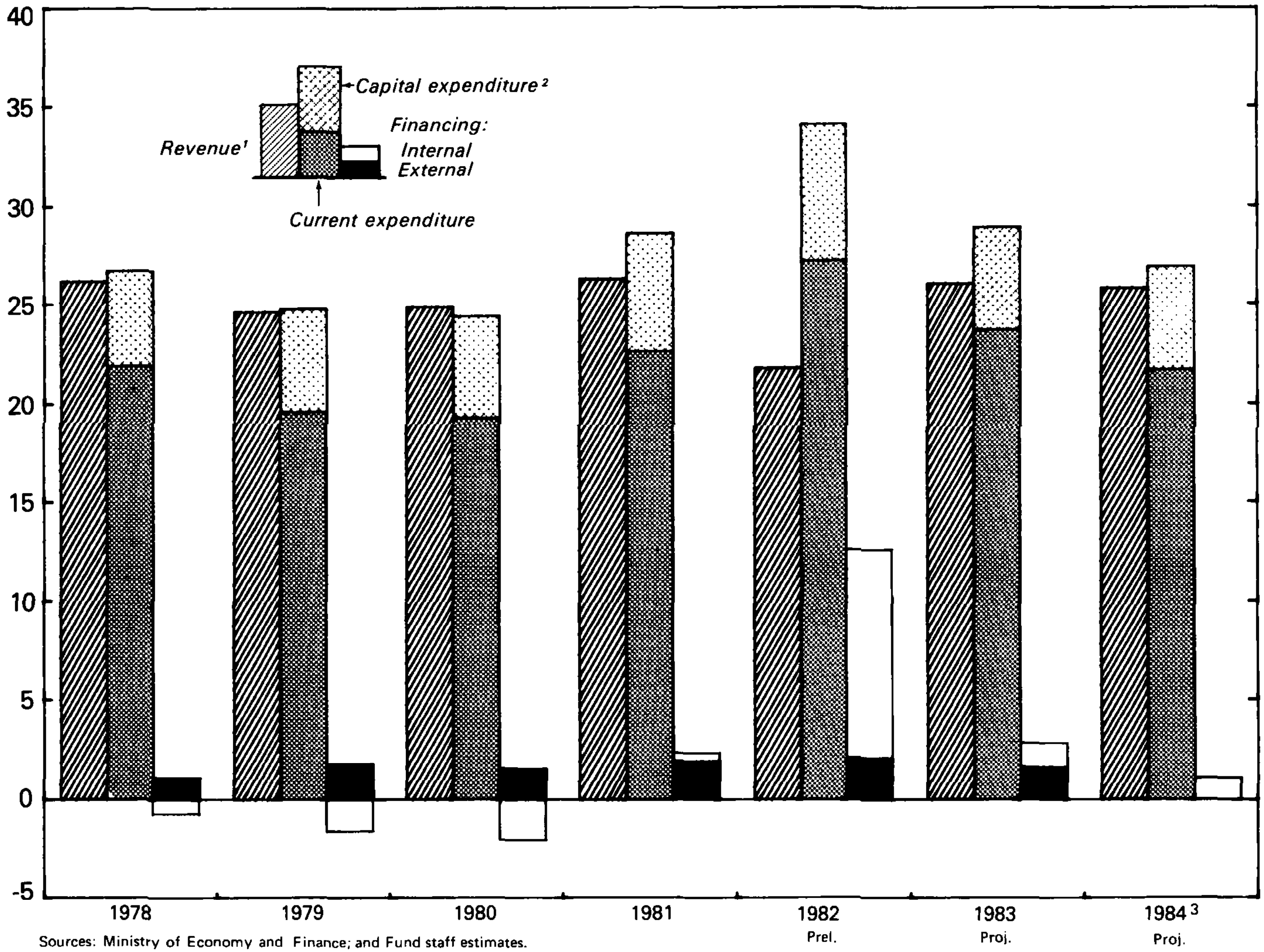
[2] A decline in the value of the index represents an appreciation of the peso.

CHART 6

URUGUAY

PUBLIC SECTOR OPERATIONS

(As per cent of GDP)



Sources: Ministry of Economy and Finance; and Fund staff estimates.

[1] Includes general government revenue and current account surplus of state enterprises.

[2] Includes extrabudgetary expenditure.

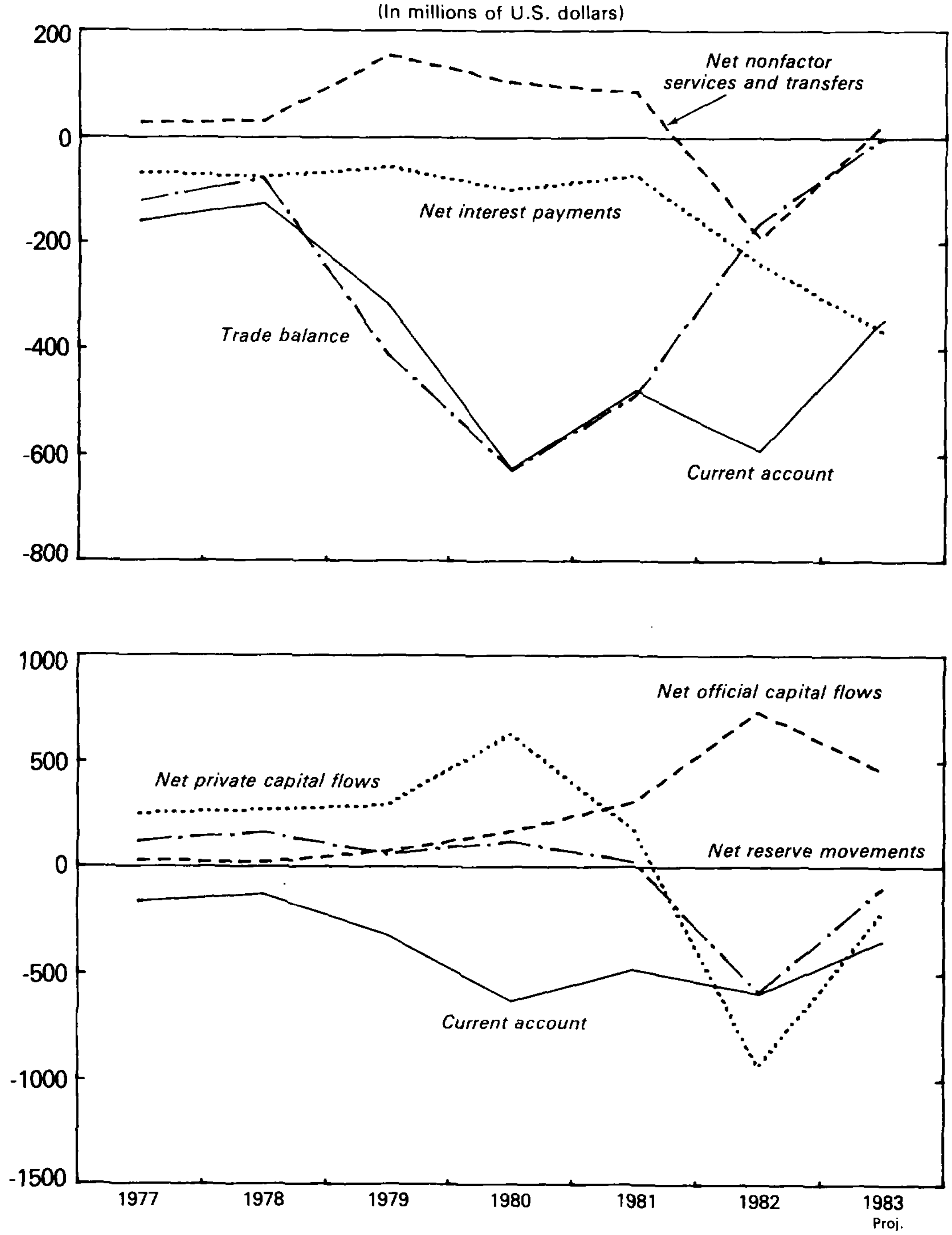
[3] First quarter 1984; composition of financing unknown.

CHART 7

URUGUAY

SELECTED BALANCE OF PAYMENTS FLOWS

(In millions of U.S. dollars)



Source: Central Bank of Uruguay; and Fund staff estimates.

Fund Relations with Uruguay

Date of membership: March 1946.

Status: Article VIII.

Quota: SDR 126 million.

Fund holdings of new Uruguayan pesos:

As of February 24, 1983	Millions of SDRs	Per Cent of Quota
Total currency holdings	201.6	160.0
Under tranche policy	31.5	25.0
Under CFF	44.1	35.0

Special Drawing Rights Department (as of February 24, 1983): Holdings are 3.4 per cent of net cumulative allocations of SDR 50 million.

Transactions with the Fund: Uruguay has had 12 stand-by arrangements from the Fund, including the last one within the first credit tranche for SDR 31.5 million, which expired on July 14, 1982. The amount available under this stand-by arrangement was purchased. A purchase of SDR 55.3 million under the compensatory financing facility was made in August 1982. A repurchase of SDR 11.2 million because of overcompensation, under the CFF, was made in February 1983.

Direct distribution of profits from gold sales (July 1, 1976-July 31, 1980): US$10.95 million.

Gold distribution: 59,052 fine ounces in four distributions.

Exchange rate: Until October 17, 1978 Uruguay maintained a dual exchange market, consisting of a commercial market for trade and certain debt transactions at a rate set by the authorities, and a financial market for other transactions at a freely fluctuating rate. On October 17, 1978, the two exchange markets were unified on a de facto basis, and on November 28, 1979 the exchange markets were legally unified. On November 26, 1982 the Central Bank withdrew from the exchange market allowing the exchange rate to be freely determined by supply and demand. As of February 21, 1983 the exchange rate was NUr$30.25 per U.S. dollar (buying) and NUr$30.50 per U.S. dollar (selling). Uruguay accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement as of May 2, 1980.

Last consultation (Article IV): Discussions April 21-May 7, 1981, consultation completed by the Executive Board on July 15, 1981 (SM/81/142 of 6/25/81).

Uruguay--Basic Data

Area and population	
Area	187,000 sq. kilometers
Population (mid-1982)	3.0 million
Annual rate of population increase (1976-82)	1.3 per cent
GDP (1982)	SDR 8.938 million
	US$9.867 million
	NUr$130.741 million
GDP per capita (1982)	SDR 2,979

	1979	1980	1981	Prel. 1982
Origin of GDP		(per cent)		
Agriculture	10.1	11.1	11.2	11.7
Manufacturing	25.6	25.2	24.2	23.0
Construction	5.3	5.2	5.1	5.0
Transportation and communications	6.8	6.9	7.1	6.7
Commerce	16.8	17.3	16.6	14.3
Other	35.4	34.3	35.8	39.3
Ratios to GDP				
Exports of goods and services	17.9	15.6	16.2	13.7
Imports of goods and services	22.5	21.9	20.6	19.8
Current account of the balance of payments	-4.5	-6.2	-4.3	-6.0
Central administration revenue	15.3	16.0	17.4	14.9
Central administration expenditure	13.2	14.4	16.3	21.2
Public sector savings	5.0	5.6	3.6	-5.4
Public sector overall surplus or deficit (-)	-0.2	0.5	-2.3	-12.3
External public debt (end of year)	12.2	10.4	12.0	22.4
Savings	13.5	11.5	11.0	6.5
Investment	18.0	17.7	15.2	12.3
Money and quasi-money (end of year)	35.9	35.8	42.3	41.3
Annual changes in selected economic indicators				
Real GDP per capita	5.6	5.1	-1.7	-9.1
Real GDP	6.2	5.8	-1.1	-8.5
GDP at current prices	78.3	69.6	30.4	7.3
Domestic expenditures (at current prices)	81.9	72.5	26.8	7.5
Investment	100.5	66.4	12.3	-13.0
Consumption	78.4	73.8	29.7	11.0
GDP deflator	67.7	60.4	31.8	17.3
Wholesale prices (annual averages)	80.4	41.8	23.4	12.9
Cost of living (annual averages)	66.8	63.5	34.0	19.0
Central administration revenues	79.6	77.5	42.2	-8.0
Central administration expenditures	78.5	83.0	45.6	40.2
Money and quasi-money	91.4	69.9	53.1	4.7
Money	88.4	50.7	12.5	21.9
Quasi-money	92.7	77.9	67.4	0.7
Net domestic bank assets 1/	72.3	60.5	49.4	15.5
Credit to public sector (net)	-7.4	-1.3	4.4	18.7
Credit to private sector	80.3	69.9	38.3	8.9
Merchandise exports (f.o.b., in U.S. dollars)	14.9	34.3	14.8	-20.9
Merchandise imports (c.i.f., in U.S. dollars)	56.5	40.7	0.9	-34.1

Central administration finances	1979	1980	1981	Prel. 1982
	(millions of new Uruguayan pesos)			
Revenue	8,424	14,955	21,260	19,552
Current expenditure	7,261	13,455	19,819	27,720
Current account deficit (-)	1,162	1,499	1,441	-8,168
Capital expenditure	1,107	1,862	2,492	3,571
Overall deficit (-)	55	-363	-1,051	-11,739
Internal financing (net)	188	249	50	10,563
External financing (net)	43	333	943	172
Dollar-denominated bills and bonds	-286	-219	57	1,003
Balance of payments	(millions of U.S. dollars)			
Merchandise exports (f.o.b.)	788.1	1,058.5	1,215.4	961.3
Merchandise imports (c.i.f.)	1,199.6	1,687.7	1,703.9	1,123.5
Investment income (net)	-57.8	-100.4	-73.8	-239.9
Other services and transfers (net)	152.5	102.3	84.0	-192.1
Balance on current and transfer accounts	-316.8	-627.3	-478.3	-594.2
Long-term capital (net)	389.2	646.3	649.3	147.7
Short-term capital (net), including errors and omissions	-20.8	151.4	-170.0	-353.0
Allocation of SDRs	11.0	11.0	10.9	--
Valuation adjustment 2/	--	-59.7	13.1	214.9
Change in official net reserves (increase -)	-62.6	-121.7	-25.0	584.6

International reserve position	Dec. 31 1981	Dec. 31 1982
	(millions of SDRs)	
Central Bank (gross)	490.6	206.5
Central Bank (net)	388.8	-119.1

1/ In relation to the stock of money and quasi-money at the beginning of the period. Excludes contra-entry of SDR allocation.

2/ Includes an adjustment to allow for the difference between the price at which gold was bought or sold and the price at which it is valued for reserve purposes (SDR 35 per ounce).

Uruguay: Main Targets, Assumptions and Elements of the Financial Program

I. Targets

1. A reduction in the overall deficit of the nonfinancial public sector (relative to GDP) to no more than 3 per cent in 1983, and around 1 per cent in 1984, compared with deficits of 2-1/2 per cent in 1981 and 12-1/3 per cent in 1982.

2. A level of public sector savings (relative to GDP) of 2-1/3 per cent in 1983 and of 4 per cent in 1984, compared with a negative level of almost 5-1/2 per cent in 1982 and a positive level of 4-2/3 per cent on the average in 1979-81.

3. Some remonetization of the economy following the decline in peso-denominated real money balances in 1982. During the program period, money balances (broadly defined) are expected to increase slightly faster than nominal income and some shift is expected from dollar-denominated to peso-denominated instruments.

4. A gradual deceleration in the rate of inflation, following the initial spurt of corrective price increase in the wake of the recent exchange rate action. Consumer prices are projected to increase on average by close to 40 per cent in 1982, up from 19 per cent in 1982, but the program would seek to limit the average increase to 16-17 per cent in 1984.

5. A reduction in the overall balance of payments deficit from US$800 million (11-2/3 per cent of GDP) in 1982 to no more than US$100 million (1-1/3 per cent of GDP) in 1983 and equilibrium in 1984, with the possibility that the deficit for the first year of the program could be adjusted up to US$200 million (2-2/3 per cent of GDP) in case of a shortfall from the projected level in net official external borrowing.

II. Assumptions

1. The decline in output is expected to end in the first half of 1983 and, for the year as a whole, real GDP is projected to increase by about 1 per cent, reflecting a mild recovery of production in the tradable goods sector. Real GDP growth is projected at 4 per cent in 1984.

2. As a result of the recent exchange rate action, exports are projected to increase by some 10 per cent in volume in 1983 with the largest gains posted by those nontraditional exports that had been barred from foreign markets because of the export subsidies previously in existence. Some increase in export market shares also is expected. Import growth is projected to remain rather weak, with a drop in the oil import bill offsetting, by a small amount, a modest recovery in

imports of other intermediate goods and of capital goods. On the basis of these assumptions, the trade balance is projected to move from a deficit in 1982 to approximate equilibrium in 1983.

3. The six-month London interbank offered rate is assumed to average 10-1/2 per cent in 1983. However, the decline in LIBOR from its average level in 1982 will be partially offset by higher spreads on public sector external borrowing.

4. Net official capital inflows are projected to be US$460 million in 1983 and no more than US$100 million in 1984. The net use of foreign savings includes up to US$250 million as the counterpart to domestic "portfolio purchases" of US$100 million, and some US$35 million in net disbursements of loans already in the pipeline. The program also assumes that all existing short-term debts of the public sector either will be rolled over or replaced by medium-term loans. Maturing dollar-denominated Treasury notes are projected to be renewed. Total net capital inflows are not expected to exceed US$245 million owing to a prospective private capital outflow of some US$215 million reflecting the discharge by the Central Bank of foreign currency denominated obligations vis-a-vis residents acquired in 1982.

III. Main Elements of the Program

1. Public sector policies

a. The improvement in the public finances is predicated on a number of revenue and expenditure measures. On the revenue side new taxes have been introduced or reinstated, including export taxes (to substitute in 1983 for the tax on farm income which is collected with a one-year lag and would have yielded little this year) and a 2 per cent levy on wages. There is also to be a substantial curtailment of export rebates which are to be replaced by refunds of indirect taxes paid during the production process in accordance with GATT rules. Tax rates also have been increased significantly, and in some cases doubled, for the wealth, real estate and most excise taxes. The value-added tax has been extended to interest on bank loans and to professional services, and the lowest rate has been raised by 4 percentage points. In the public enterprises, prices and tariffs have been increased by 25-50 per cent and additional increases are to take place over the course of the year as circumstances require. In the social security system, employees' contributions have been increased and employers' contributions reinstated.

b. On the expenditure side, wages and social security benefits have been increased by 15 per cent, effective January 1, 1983, payable in two stages in the case of the latter. Henceforth, the Government will abstain from granting across-the-board adjustments and, instead, will manage the wage and social security bills in the light of overall spending priorities and the need to reduce the public sector's borrowing requirements. Other current government outlays (excluding interest payments) are to grow by no more than 7 per cent in nominal terms, representing a sharp decline in real terms.

c. Public sector investment is to decline by more than 1-1/2 percentage points of GDP; a recovery in outlays on telecommunications, power distribution, improved port facilities and public works would offset only part of the drop in real capital spending resulting from completion of the PALMAR hydroelectric project and of the state airlines' modernization program.

d. Cumulative quarterly limits have been placed on the total borrowing--defined to include net external borrowing, net borrowing from the domestic financial institutions, and the net increase in the private sector's holdings of Treasury bills and bonds (to the exclusion of those issued for purposes of open market operations)--of both the nonfinancial public sector and the Central Administration (Treasury).

2. Money and credit

a. Legal reserve requirements, which had been discontinued in 1979, have been reintroduced, with the basic rate set at 10 per cent and the marginal rate at 50 per cent for peso-denominated deposits. The authorities also intend to subject dollar deposits to reserve requirements once confidence has strengthened and these deposits, which fell sharply in the wake of the exchange rate action, begin to grow again. Open market operations also have been resumed and the program calls for flexible management of these instruments by the Central Bank in order to keep credit growth consistent with the price and balance of payments targets of the program.

b. The increase in the net domestic assets of the Central Bank is to be limited to the growth of currency issue with an upper limit constrained to the inflation target, plus specified peso amounts for each quarter that are consistent with the overall balance of payments target. These limits are adjustable up to a limit in case of a shortfall in net official external borrowing from the level envisaged in the program.

3. Wages

Wage policy is to be geared to the achievement of a significant deceleration of inflation, once the process of corrective price adjustments triggered by the recent exchange rate action has worked its way through the economy. The Government is to abstain from intervening in the process of wage determination in the private sector. Wage developments in the Government and the public enterprises will be determined by availability of resources.

4. External sector

a. In the early months of the program, the determination of the exchange rate is essentially to be left to the free play of supply and demand without Central Bank intervention in order to give time for domestic adjustment policies to take hold and for the exchange rate to find its equilibrium level. Subsequently, the exchange rate will be managed flexibly either through a continued float with a measure of Central Bank intervention to prevent excessive fluctuations, or through the adoption of a crawling peg system. In managing the exchange rate, the authorities are to be guided by the need to preserve the competitiveness of the economy and to meet the balance of payments objectives of the program.

b. Implementation of the schedule of import duty reductions introduced in late 1978 has been advanced by one year, and the highest duty rate now stands at 55 per cent, down from 75 per cent prior to the float of the peso. The import reference prices maintained by the Bank of the Republic have been eliminated and reliance on this device is to be discontinued altogether except in instances of foreign dumping. The authorities are to keep import policies under review during the program period with a view to improving resource allocation.

c. The system of export tax rebates has been discontinued and, in accordance with GATT rules, exporters are to be refunded no more than indirect taxes paid in the production process.

d. The net increase in the external indebtedness (excluding short-term foreign liabilities of the monetary authorities) of the public sector during the first year of the program is to be limited to US$460 million (US$485 million through March 31, 1984) and to US$100 million in 1984; borrowing from all sources and all maturities is covered by this limit. Should actual net external official borrowing fall short of this amount, the target of the balance of payments deficit for the first year of the program is to be adjusted upward by up to but not more than US$100 million, and the test on the net domestic assets of the monetary authorities is to be adjusted upward by up to but not more than NUr$2.6 billion. In the event that net official external borrowing during the first three quarters of 1983 should exceed the indicative cumulative limits as of the end of each one of these quarters because of an inability to control fully the timing of disbursements on foreign loans, the first three quarterly targets for the balance of payments deficit and the net domestic assets of the Central Bank will be adjusted downward, for the full amount of this excess.

e. To improve the maturity profile of the external debt, the net increase in the external debt of the public sector with original maturities of one year or less, but excluding the short-term foreign liabilities of the Central Bank, is not to exceed US$50 million through end-March 1985. This limit will be adjusted downward, including to negative values, in the event that the public sector should succeed in substituting medium-term obligations for this short-term foreign liabilities outstanding at the end of December 1982.

Stand-By Arrangement - Uruguay

Attached hereto is a letter with annexed memorandum dated February 1, 1983 from the Minister of Economy and Finance and the President of the Central Bank of Uruguay requesting a stand-by arrangement and setting forth the objectives and policies that the authorities of Uruguay intend to pursue for the period of this stand-by arrangement.

To support these objectives and policies the International Monetary Fund grants this stand-by arrangement in accordance with the following provisions:

1. For a period of two years from April , 1983 Uruguay will have the right to make purchases from the Fund in an amount equivalent to SDR 378 million, subject to paragraphs 2, 3, 4, and 5 below, without further review by the Fund.

2. (a) Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 47.25 million until August 20, 1983, the equivalent of SDR 94.5 million until November 20, 1983, the equivalent of SDR 151.2 million until February 20, 1984, the equivalent of SDR 189 million until May 20, 1984, the equivalent of SDR 236.25 million until August 20, 1984, the equivalent of SDR 283.5 million until November 30, 1984, and the equivalent of SDR 330.75 million until February 20, 1985.

(b) None of the limits in (a) above shall apply to a purchase under this stand-by arrangement that would not increase the Fund's holdings of Uruguay's currency in the credit tranches beyond 25 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota.

3. Purchases under this stand-by arrangement shall be made from borrowed resources until purchases under the arrangement reach the equivalent of SDR 15,750,000 and then from ordinary and borrowed resources in the ratio of 1 to 1.2, until purchases under this arrangement reach the equivalent of SDR 223,650,000 and then each purchase shall be made from borrowed resources, provided that any modification by the Fund of the proportions of ordinary and borrowed resources shall apply to amounts that may be purchased after the date of modification.

4. Uruguay will not make purchases under this stand-by arrangement, other than the initial purchase equivalent to SDR 47.25 million that it may request not later than within 15 days of the effective date of this arrangement, that would increase the Fund's holdings of Uruguay's currency in the credit tranches beyond 25 per cent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12.5 per cent of quota:

(a) Until March 31, 1984, during any period in which the ceiling on the net domestic assets of the Central Bank described in paragraph 5 of the Memorandum of Understanding annexed to the attached letter has been exceeded; or

(b) Until March 31, 1984, during any period in which the data at the end of the preceding calendar quarter indicate that

(i) the cumulative overall balance of payments targets described in paragraph 2 of the Memorandum of Understanding annexed to the attached letter have not been met, or

(ii) the limit on the cumulative global deficit of the nonfinancial public sector described in paragraph 3 of the Memorandum of Understanding annexed to the attached letter has been exceeded, or

(iii) the limit on the cumulative global deficit of the Treasury described in paragraph 3 of the Memorandum of Understanding annexed to the attached letter has been exceeded, or

(iv) the limit on the cumulative increase in the outstanding disbursed external debt of the public sector described in paragraph 4 of the Memorandum of Understanding annexed to the attached letter has been exceeded, or

(v) the limit on the cumulative increase in the out standing short-term external debt of the public sector described in paragraph 4 of the Memorandum of Understanding annexed to the attached letter has been exceeded, or,

(c) For the period from April 1, 1984 through the end of the stand-by arrangement if before March 31, 1984 suitable performance clauses for this period have not been established in consultation with the Fund as contemplated in paragraph 25 of the attached letter, or if such clauses, having been established, are not observed, or

(d) During the entire period of this stand-by arrangement, if Uruguay

(i) imposes restrictions on payments and transfers for current international transactions, or

(ii) introduces any multiple currency practice, or

(iii) concludes bilateral payments agreements which are inconsistent with Article VIII, or

(iv) imposes or intensifies import restrictions for balance of payments reasons.

When Uruguay is prevented from purchasing under this stand-by arrangement because of this paragraph 4, purchases will be resumed only after consultation has taken place between the Fund and Uruguay and understandings have been reached regarding the circumstances in which such purchases can be resumed.

5. Uruguay's right to engage in the transactions covered by this stand-by arrangement can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally, or in order to consider a proposal, made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of Uruguay. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 5, purchases under this arrangement will be resumed only after consultation has taken place between the Fund and Uruguay and understandings have been reached regarding the circumstances in which such purchases can be resumed.

6. Purchases under this stand-by arrangement shall be made in the currencies of other members selected in accordance with the policies and procedures of the Fund, and may be made in SDRs if, on the request of Uruguay, the Fund agrees to provide them at the time of the purchase.

7. The value date of a purchase under this stand-by arrangement involving borrowed resources will be normally either the 15th day or the last day of the month, or the next business day if the selected day is not a business day. Uruguay will consult the Fund on the timing of purchases involving borrowed resources.

8. Uruguay shall pay a charge for this stand-by arrangement in accordance with the decisions of the Fund.

9. (a) Uruguay shall repurchase the outstanding amount of its currency that results from a purchase under this stand-by arrangement, in accordance with the provisions of the Articles of Agreement and decisions of the Fund, including those relating to repurchases as Uruguay's balance of payments and reserve position improves.

(b) Any reductions in Uruguay's currency held by the Fund shall reduce the amounts subject to repurchase under (a) above in accordance with the principles applied by the Fund for this purpose at the time of the reduction.

(c) The value date of a repurchase with respect to a purchase financed with borrowed resources under this stand-by arrangement will be normally either the 6th day or the 22nd day of the month, or the next business day if the selected day is not a business day, provided that the repurchase will be completed not later than seven years from the date of purchase.

10. During the period of the stand-by arrangement Uruguay shall remain in close consultation with the Fund. These consultations may include correspondence and visits of officials of the Fund to Uruguay or of representatives of Uruguay to the Fund. Uruguay shall provide the Fund, through reports at intervals or dates requested by the Fund, with such information as the Fund requests in connection with the progress of Uruguay in achieving the objectives and policies set forth in the attached letter and annexed memorandum.

11. In accordance with paragraph 25 of the attached letter, Uruguay will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because any of the criteria in paragraph 4 above have not been observed or because he considers that consultation on the program is desirable. In addition, after the period of the stand-by arrangement and while Uruguay has outstanding purchases in the upper credit tranches, the Government will consult with the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning Uruguay's balance of payments policies.

Montevideo, Uruguay
February 1, 1983

Mr. J. de Larosiere
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Mr. de Larosiere:

1. During most of the post-war period, government policies in Uruguay promoted import substitution behind high tariff and other trade barriers, while capital movements were severely restricted. Such inward-looking economic policy, together with lax domestic demand management, resulted in misallocation of resources and contributed to a steady weakening of the country's overall economic position, as reflected in a high and variable rate of inflation, a marked instability in the balance of payments, and negligible real GDP growth.

2. To ensure resumption of sustained growth with approximate stability, the course of economic policies was altered radically in the mid-1970s. Priority initially was given to reducing financial imbalances and to redressing distortions in the economy. The policies employed for this purpose centered on a tightening of domestic demand management, the pursuit of a flexible exchange rate policy and extensive corrective price adjustments. As these policies took hold, greater emphasis was placed from 1978-79 on raising the growth potential of the economy and controlling inflation. All but a few price controls were eliminated; the tax structure was revamped to minimize distortions in resource allocation; a six-year program of reduction of import restraints was introduced; the financial and exchange systems were freed; and, in an attempt to promote gradual convergence of domestic price increases with those abroad, the authorities in late 1978 shifted from the crawling peg system in use since 1974 to the announcement of an exchange rate schedule several months in advance. These policies were supported by a series of one-year stand-by arrangements in the first credit tranche from the International Monetary Fund starting in 1975.

3. We are satisfied that this strategy served the country well during the period 1975-80. Public sector finances were strengthened to the point where virtual equilibrium was achieved during 1978-80. Confidence in the peso was restored, and there was a marked real increase in the flow of private financial savings into the domestic banking system. Since the Central Bank consistently adhered to prudent credit policies, the balance of payments was turned around dramatically, and by the end of 1980 gross official foreign reserves reached an all time high of four months of imports of goods and services. Particularly gratifying was the rebound in the rates of output growth and employment

creation. The increase in real GDP averaged 5 per cent during 1976-80, while in the same period unemployment dropped from 13 per cent to 6 per cent.

4. Progress in controlling inflation, however, was uneven and much slower. Despite the change in exchange rate policy in December 1978, prices in 1979 advanced almost twice as fast as the year before; and, although inflation was about halved in 1980, it remained in excess of 40 per cent. There were a number of reasons for this stickiness of prices. Seen in retrospect, the import liberalization program probably was not implemented with the required speed, which maintained an effective protection in the early stages of the new policy that prevented inflation from decelerating at the pace sought by the slope of the announced exchange rate schedule. Another reason was the indexing of remunerations and social security benefits on past price and wage inflation. Yet a third reason was the surge of domestic expenditure in 1979-80 fueled by heavy Argentine travel to, and investment in, Uruguay.

5. Not until 1981 did external policies effectively assist in reducing inflation (to less than 30 per cent). But, in other respects Uruguay's economic and financial position deteriorated very rapidly. The cost/price distortions induced by the indexing of wages and social security benefits at a time when the announced exchange rate schedule was aiming at a sharp deceleration of inflation threw the economy, particularly nontraditional exports, into a tailspin. This weakening of economic performance was aggravated by the appreciation of the U.S. dollar and the international recession. Moreover, Argentina's and Brazil's efforts to adjust their economies had the effect of reducing demand for Uruguayan products, which compounded the recessionary impact of the overvaluation of the currency. Real GDP growth slowed markedly in the first half of 1981, and for the year as a whole output declined. At the same time, the public sector financial position began to weaken as a result of the rise in the wage and social security bills and of the slowdown in revenue growth attendant on the deceleration in the rate of increase of money GDP. The public sector moved from a surplus in 1980 to a deficit equivalent to 2-1/3 per cent of GDP in 1981. Equilibrium in Treasury operations, a cornerstone of policies in previous years, also proved beyond reach in 1981. As the policy approach adopted in late 1978 did not allow for deviations from fiscal restraint nor for any significant credit expansion by the Central Bank, confidence began to wane, a trend accentuated by Argentina's abandonment of a similar exchange rate regime earlier in the year. There was substantial capital flight and the growth of M2 decelerated steadily throughout 1981 despite a continuous rise in interest rates.

6. The balance of payments current account deficit narrowed somewhat in 1981, but the overall balance of payments would have ended in a large deficit--the first in six years--had it not been for a near doubling of net official external borrowing. This borrowing approximately offset a reduction in private capital inflows from US$630 million in 1980 to US$170 million in 1981.

7. Despite attempts at corrective action in February, May, and October of 1982, Uruguay's economic and financial position took a further turn for the worse last year. While inflation fell progressively to international levels, real interest rates reached unprecedented highs (45 per cent in mid-November) as the pace of exchange rate depreciation was accelerated to correct the overvaluation of the peso and the country risk premium tended to rise in response to the worsening domestic and international financial situation. The high cost of credit, together with Uruguay's growing inability to retain export market shares and with the softening of world demand, caused output to fall by an estimated 8.5 per cent. Meanwhile, the financial performance of the public sector continued to weaken, with the overall deficit exceeding 12 per cent of GDP.

8. Other sources of imbalance also emerged, that further eroded confidence in the peso. Reflecting a sharp increase in lending to compensate for the slack in private construction activity, the financing needs of the Mortgage Bank rose to US$530 million, or 5-1/3 per cent of GDP, in 1982, a substantial part of which had to be satisfied by Central Bank advances. Further pressure on the Central Bank resulted from the deterioration in the financial position of the commercial banking system brought about by the growing inability of borrowers to repay principal and to meet interest obligations. Although in general arrangements were made promptly for the sale to foreign financial institutions of those banks facing difficulties, the Central Bank had to extend credit on a sizable scale to meet deposit withdrawals.

9. Altogether, Central Bank credit in the first 11 months of 1982 nearly doubled in relation to the stock of currency issue at the end of 1981. But as currency issue contracted by 9 per cent in the same period, the net official international reserve loss amounted to US$565 million. In part, this loss mirrored a widening of the balance of payments current account deficit from US$480 million, or 4-1/3 per cent of GDP, in 1981 to an estimated US$595 million, or about 6 per cent of GDP, in 1982. It also reflected a downturn in the capital account as large official external borrowing--which raised the public external debt to more than US$2.0 billion, or 20-1/2 per cent of GDP--was more than offset by private capital outflows of US$940 million.

10. On these trends, reserves would have been exhausted in a matter of months. Accordingly, the adjustment path chosen earlier in the year through an acceleration of the announced rate of depreciation of the peso had to be abandoned in favor of a more radical adjustment of exhange rate policy. On November 29, 1982, the Central Bank withdrew from the exchange market and the peso was left to float freely. A number of complementary measures were announced on the same day, which were followed by the development of a comprehensive adjustment and recovery program in early December. The program aims at correcting present imbalances as rapidly as possible, but it also seeks to provide for a gradual resumption of economic growth. To this end, the program seeks to consolidate the economic reforms implemented in recent years,

especially in the area of trade liberalization. In carrying out this program, the Government of Uruguay would like to count on the support of the International Monetary Fund in the form of a two-year stand-by arrangement in a total amount equivalent to SDR 378 million from ordinary and enlarged access resources.

11. The macroeconomic assumptions and objectives of our program, expressed in terms of GDP, are presented in attached Table 1. Foremost among our objectives are (1) the restoration of a balance of payments position that can be sustained over the medium-term; (2) a resumption of output and employment growth; and (3) a return to approximate price stability once the corrective price adjustments associated with the recent freeing of the exchange rate have worked their way throughout the economy. These objectives will be pursued by an appropriate mix of external, incomes, financial and resource allocation policies. The ultimate balance of payments target is a current account deficit consistent with Uruguay's external borrowing capacity, taking account of the difficulties now being encountered by Latin American countries in raising new funds--and at terms which are satisfactory--from the international capital market. The inflation target for 1983 is to hold price increases to around 40 per cent, and, for 1984, to achieve a gradual deceleration of inflation to a rate approximating that abroad by the last quarter of the year. We realize that the goal of reactivating the economy may be more elusive, but we hope that the decline in output of the last two years will come to a halt in the first half of 1983, and that a modest positive growth will be within reach for the year as a whole. A more robust rebound of real GDP is not expected until the second year of our program.

12. The central feature of the adjustment program is the abandonment of the exchange rate schedule (and of the exchange guarantee scheme managed by the state-owned Bank of the Republic) in favor of a float of the peso. After a period in which exchange rate oscillations are likely to be quite pronounced, and as other policies begin to take hold and the development of a forward exchange market allays uncertainties, hopes are that the exchange rate will stabilize within a narrow range. Once the exchange rate has moved to its equilibrium level, we intend to pursue a flexible exchange rate policy, which may consist either in a float with substantial Central Bank intervention or in a crawling peg, as balance of payments circumstances dictate.

13. With this exchange rate adjustment, and taking into account the prospective evolution of the terms of trade, the current account balance of payments deficit is expected to be reduced to US$345 million in 1983 and US$285 million in 1984. Assuming that Uruguay will be able to roll over or refinance all of its short-term debts which fall due in 1983 and to count on net external savings of about US$245 million in 1983, the program aims at an overall balance of payments deficit of no more than US$100 million in 1983 and at equilibrium in 1984. The quarterly targets, however, allow for temporarily larger deficits because

of the uneven distribution over the course of the year of certain Central Bank foreign exchange expenditures resulting from obligations acquired in 1982.

14. Reflecting prudent fiscal management in the 1970s, Uruguay's official external debt remained one of the lowest in the Western Hemisphere, amounting to no more than 12 per cent of GDP at the end of 1981; debt service payments, in terms of national income or export earnings, also were low. Under normal international economic conditions and with a fluid international capital market Uruguay should not have had difficulty in securing the amount of foreign savings needed to meet its requirements in 1982 and tie it over the adjustment period ahead. Access to foreign commercial bank lending, however, has become increasingly difficult, and the bulk of the foreign borrowing undertaken in 1982 was at less than one year. In these circumstances, we believe it to be important that (1) Uruguay's borrowing plans for the next two years, including refinancing of existing short-term loans, be made an integral part of our economic program; (2) these plans be presented as such to prospective lenders when we approach them in early 1983; (3) to the extent feasible, the Fund provide us with the assistance necessary vis-a-vis the international financial market to obtain new financing and substitute medium-term for short-term debt; and (4) after peaking in 1982, net access of the public sector to foreign loans decline gradually in absolute terms during 1983-84. Consistent with our fiscal program and with the prospective financial needs of the state-owned Mortgage Bank, net recourse to external savings by Uruguay's public sector, including official financial institutions, has been programmed at US$460 million in 1983 and US$100 million in 1984. To agree with the projected financing requirements of the public sector, net disbursements on foreign loans will be subject to quarterly limits.

15. For the recent exchange rate adjustment to produce a lasting improvement in the competitiveness of the Uruguayan economy, wage policy must remain prudent. Moreover, after two years of increase in unemployment, we would hope that any resumption of economic growth will translate into job creation rather than in real wage increases. Although the recent depreciation of the peso is expected to result in a marked increase in prices, the Government has kept the accompanying wage increase to 15 per cent for both the public and private sector, effective January 1, 1983. Social security benefits are to be raised by the same percentage in 1983, although adjustments are to be phased in two steps to lessen their impact on the General Government budget. Henceforth, save for the minimum wage which must be set by law, the Government does not intend to intervene in the process of wage determination. Wage levels thus will depend primarily on the economic position of each firm and on the labor market situation in general. Government salary raises are to be granted only to the extent that they can be accommodated without jeopardizing the goal of a sizable reduction in the Treasury's and in the overall public sector deficits.

16. In Uruguay, where the financial position of the Treasury heavily influences the price and exchange rate expectations of the public, a return to equilibrium in Treasury operations at the earliest possible date is desirable. However, because the measures that have just been announced will produce their effects only with a lag, the program for 1983 can aim but at a gradual reduction of the deficit during the course of the year. For 1983 as a whole, the program seeks a reduction in the Treasury deficit to 2 per cent of GDP, down from an estimated 9 per cent of GDP in 1982. The goal for 1984 will be around three quarters of 1 per cent of GDP. As for the overall public sector financing requirement, domestic and foreign financial constraints do not allow for gaps in excess of 3 per cent of GDP in 1983 and of around 1 per cent of GDP in 1984. To ensure adherence to these objectives, quarterly cumulative limits have been established on both the deficits of the Treasury and of the overall nonfinancial public sector.

17. The fiscal measures announced on November 26, 1982 in support of the exchange rate action should go a long way toward reducing the deficit of the nonfinancial public sector. These measures include the elimination of export subsidies, the introduction of a tax on traditional exports and adjustments for inflation of the tax base for purposes of computation of corporate income and property tax liabilities. In addition, there was a 25 per cent increase in the wealth tax, combined with an additional doubling of the effective rate of the real estate tax. Virtually all excise taxes have been raised by 10 per cent, while the minimum rate of the value-added tax was moved from 8 per cent to 12 per cent and the coverage of the VAT was extended to interest on bank loans and to professional services. Finally, the 2 per cent levy on wages discontinued in 1980 was reinstated and the corporate profits tax rate was raised from 25 per cent to 30 per cent. In the rest of the public sector, state enterprise tariffs and prices have been adjusted by between 25 per cent and 50 per cent, effective January 1, 1983; and it is the intention of the authorities to continue with these adjustments to provide operating surpluses sufficiently large to reduce the overall financing needs of the enterprises with the minimum possible sacrifice of their investment programs. Some of these are one-time measures and might cease to be necesary in 1984 and beyond as economic activity picks up and receipts from taxes which are collected with a one-year lag begin to reflect the increase in the profitability of the productive sector.

18. On the expenditure side, raises in wage and social security benefits, as already indicated, are to compensate for only part of the inflation anticipated in the wake of the exchange rate adjustment; henceforth, wages will be adjusted in the light of the government revenue performance and of overall spending priorities. Utmost austerity is to be maintained in other current outlays. Following a series of reforms in October of last year, including an increase in contributions, the finances of the social security system have been strengthened considerably, with the result that Treasury assistance to the system in 1983 is expected to decline in real terms for the first time in four

years. Henceforth, the authorities will see to it that the growth of benefits remain moderate and is financed out of direct contributions by employers and employees.

19. The task of monetary management should be eased somewhat as a result of the currency adjustment through its effects on private demand for financial assets and on the public sector financing requirement. The resources available to the Central Bank also should be increased by our recent decisions to introduce reserve requirements on the growth of bank deposits above their level at the end of December 1982 and to resume actively open market operations. At the same time, claims on Central Bank resources should be alleviated by the planned reduction in the public sector borrowing needs. In the short run, however, pressures will persist on account of (1) Central Bank interest payments under the domestic debt refinancing scheme, and exchange losses resulting from the unwinding during the first half of 1983 of the export prefinancing scheme, both introduced last September; (2) the continued sizable financing needs of the Mortgage Bank; and (3) large interest payments on the Central Bank's short- and medium-term external debt, and amortization payments on behalf of the rest of the public sector.

20. These various claims on Central Bank resources, which largely reflect commitments entered into in 1982, together with assumptions on the rate of growth of financial resources consistent with the inflation target have been incorporated in the monetary program for 1983. The program constrains the growth of the Central Bank's net domestic assets to the targeted increase in the currency issue plus an amount equivalent to a maximum loss of US$100 million in net official international reserves. Given the uncertainties surrounding demand for money following the large exchange rate change of last November, the Central Bank will maintain utmost flexibility in its use of monetary policy instruments. In particular, it will not hesitate to raise legal reserve requirements to the levels necessary to finance its credit expansion without endangering the net foreign reserve target. To ensure adherence to this monetary program, quarterly ceilings have been placed on the net domestic assets of the Central Bank.

21. To underscore the determination of the Government to continue with the market-oriented policies and outward-looking growth strategy pursued since 1974, the freeing of the exchange rate was accompanied by a major acceleration of the trade liberalization process. Effective January 1, 1983, the structure of customs duties was narrowed to five basic categories, and the highest duty rate lowered from 75 per cent to 55 per cent. This measure, which was aimed at restraining price overshooting in the wake of the exchange rate adjustment, advanced by one year the schedule of annual reductions in customs duties introduced in late 1978. Moreover, our intention is to keep tariff policies under review in 1984 and early 1985 with the view of continuing to foster improvements in resource allocation. We also have done away with the import reference prices (aforos) maintained by the Bank of the Republic--even though, in special circumstances and as an antidumping device,

reference prices will be retained, or established, though not to the point of resulting in redundant protection. The special 10 per cent export rebate/import surcharge introduced in mid-1982 and the export prefinancing scheme adopted last September have been eliminated. Last but not least, all export subsidies and rebates, which in recent years had entailed ever-rising fiscal costs, have been canceled. Henceforth, in accordance with GATT rules, this system will be replaced by automatic rebates to exporters of indirect taxes paid during the production process.

22. A central component of our program is the maintenance of complete freedom of exchange transactions on both current and capital account. We believe that a free exchange market has served Uruguay well in recent years, imposing as it did discipline in demand management and helping in raising the rates of private capital formation and economic growth to levels unprecedented in the post-World War II period. In keeping with our principles as a member in good standing of the International Monetary Fund, and one which had a net creditor position until late 1981, we also are determined not to introduce any multiple currency practice, or to enter into bilateral payments agreements, or to introduce import restrictions for balance of payments reasons.

23. Uruguay's public sector accounted for one third to two fifths of total domestic investment until 1980, a share which rose to 50 per cent in 1981-82 because of the drop in private capital formation. We are concerned that public investment should not deviate much from its historical range of 5-6 per cent of GDP lest private investors should be crowded out of the capital market and chances for a gradual, broad-based recovery of the economy should be jeopardized. The completion in 1982 of the Palmar hydroelectric project (the largest single public program in Uruguay in recent years) and of the modernization program of the state airlines would cause the overall level of public investment to fall abruptly in real terms in 1983. Not to worsen the unemployment situation, capital spending will be stepped up in other areas, although total public investment should decline somewhat in real terms.

24. It is crucial in our view that new public investments be governed by strict criteria of efficiency. For this reason, we are presently reviewing the effectiveness of current mechanisms for allocating public sector investment resources. While the information flow on investment plans has been much improved, progress toward satisfactory identification, preparation, and evaluation of projects-and in ensuring their compatibility with resource availability--has been uneven, and the definition of national development priorities and project standards remains incomplete. Accordingly, we intend to establish a preinvestment and financial programing system for the public sector over the course of the next two years. We also hope to have developed a pipeline of projects of sufficient size to make certain that no major new investment projects will be incorporated in the 1985 budget unless they have been subjected to review and approval through this new screening mechanism. In the meantime, pending the development of a fully operative system

for ranking investment priorities, we intend to consult periodically with the international development institutions of which Uruguay is a member, such as the World Bank, the InterAmerican Develoment Bank, etc., regarding the composition of the investment program.

25. The Government of Uruguay believes that the policies described in this letter are adequate to achieve the objectives of its program, but it is prepared to take any further measures that may be required for this purpose. Uruguay will consult with the Fund on the adoption of any measures that may be appropriate, in accordance with the policies of the Fund on such consultations. Our preference would be for informal consultations to take place at about quarterly intervals during the period of the arrangement to review progress under the economic program and the appropriateness of exchange rate policy in the light of our balance of payments target. Uruguay will reach understandings with the Fund prior to March 31, 1984, on the quantitative targets of the program for 1984 and the first quarter of 1985.

/s/
Walter Lusiardo-Aznarez
Minister of Economy and Finance

/s/
Jose Maria Puppo
President, Central Bank of Uruguay

Table 1. Uruguay: 1983-84 Program 1/2/

	1979	1980	1981	Est. 1982	Prog. 1983	Prog. 1984
	(Percentage changes)					
Real GDP	6.2	5.8	-1.1	-8.5	1.0	4.0
Money GDP	78.0	69.6	30.4	7.3	39.9	21.2
Deflator	67.7	60.4	31.8	17.3	38.5	16.5
	(In per cent of GDP)					
External sector						
Exports GNFS	17.1	14.8	14.8	12.4	21.5	23.7
Imports GNFS	20.9	20.0	18.5	16.0	21.3	22.4
Factor payments and transfers	-0.7	-0.9	-0.5	-2.4	-5.1	-5.2
Current account deficit (-)	-4.5	-6.1	-4.2	-6.0	-4.9	-3.9
Official capital	1.1	1.7	2.7	7.4	6.5	1.4
NFPS	(1.3)	(1.6)	(1.8)	(2.9)	(1.4)	(1.0)
Official banks	(-0.2)	(0.1)	(0.9)	(4.5)	(5.1)	(0.4)
Nonbank private sector 3/	2.5	2.7	0.8	-7.3	)	)
Private financial system	1.8	2.9	0.9	—	) -3.0	) 2.5
Net reserve change (increase -)	-0.9	-1.2	-0.2	5.9	1.4	—
Nonfinancial public sector						
Saving 4/	5.1	5.6	3.7	-5.3	2.2	4.1
General government 4/	(2.0)	(0.4)	(-1.4)	(-8.1)	(-1.7)	(-0.5)
Public enterprises 4/	(3.1)	(5.3)	(5.1)	(2.8)	(3.9)	(4.6)
Investment	5.3	5.1	6.0	7.0	5.2	5.2
Overall deficit (-)	-0.2	0.5	-2.3	-12.3	-3.0	-1.1
External financing	1.3	1.6	1.8	2.9	1.4	1.1
Internal financing	-1.1	-2.1	0.5	9.4	1.6	—
Saving and investment						
Public investment	5.3	5.1	6.0	7.0	5.2	5.2
Private investment	11.2	12.2	9.6	6.4	7.4	8.6
Investment = saving	16.5	17.3	15.6	13.4	12.6	13.8
External saving	4.5	6.1	4.2	6.0	4.9	4.0
Nonfinancial public sector	(1.3)	(1.6)	(1.8)	(2.9)	(1.4)	(1.1)
Financial system and other	(4.1)	(5.7)	(2.6)	(-2.8)	(2.1)	(2.9)
Net reserve change (increase -)	(-0.9)	(-1.2)	(-0.2)	(5.9)	(1.4)	(—)
Domestic saving	12.0	11.2	11.4	7.4	7.7	9.8
Nonfinancial public sector	(5.1)	(5.6)	(3.7)	(-5.5)	(2.2)	(4.1)
Private sector	(6.9)	(5.6)	(7.7)	(12.9)	(5.5)	(5.7)

Sources: Ministry of Economy and Finance; SEPLACODI; Social Security Directorate; public enterprises; and Central Bank of Uruguay.

1/ Cash basis.
2/ External accounts converted to new Uruguayan pesos at average annual exchange rate.
3/ Includes SDR allocation, gold valuation adjustments and errors and omissions.
4/ Before receipts and transfer payments; also includes capital receipts.

ATTACHMENT III

Montevideo, Uruguay
February 1, 1983

MEMORANDUM OF UNDERSTANDING

1. This memorandum sets forth in greater detail the key targets and policy undertakings of the accompanying letter on the economic program of the Government of Uruguay for 1983 and 1984.

2. The overall balance of payments target is a deficit of no more than US$100 million in 1983 and equilibrium in the first quarter of 1984. However, because of the uneven distribution over the course of the year of the foreign exchange expenditure which the Central Bank has to make on its own account or on behalf of the rest of the public sector or of the private sector as a result of contractual obligations acquired prior to the float of the peso, the intermediate targets are a deficit of no more than US$90 million in the period from December 31, 1982 until June 30, 1983; and a deficit of no more than US$150 million until September 30, 1983. However, should Uruguay's public sector be unable to raise net external financing of US$460 million in 1983 and US$485 million in the fifteen months through March 1984 as envisaged in the program and explained further in paragraph 4 below, these quarterly cumulative limits will be adjusted downward for this shortfall, with a limit of US$40 million in the period from December 31, 1982, until June 30, 1983; of US$60 million until September 30, 1983; of US$80 million until December 31, 1983; and of US$100 million until March 31, 1984. Conversely, should net official foreign borrowing exceed in the first three quarters of the year the amounts indicated in paragraph 4 below, these quarterly cumulative limits will be adjusted upward for the full amount of the excess. For the purpose of this target, the balance of payments performance will be measured by changes in the net international reserves of the Central Bank of Uruguay. The Central Bank's net international reserves will be defined as the difference between the value of (a) its gold and SDR holdings, Fund reserve position and all other claims on nonresidents and (b) all its liabilities to nonresidents at less than one year, regardless of their currency denomination, plus its obligations to the International Monetary Fund. Also for purposes of this target, gold will be valued throughout the program period in U.S. dollars at the rate of US$42 per troy ounce; its SDR holdings and Fund position, be the latter positive or negative, will be valued in SDRs converted into U.S. dollars at the SDR value of the U.S. dollar on December 31, 1982; and all other claims on, and liabilities to nonresidents will be valued at the respective market rates on December 31, 1982. In the event that gold sales should continue, however, the change in the Central Bank's net international reserves will be measured excluding the exchange gain resulting from such sales.

3. The cumulative global deficit of the nonfinancial public sector will not exceed NUr$3.3 billion from January 1, 1983 until June 30, 1983; NUr$4.6 billion until September 30, 1983; NUr$5.5 billion until December 31, 1983; and NUr$6.2 billion until March 31, 1984. The deficit of the nonfinancial public sector will be defined as the sum

of the net increase above their respective stocks in December 31, 1982, in (a) the external debt of the nonfinancial public sector denominated in U.S. dollars, including foreign currency denominated Treasury bills and bonds, and converted into new Uruguayan pesos at the exchange rate of NUr$26 per U.S. dollar; (b) the debt of the nonfinancial public sector to the domestic financial system, excluding any valuation adjustments for alterations in the external value of the new Uruguayan peso in the pertinent foreign currency denominated accounts; and (c) the net placement of peso denominated Treasury bills and bonds with the nonbank private sector to the exclusion of those issued for purposes of open market operations. In addition, the cumulative global deficit of the Treasury will not exceed NUr$2.5 billion from January 1, 1983 until June 30, 1983; NUr$3.2 billion until September 30, 1983; NUr$3.5 billion until December 31, 1983; and NUr$3.8 billion until March 31, 1984. The deficit of the Treasury will be defined as the sum of the net increases above their respective stocks on December 31, 1982, in (a) the external debt of the Treasury denominated in U.S. dollars, including foreign currency denominated bills and bonds, and converted into new Uruguayan pesos at the exchange rate of NUr$26 per U.S. dollar; (b) the debt of the Treasury to the domestic financial system excluding any valuation adjustments for alterations in the external value of the Uruguayan peso in their pertinent foreign currency denominated accounts; and (c) the net placement of peso denominated Treasury bills and bonds with the nonbank private sector to the exclusion of those issued for purposes of open market operations.

4. The external borrowing of the public sector in 1983, including that of official banks but excluding the borrowing of the Central Bank of Uruguay at less than one year, will not exceed an amount that would raise the disbursed external debt outstanding on December 31, 1982 (an estimated at US$2,111 million)--including that with maturities with less than one year to the exception of that of the Central Bank of Uruguay--by more than US$345 million from January 1, 1983 until June 30, 1983; by more than US$410 million until September 30, 1983; by more than US$460 million until December 31, 1983; and by more than US$485 million until March 31, 1984. These amounts will exclude any valuation adjustments due to alterations in the external values of foreign currencies. For purposes of the program any new medium-term external borrowing by the Central Bank undertaken to substitute for existing short-term foreign obligations will continue to be treated as a reserve liability. However, given that the schedule of disbursements on loans from the international financial market does not depend on Uruguay only, any net cumulative disbursement of foreign loans at the end of each one of the first three quarters of 1983 in excess of the indicated amounts will give rise to an equivalent upward adjustment in the targets for the cumulative changes in the net international reserves of the Central Bank of Uruguay as of the same testing dates described in paragraph 2 above, and to an equivalent downward adjustment in the cumulative limits on the increase in the net domestic assets of the Central Bank of

Uruguay as of the same testing dates described in paragraph 5 below. Moreover, the outstanding stock of public sector debts with maturities of less than one year, excluding those of the Central Bank of Uruguay, but including U.S. dollar denominated Treasury bills held by nonresidents, will not increase by more than US$50 million in the period December 31, 1982-March 31, 1984. This limit will be adjusted downward--including to negative values--for any substitution of medium-term external debts for existing short-term debts over the course of the program period.

5. The net domestic assets of the Central Bank of Uruguay will not, during the first half of 1983, increase by more (decrease by less) than the increase (decrease) in its banknote issue above (below) its base stock on December 31, 1982 plus NUr$2,340 million, but in no event by more than NUr$3,450 million; during the third quarter of 1983 increase by more (decrease by less) than the increase (decrease) in its banknote issue above (below) its base stock, plus NUr$3,900 million, but in no event by more than NUr$4,250 million; during the fourth quarter of 1983 increase by more (decrease by less) than the increase (decrease) in its banknote issue above (below) its base stock, plus NUr$2,600 million, but in no event by more than NUr$5,340 million; during the first quarter of 1984 increase by more (decrease by less) than the increase (decrease) in its banknote issue above (below) its base stock plus NUr$2,600 million, but in no event by more than NUr$5,690 million. In case of a shortfall in actual as compared to projected disbursements of foreign loans by the public sector, these quarterly limits will be adjusted upward for this shortfall with a limit of NUr$1,040 million through the end of the second quarter of 1983; NUr$1,560 million through the end of the third quarter of 1983; NUr$2,080 million through the end of 1983; and NUr$2,600 million through the end of the first quarter of 1984. Conversely, should net official foreign borrowing exceed in the first three quarters of 1983 the amounts indicated in paragraph 4 above, these quarterly accumualtive limits will be adjusted downward for the equivalent of the excess. For the purposes of this ceiling the net domestic assets of the Central Bank of Uruguay will be defined as the difference between (a) its banknote issue and (b) its net international reserve holdings as defined in paragraph 2 above, with the U.S. dollar value converted at all times into pesos at the accounting rate of NUr$26 per U.S. dollar.

/s/	/s/
Walter Lusiardo-Aznarez	Jose Maria Puppo
Minister of Economy and Finance	President, Central Bank of Uruguay