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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/90

10:00 a.m., May 28, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
C. H. Dallara	
J. de Groote	
M. Finaish	T. Alhaimus
	M. Sugita
G. Grosche	
	Song G., Temporary
J. E. Ismael	
	J. R. N. Almeida, Temporary
	M. Foot
	S. Simonsen, Temporary
	W. N. Engert, Temporary
E. I. M. Mtei	
F. L. Nebbia	
Y. A. Nimatallah	L. P. Ebrill, Temporary
	G. Ortiz
	V. Rousset, Temporary
	J. de Beaufort Wijnholds
	A. Steinberg, Temporary
	A. V. Romuáldez
	B. Tamami, Temporary
	A. S. Jayawardena
	L. Tornetta, Temporary

L. Van Houtven, Secretary
J. K. Bungay, Assistant

Also Present

African Department: G. E. Gondwe, Deputy Director; N. Abu-zobaa, Buu Hoan, S. E. Cronquist, S. N. Kimaro, R. H. Nord, M. A. Pinho, R. T. Stillson, J. C. Williams. Asian Department: U. Baumgartner. Exchange and Trade Relations Department: M. Guitián, Deputy Director; S. Kanesa-Thasan, M. H. Rodlauer, M. O. Tyler. Fiscal Affairs Department: C. A. Aguirre, A. M. Mansoor. Legal Department: H. Elizalde, A. O. Liuksila, J. M. Ogoola, S. A. Silard. Research Department: W. C. Hood, Economic Counsellor and Director; N. M. Kaibni, T. K. Morrison, B. E. Rourke. Treasurer's Department: J. Caskey. Western Hemisphere Department: S. T. Beza, Associate Director; D. N. Lachman, R. Ramaciotti, C. L. Ramírez-Rojas, A. G. Santos. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: M. B. Chatah, G. Nguyen, A. Ouanes, D. C. Templeman, M. A. Weitz. Assistants to Executive Directors: A. Alaoui-Abdallaoui, A. Bertuch-Samuels, O. S. M. Bethel, B. Bogdanovic, F. Di Mauro, G. Ercel, R. Fox, V. Govindarajan, G. K. Hodges, O. Isleifsson, A. R. Ismael, S. King, J. A. K. Munthali, J. E. Rodríguez, D. Saha, E. L. Walker, B. D. White.

1. URUGUAY - 1986 ARTICLE IV CONSULTATION AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1986 Article IV consultation with Uruguay and the review under the 18-month stand-by arrangement with Uruguay approved on September 27, 1985 (EBS/86/101, 5/1/86; and Cor. 1, 5/13/86). They also had before them a report on recent economic developments in Uruguay (SM/86/95, 5/7/86).

The staff representative from the Western Hemisphere Department said that the most recent data received from Uruguay suggested that all the program's performance criteria for March 1986 had been met. The data on the public sector borrowing requirement indicated that revenue performance in the first quarter of 1986 had been broadly in line with that programmed. At the same time, public expenditures had been somewhat lower than projected, reflecting reduced transfer payments, lower international oil prices, and lower interest rates. The margin already established for the public sector borrowing requirement during the first nine months of the program would allow the authorities to attain their fiscal objective of reducing the combined deficit of the nonfinancial public sector and of the Central Bank to no more than 6 percent of GDP for the year ending June 1986.

As of mid-May 1986, the international reserves of Uruguay were $150 million above their programmed level for end-June 1986, the staff representative continued. The stronger than anticipated performance in the external sector during the early months of 1986 had reflected mainly the continued strength in the capital account. However, there also appeared to have been a significant improvement in the trade balance. Export registrations in U.S. dollars during the first four months of 1986 had been 22 percent above their corresponding levels in 1985, and import registrations had been 12 percent higher than in 1985.

The 12-month rate of the consumer price index had decelerated from 83 percent at end-1985 to 74 percent in April 1986, the staff representative from the Western Hemisphere Department reported. The authorities had recently begun discussions on the June-July 1986 wage round. In keeping with the program, they had announced a wage guideline of 15 percent for those settlements, compared with a 21 percent consumer price increase during the first four months of 1986.

Mr. Nebbia made the following statement:

> The Uruguayan authorities are in basic agreement with the staff paper and its conclusions. Since the important improvement achieved in the economy is described in a comprehensive way in the excellent staff report, my remarks will focus on a few considerations that are important for my authorities.

The adjustment program introduced last year, and supported by the Fund with a stand-by arrangement, has been most successful. Since June 1985 there has been a substantial strengthening in Uruguay's external accounts, as evidenced by a very strong accumulation of international reserves. Moreover, inflation has been contained, and there are clear indications of a healthy upturn in economic activity and a recovery in real wages. These developments have contributed to a marked improvement in both domestic and international confidence in the Uruguayan economy, which augurs well for Uruguay's economic prospects for 1986.

The significant degree of adjustment attained over the past nine months has reflected the successful implementation of the policies under the program. In this regard it might be noted that Uruguay observed all the performance criteria for December 1985 and for the first quarter of 1986.

As the staff report has noted, since June 1985 there has been a fundamental reorientation of fiscal policy. As a result of substantial efforts to improve revenue and expenditure performances, the overall deficit of the nonfinancial public sector and of the Central Bank has been reduced from the equivalent of 9 1/2 percent of GDP in 1984 to about 6 1/2 percent of GDP in 1985, which represents a larger than programmed reduction in the fiscal deficit, in the order of 1 1/2 percent of GDP. The improved fiscal situation has helped to increase confidence in the program in relation to the inflation and external objectives.

The performance of prices in 1985 has been encouraging--the significant decline in the rate of price increases has resulted in a rate of inflation for the year that is close to the target. For the ten months ended in April 1986, prices increased by 62 percent, compared with an annual rate of inflation of about 100 percent in the early months of 1985.

The current account deficit was broadly in line with the program's projections, although its structure differed somewhat from that originally envisaged in the program. In fact, the trade surplus was lower than expected, reflecting a deterioration in export prices for both traditional and nontraditional goods, as well as a reduction in access to markets. The lower than expected performance of the trade balance was nevertheless compensated by lower interest rates in the international markets, the decline in the volume of petroleum imports, and a better than anticipated tourist season.

During the early months of 1986, the balance of payments has continued to be strong and by mid-May 1986 international reserves were some US$150 million above the program's level.

For 1986, my Uruguayan authorities are fully committed to continue along the economic path of adjustment on which they had embarked last June. The main objectives of policy will be to reduce inflation to 45 percent by year-end as originally envisaged in the program, and to bring down the current account deficit in the balance of payments to 1.5 percent of GDP. My authorities remain of the view that restoring domestic and external balance is necessary to attain their ultimate objective of reactivating the economy on a sustainable basis.

The main thrust of the adjustment effort in 1986 will center on reducing further the overall deficit of the public sector to below 5 percent of GDP. To this end, a series of revenue measures have already been introduced and steps have been taken to keep public sector spending strictly under control. My authorities believe that the measures adopted in the fiscal area are adequate to reduce significantly Uruguay's dependence on external sources of finance, as well as to make room for a recovery in private sector investment.

An important element of the program for 1986 will be the implementation of a more active monetary policy. More specifically, my authorities are committed to reducing the rate of growth of M2 to 50 percent by end-1986. In pursuit of this objective, they have, in recent months, tightened the instruments of monetary policy and increased coordination over the credit operations of the Banco de la República. It should also be emphasized that in December 1985, they removed the ceilings previously in effect on the credit operations of the commercial banks, as a result of which all interest rates in Uruguay are now free of administrative control. My authorities intend to maintain the system of interest rates free of control in the period ahead.

My Uruguayan authorities are fully aware of the importance of a prudent wage policy to support the stabilization objectives. Accordingly, the Government will continue its policy of wage settlements at intervals no shorter than four months. But what is even more important is that wage arrangements will be guided by the program rather than by the past rate of inflation. In line with this policy, the Government recently announced that in the forthcoming wage round private sector wages are not to be increased by more than 15 percent.

Uruguay has maintained an exchange and trade system completely free of restrictions on international capital and current transactions. My authorities are fully committed to maintaining such freedom of external transactions in the period ahead. They are also fully committed to limiting intervention in the foreign exchange market. They believe that such an exchange rate policy promotes the best measures of safeguarding for Uruguay an adequate level of international competitiveness.

Since September 1985, the Uruguayan authorities have made substantial progress in negotiating a multiyear rescheduling of Uruguay's external debt. Toward the end of last year, Uruguay's commercial bank creditors agreed in principle to the multiyear rescheudling of about US$1.7 billion on virtually all maturities falling due between 1985 and 1989. My authorities expect that this rescheduling exercise will be completed in the next few weeks and they believe that it will provide Uruguay with an orderly framework to secure the external adjustment of the economy that is being sought.

Finally, on behalf of the Government of Uruguay, I would like to thank the management and the staff for their support of Uruguay's adjustment effort.

Mr. Almeida said that the authorities had shown courage and determination in their efforts to meet the strong program associated with the stand-by arrangement. During the past nine months, a wide array of adjustment policies had been adopted, primarily through major adjustments in the public finances. The policy actions taken in the last quarter of 1985 had been particularly important, including the approval of a major tax package and the timely readjustment of public enterprise tariffs. The authorities had extended the interval between wage settlements and had set wage guidelines consistent with the desired deceleration in the rate of inflation. Monetary policy had been kept flexible, the control of the Central Bank over the cash reserves of the Banco de la República had increased, and the ceilings on domestic currency loan rates had been eliminated at the end of 1985. The results of those actions had been encouraging, and most of the program targets had been exceeded, particularly those for the fiscal deficit, consumer prices, and the overall balance of payments. Consistent with the authorities' flexible stance, the Treasury had been able to capture part of the gain from the recent oil price decline by a new tax on the profits of the state petroleum enterprise that would more than compensate for the lower tax revenue associated with lower petroleum prices.

However, the remaining difficulties were not insignificant, Mr. Almeida remarked. First, public sector capital expenditures had declined greatly in 1985, which might cause problems for the resumption of economic growth at a faster and more sustainable rate. The small expected increase in public sector capital expenditures for 1986 was still well below the average of the past three years, and much needed to be done in that area. Second, the substantial spread of subsidies to beef production and exports by the European Communities might affect the growth of Uruguayan exports for 1986 and beyond. Third, despite the optimism of the staff, the process of foreign currency substitution had not abated, and the ratio of resident foreign currency deposits to total deposits had increased in 1985 for the second time in a row. The improvement in the balance of payments and the recovery of external confidence had not reversed the process of foreign currency substitution. Staff comment on the options available to the authorities to reverse the process of currency substitution would be helpful.

The authorities should be commended for their flexible exchange rate policy, Mr. Almeida commented. The maintenance of freedom in exchange transactions and the lack of restrictions in the current and capital accounts of the balance of payments were also noteworthy.

Mr. Ortiz congratulated the authorities on the success of the adjustment program that had been implemented by the administration that had taken office in early 1985 and stated his support for the proposed decision. Against a difficult domestic and external situation, the authorities had designed and implemented a strong economic program that had already produced significant results. Those results were reflected both in the strengthening of the public finances and the external position of the country, and, perhaps more important, in the restoration of confidence in the Government's ability to manage a difficult economic and political situation.

The correction of the public sector deficit, a central feature of the adjustment program, had been achieved at an even faster pace than originally contemplated, contributing significantly to the improvement of the balance of payments, Mr. Ortiz remarked. The important fiscal measures introduced in 1985 would yield an additional dividend in the current year, thus facilitating the task of attaining the targets for the public sector deficit. However, the overachievement of the fiscal targets for 1985 for the nonfinancial public sector had come from lower than programmed capital expenditures. As in a number of recent adjustment programs in Latin America and other developing countries, the correction of Uruguay's public finances had been achieved largely by a reduction of investment expenditures, which hampered economic growth.

Although the rate of price increases had declined significantly since mid-1985, progress in curtailing the rate of inflation had been less than expected, Mr. Ortiz noted. The staff seemed to be especially preoccupied with the growth of monetary aggregates, even to the point of setting an automatic sterilization rule equivalent to 65 percent of the increase in international reserves above the amounts contemplated in the monetary program. Several remarks could be made on that point. First, the observed expansion of the monetary aggregates was the result of capital inflows and changes in portfolio preferences on the part of the public between assets denominated in domestic currency and those denominated in foreign currency. However, the fiscal targets had been exceeded, and the ceiling on net domestic asset expansion of the Central Bank had been met with ample margins at the end of 1985. In view of those developments, it was difficult to see how monetary expansion had helped to fuel inflation. The staff seemed to have difficulty identifying whether the monetary expansion could be attributed to supply factors or whether it could be more appropriately judged as responding to demand conditions. However, if the main source of the expansion was capital inflows, which the authorities had monetized partially in order to avoid an unwanted appreciation of the real exchange rate and, if those inflows had been sustained for several months, it was not easy to conclude that the monetary expansion was not responding to an increased demand for money on the part of the public. In addition, all the monetary aggregates had increased substantially in real terms during 1986.

Economic activity in Uruguay, which had been depressed over the past few years, was showing signs of a modest turnaround, Mr. Ortiz continued. GDP had increased--albeit marginally--in 1985 after three years of continuous decline, and it was expected to grow again in 1986 by about 3 percent. It would be unfortunate to cut the momentum of the recovery by an excessively restrictive monetary policy--reflected in excessively high real interest rates and/or credit rationing--especially if the monetary expansion was responding to a change in the portfolio preferences of the public. He was troubled by the setting of an automatic sterilization mechanism at 65 percent of reserve gains; that percentage could as easily be set at 80 or 50. He wondered why the staff had set a limit instead of leaving the decision to the authorities, who were capable of interpreting the signals transmitted by the foreign exchange and credit markets.

If the monetary aggregate M2 included only deposits denominated in domestic currency, whereas M3--the broader aggregate--also included Eurodollar deposits, Mr. Ortiz asked how was it possible to set targets for the growth of M2 in the face of the rapidly changing portfolio preferences of the public?

The change effected by the authorities in wage negotiations from backward- to forward-looking settlements constituted an important step toward consolidating the gains in the fiscal front as well as containing inflationary pressures, Mr. Ortiz observed. It appeared that the inflationary pressures had been caused more by cost-push elements, such as the real depreciation of the exchange rate and the adjustment of prices of goods and services of public enterprises, than by demand factors associated with excessive money creation.

The authorities' external policies--including exchange rate, commercial, and debt-management policies--had helped to strengthen the balance of payments significantly, Mr. Ortiz noted. In comparison with the sluggish export performance of 1985, the results for the first part of 1986 had been quite encouraging.

Mr. Romuáldez, commending the authorities for their adjustment efforts in 1985, said that they had gone a long way toward re-establishing the economy on a sustainable growth path by adopting and adhering closely to a comprehensive adjustment program designed to strengthen Uruguay's balance of payments position, to reduce domestic financial imbalances, and to combat inflation. It was heartening to learn that as of end-December 1985 and end-March 1986, Uruguay had fully observed all the quantitative performance criteria under the stand-by arrangement. Nevertheless, the authorities still faced a significant adjustment task in 1986, and a conscientious application of the proposed policies would be necessary to progress further.

In particular, in 1986 further significant reductions in the size of the combined deficit of the nonfinancial public sector and of the Central Bank were essential to the continuing success of the program, Mr. Romuáldez added. While he was encouraged to learn that a larger than projected decline in the fiscal deficit had been achieved in 1985 and that a further trimming of the deficit was projected for 1986, it was noteworthy that the 1986 deficit reduction was expected to derive largely from a reduced central administration deficit and from increased revenues rather than from expenditure reduction. The authorities needed to make greater efforts toward reducing the central bank deficit. In that context, it was disappointing that they were not proposing a substantial increase in the collection of the Central Bank's private sector loan portfolio in 1986 and a reduction in public expenditure, particularly because some of the projected revenue gains generated from the decline in oil prices might prove to be short-lived.

The authorities might have made inadequate use of monetary policy instruments in 1985 to control the growth of money aggregates and the rate of inflation, Mr. Romuâldez considered, and there was a danger that the situation might be repeated in 1986. The staff projections indicated that the authorities were continuing their gradualist approach to monetary policy, which carried an upside inflation risk. As in 1985, the growth of M1 and M2 was projected to remain steady or increase slightly in real terms in 1986 (Chart 3, EBS/86/101, 5/1/86). The somewhat loose arrangement between the Central Bank and the Banco de la Repûblica remained a problem for the control of monetary policy. The staff's discussion of monetary policy objectives, the authorities' commitment to those objectives, and the use of instruments generally had not been as complete or specific as he would have liked; perhaps the staff would comment further on the ways in which the authorities could meet the problem of continued domestic credit expansion. There seemed to be a wait-and-see attitude in the authorities' stance toward monetary policy. As the events of 1985 had reflected the problems with such an approach, he was pleased to note the authorities' commitment to a more active implementation of monetary policy in 1986.

In view of the difficulties that the authorities had had with the control of wages in 1985, he fully endorsed the staff's comment on the importance of successful implementation of the wage policy over the course of 1986, Mr. Romuâldez stated. Finally, he supported the proposed decision.

Mr. Ebrill recalled that in June 1985 the Uruguayan authorities had started implementing a comprehensive adjustment program with a view to reducing economic imbalances and laying a basis for sustained growth. The latter emphasis had been particularly appropriate, given the estimated 18 percent cumulative decline in real GDP--with its concomitant sharp reduction in imports--that Uruguay had experienced since 1981. The authorities' strong adjustment efforts had been supported by a stand-by arrangement with the Fund, and the performance criteria associated with the stand-by arrangement had been fully observed through end-March 1986. The greater than programmed reduction in the fiscal deficit was particularly noteworthy, given its crucial role. It was also encouraging to learn that the severe recession in the Uruguayan economy was thought to have bottomed out, and the authorities deserved commendation for their significant achievements.

The authorities were committed to maintaining the momentum of adjustment, and they intended to continue with the adjustment strategy that they had implemented in 1985, Mr. Ebrill noted. Uruguay had recently experienced a relatively high rate of inflation, and the authorities had responded by adopting a gradualist approach to reduce it. For example, the targeted rate of inflation for 1986 was 45 percent, in contrast to an estimated rate of inflation of 83 percent for 1985. The decision to take such an approach had been based on the assumption that the costs of inflation were low, because most prices were market determined, thus reducing the possibilities of inflation-induced relative price distortions. The case of Uruguay was of special relevance, given the growth of interest in the merits of a shock, as opposed to a gradualist, approach to inflation reduction, and further consideration of the case might be warranted in the context of any general study of that important issue.

Given the authorities' decision to adopt a gradualist approach to inflation, a number of aspects of Uruguayan economic policy were particularly welcome, Mr. Ebrill stated. First, a number of useful steps had been taken to accelerate tax collections, which should help greatly to reduce the significance of the so-called Tanzi effect. Second, the recent decision to break the automatic link between social security benefits and wage increases--thereby reducing the cost of social security--was welcome, because the Uruguayan social security system, with expenditures of about 10 percent of GDP, was large for a country at that stage of development. Third, while nominal wages would continue to be indexed, they would henceforth be indexed to programmed rather than to past rates of inflation. That move, which would reduce the probability of large real wage increases as inflation decelerated, was particularly important given the sharp increases in real wages in 1985. However, it should be pointed out that the widespread use of indexation techniques of whatever form might weaken the effect of anti-inflation policies and might reduce the capacity of the economy to make necessary real adjustments.

He was in broad agreement with the thrust of the adjustment program, Mr. Ebrill continued. It was appropriate to give continuing prominence to the objective of reducing the combined deficit of the nonfinancial public sector and the Central Bank. In that context, the ongoing efforts to improve tax administration were welcome. It was important to obtain revenue increases by that route as much as possible so as to avoid excessive increases in tax rates. He wondered whether the absence of a global personal income tax had resulted in a disproportionate tax burden being levied on a limited number of activities, notably, agriculture, and hence implicitly, exports.

The operations of the Central Bank had a direct bearing on the fiscal situation, because of major quasi-fiscal operations, Mr. Ebrill pointed out. Most recently, those operations had involved a private sector loan portfolio purchase scheme. Further progress in reducing the quasi-fiscal deficit associated with that scheme was contingent upon an improvement in the Central Bank's collection rate on the portfolio. It was hoped that the recent passage of domestic debt refinancing legislation would lead to such an improvement without imposing additional demands on the budget.

As the fiscal deficit declined, pressures on monetary policy would be alleviated, Mr. Ebrill remarked. The monetary authorities would need to reinforce the stance of fiscal policy by continuing to pursue a cautious monetary policy. Mr. Nebbia's comments to the effect that the authorities were strengthening the instruments of monetary policy were reassuring.

The external sector had been a cause for concern for the authorities for a number of years, Mr. Ebrill indicated. A number of welcome measures had already been taken and had resulted in a considerable strengthening of the external accounts. However, those gains should be seen in the context of recent trends in exports. Specifically, the nominal value of exports in U.S. dollar terms had declined some 30 percent between 1981 and 1985. As a result, the medium-term scenario projected that the nominal value of exports would not exceed the 1981 levels until 1990, although that might be overly pessimistic, in view of Uruguay's recent strong export performance. The relatively poor export performance of Uruguay had been largely attributable to an unavoidable decline in the world price of the country's main exports; nonetheless, it served to emphasize the importance of diversifying the export base. Diversification measures would be crucial to the success of efforts aimed at restoring sustained growth. In that context, the authorities' commitment to flexible exchange rate and pricing policies, with a view to ensuring Uruguay's competitiveness, was welcome, as was the prospective increase in the World Bank's involvement through structural adjustment or sector loans. Finally, he supported the proposed decision.

Mr. Sugita remarked that Uruguay was a good example of how a comprehensive Fund-assisted adjustment program, pursued with determination, could bring about a remarkable turnaround in economic performance. With the recovery of confidence, there had been a significant inflow of capital, and the overall balance of payments had improved. The trend toward "dollarization" had been arrested and, above all, real economic growth had resumed. The authorities deserved commendation for those achievements. The medium-term scenario showed that if the authorities continued their efforts, the prospects were good for sustainable economic growth and a viable balance of payments position. In that connection, it was particularly noteworthy that almost all the important elements for growth-oriented structural reform were embodied in the adjustment policies adopted by the authorities: tax reform, reform of the public enterprises, realistic exchange rate and interest rate policies, and, not least, maintenance of a free system of international transactions.

The rate of inflation had been reduced significantly and was expected to decline further to 45 percent by the end of 1986, Mr. Sugita noted. In view of the remarkable success of the authorities' stabilization policies in other areas, and the desirability of consolidating such gains, perhaps the authorities could set more ambitious targets for reducing the rate of inflation. The dramatic declines in inflation in neighboring countries might also have created a good environment for Uruguay's fight against inflation, although the drastic measures adopted by neighboring countries might not be readily applicable to Uruguay, which had already made significant progress in economic adjustment.

While the deficit had been reduced appreciably, the combined deficit of the nonfinancial public sector and the Central Bank was still high, Mr. Sugita indicated. Tight control of public expenditure, improved tax administration, and timely adjustment of public enterprise tariffs were essential to lower that deficit. It was also important to ensure that the domestic debt refinancing did not result in additional costs to the budget.

The recent capital inflows seemed to have put the authorities into a quandary as to how to avoid undue appreciation of the currency without incurring the risk of excess liquidity resulting from foreign exchange market intervention, Mr. Sugita observed. He could support the official policy of accumulating foreign reserves, but only to the extent that the excess liquidity associated with it could be sterilized. The rate of inflation in Uruguay remained too high to be ignored. In that connection, comments from the staff or Mr. Nebbia on whether there were any technical or institutional limits to such sterilization efforts would be helpful.

The performance criterion for net domestic assets of the Central Bank provided that the ceiling was to be adjusted downward for only 65 percent of the excess international reserves of the Central Bank or the prescribed level, Mr. Sugita continued. However, if the capital inflows reached a much higher level than previously envisaged, a situation could arise in which the margin provided by the performance criterion might lead to excessive expansionary growth in the monetary base. He realized that his position was the opposite of that of Mr. Ortiz, and welcomed any additional comments the staff might have on the issue. Finally, he supported the proposed decision.

Mr. Wijnholds remarked that economic developments in Uruguay had generally been encouraging in 1985 and adherence to the stand-by arrangement had been satisfactory. Uruguay's immediate prospects were also favorable: the main economic indicators pointed to an upturn in economic activity and unemployment was declining. The principal weak spot remaining in the domestic economy was the high rate of inflation. The authorities were gearing policies toward bringing down the rate of inflation to 45 percent by end-1986; although that rate would represent a considerable improvement over that of past years, the authorities should not feel satisfied with it but should endeavor to bring about a further deceleration of inflation after 1986. The containment of the current account deficit in 1985 was the result of a considerable decline in the volume of petroleum imports and lower interest payments. Exports had been significantly weaker than expected--traditional exports declining by 13 percent and nontraditional exports by 5 percent--and the level of trade had been considerably lower than that of the early 1980s. A relatively large improvement in the current account was projected for 1986; to achieve that result, the authorities should not slacken their efforts in the areas of demand management and exchange rate policies.

It was desirable to "sanitize" the balance sheet of the Central Bank, Mr. Wijnholds emphasized. Some US$600 million not collected on private sector loans was indeed of concern, and it was hoped that the new domestic debt law would improve collection.

With regard to the effect of capital inflows on monetary policy, he wondered whether the authorities had not been tardy in reacting to, and sterilizing, those inflows, Mr. Wijnholds indicated. In view of the need to curtail inflation further, the authorities should implement without delay the sterilization of any future sizable capital inflows. In 1985 and early 1986, official inflows had mainly taken the form of placements in treasury paper denominated in U.S. dollars, thus contributing to a sizable increase in Uruguay's net international reserves. Treasury paper placements had been facilitated by a strong increase in demand from Argentine investors. The freedom of capital transactions in Uruguay made it an attractive haven for funds from neighboring countries, because there was no risk of the so-called mousetrap financial centers, which willingly accepted deposits but showed less willingness to permit withdrawals on demand. Staff comments on Uruguay's role as a haven for financial investment for nonresidents would be helpful.

The restructuring of Uruguay's external debt through a multiyear rescheduling arrangement with the commercial banks would provide considerable relief over the period 1985-89, especially since a lower interest rate had been negotiated, Mr. Wijnholds observed. It was encouraging that Uruguay's balance of payments prospects for the coming years were relatively favorable, with healthy increases projected in international reserves, even though no new commercial bank lending was assumed. The debt service ratio would reach a peak of 46 percent in 1986, and was projected to decline thereafter to more comfortable--albeit still rather high--levels. He wondered whether, given that relatively favorable outlook, Uruguay should not be encouraged to roll back the 5 percent increase in import tariffs introduced in 1985. He had been surprised that the staff appraisal had not called for such a rollback.

Welcome discussions were under way for a structural adjustment loan from the World Bank, which would cover such areas as taxes, the social security system--where there seemed to be considerable problems--and the foreign trade regime, Mr. Wijnholds noted. Such a loan could be a useful complement to the stand-by arrangement with the Fund. Finally, he supported the proposed decision.

Mr. Grosche, noting his broad agreement with the staff appraisal, said that he had no difficulties with the 1986 program targets and that he could thus support the proposed decision. Uruguay's progress under the stand-by arrangement had been remarkable. It was particularly encouraging that some performance criteria had been met with rather comfortable margins. Progress had been made in reducing the public sector imbalances and in strengthening the external accounts. Moreover, economic activity had picked up recently.

Unfortunately, that positive picture was somewhat marred by a number of disappointing developments, namely, the unresolved issue of the recovery of the Central Bank's private sector loans and the less than satisfactory results on the inflation front, Mr. Grosche remarked. There appeared to be full agreement between the authorities and the staff on the urgent need to recover the loans made by the Central Bank to the private sector. Since the lack of progress might be explained by the wait-and-see attitude of debtors pending the introduction of domestic debt refinancing legislation, it was probably premature to come to any firm conclusion on the issue.

A few comments were warranted with respect to the problem of inflation, Mr. Grosche continued. The expansion of monetary aggregates had been one of the major causes behind the smaller than expected reduction in the rate of inflation. While part of the monetary expansion had its origins in the higher than anticipated capital inflows, the authorities' failure to sterilize those inflows and the conduct of monetary policy in general had reflected too gradual an approach to the problem of inflation.

Another worrying development was the excessive wage increases that had been granted in 1985, Mr. Grosche added. Although the authorities had introduced some measures--for example, extending the interval between wage settlements--those measures had been insufficient to stop wages from increasing by as much as 12 percent in real terms. He was glad to learn that wage increases were currently expected to remain markedly below the rate of inflation, and that the authorities were planning to tighten monetary conditions in line with their objective of reducing the rate of inflation to 45 percent. While those steps were certainly welcome, the targeted rate of inflation would still be considered as unacceptably high by many countries; therefore, he questioned the rationale behind the choice of such a gradual path, because it ran the risk of failing to bring inflation fully under control. To be sure, there were limitations to cross-country comparisons, but he believed that there were some lessons to be drawn from the experience of several hitherto high-inflation countries in which the authorities, after having unsuccessfully employed a gradual approach, had decided that inflation could be dealt with effectively only by facing it directly. Additional comments from Mr. Nebbia or the staff about the authorities' reasons for having adopted their current strategy, which appeared to avoid tackling inflation more ambitiously, would be helpful.

The authorities merited commendation for having eliminated restrictions on interest rates and for having maintained an open-trade and payments system, Mr. Grosche commented. Those actions were particularly welcome in an international environment in which free trade was becoming increasingly threatened by protectionist pressures.

Mr. Dallara said that, like other Directors, he had been favorably impressed with Uruguay's economic performance during 1985. All the performance targets under the program had been met, which was reflected in the positive developments in the economy with respect to real growth, the deceleration of inflation, and the overall balance of payments. Nonetheless, a number of areas were matters of concern, including some in which policies had been applied less rigorously than had been expected; problems in other areas had been caused partly by exogenous factors, and perhaps partly by policy slippages. Three areas of particular concern were the developments in the monetary aggregates, where control had been inadequate; the developments in real wages; and the export performance prospects for Uruguay for the medium term, the recent positive developments notwithstanding.

There had been positive developments in real economic activity, beginning with a recovery late in 1985, and real economic growth was expected to be in the range of 3 percent in 1986, Mr. Dallara remarked. However, an examination of the underlying pattern of savings and investment in Uruguay gave rise to concern as to whether the higher growth rate could be sustained. Gross domestic investment as a share of GDP had amounted to only 8 percent in 1985, and private investment and private savings had both fallen and were in the range of 5-6 percent of GDP. Comments by the staff or Mr. Nebbia on Uruguay's economic growth prospects would be helpful.

Nevertheless, public savings and the overall balance of the public sector had improved during the past year or so, Mr. Dallara went on. The combined deficit--including the quasi-fiscal losses of the Central Bank--had fallen, from about 16-18 percent of GDP some four years earlier, to about 6.5 percent in 1985, a rather impressive achievement over a relatively short period of time.

The authorities had recently taken a number of commendable steps in the revenue field, including the shortening of the lag in payment of the value-added tax, regular adjustments to prices charged by the public enterprises, and efforts to strengthen tax administration, Mr. Dallara continued. Together with those steps, the authorities had placed considerable emphasis on expenditure restraint, and overall government expenditures as a percentage of GDP had fallen notably. Nevertheless, the large number--and perhaps small impact--of the various revenue measures recently employed to generate revenue raised questions about the adequacy of the overall structure of the tax system. In that connection, staff comments on developments in corporate income tax would be helpful. The burden of corporate income tax over the past few years had indeed dropped, but it was expected to increase significantly as a percent of GDP in 1986. That increase might be attributable in part to a change in the way in which corporate tax losses had been accounted for, but it was not clear why the corporate income tax revenues as a percentage of GDP had almost doubled between 1985 and 1986. More generally, he wished to know whether consideration was being given to more basic tax reform. The Fiscal Affairs Department had supplied technical assistance to Uruguay in the field of tax reform, and further information on the thrust of those efforts would be of interest.

Despite Uruguay's impressive expenditure performance in recent years, the expenditure constraint effort seemed to have lost momentum, Mr. Dallara commented. However, it was difficult to point to particular areas giving rise to concern, except wages and salaries. He wondered whether there was further scope for a more general reduction of expenditures as a percentage of GDP.

There had been a welcome turnaround in the direction of price performance, Mr. Dallara remarked, but in the past year or so that performance had not been as good as expected. While unfavorable climatic conditions and a better than expected tourist season had been partially responsible for that price performance, it was also partly attributable to wage and monetary policy developments. While the nearly 16 percent increase in real wages in 1985 had been compensating for the substantial reductions in the previous two years, a continuation of that trend would be a matter of concern. He recognized that the authorities were taking a number of steps to exercise restraint in the wage area. However, it was not clear that the 18-18.5 percent wage increases that had already been decreed--combined with the anticipated 15 percent limit--would be fully consistent with the objective of reducing prices, specifically with the average price rise target of 45 percent during the course of 1986. Successful implementation of wage policy was essential if the authorities were to achieve their price and other objectives of the program.

The authorities had experienced some problems in implementing monetary policy during the past year, Mr. Dallara stated. One aspect of the problem had been the role of the Banco de la República. It was important to have full compliance with the measures that had been taken or had been agreed with the Fund, such as the offsetting rise in the banks' portfolio investment requirement and the quasi-reserve requirement arrangement between the Central Bank and the Banco de la República. His position on the planned partial sterilization of the larger than expected capital inflows was closer to that of Mr. Sugita than to that of Mr. Ortiz, although the emphasis was slightly different. Given Uruguay's history of open capital markets and capital inflows during times of general restoration of confidence, it was surprising that neither the authorities nor the staff had incorporated clear provisions for sterilization at the outset of the program. In the 1970s, and perhaps at other times, such capital inflows had made it difficult for the authorities to achieve their monetary and other policy objectives. Therefore, he welcomed their commitment to sterilize a significant part of any such inflows. Any additional information on the background of the approach taken in the past year would be helpful.

The real effective appreciation of the peso that had occurred in the late 1970s and early 1980s had been completely reversed, Mr. Dallara observed. The authorities' intent to build up international reserves in 1986 if unexpectedly large capital inflows continued, rather than to allow any significant currency appreciation, was welcome. Nonetheless, he wondered whether there was some structural reason underlying Uruguay's past record of rather weak export performance. The medium-term balance of payments projections were for real export growth in the range of 4-5 percent from 1988 onward--consistent with real GDP growth of about 4 percent--which was understandable, because many of Uruguay's markets had not been growing rapidly. However, the export plan was not overly ambitious, and merited reconsideration by the authorities.

Uruguay's external financial situation had strengthened considerably, in part because of the plans for a multiyear rescheduling arrangement by the commercial banks and because of increased lending anticipated from the World Bank in support of important policy changes, Mr. Dallara indicated. Indeed, the medium-term balance of payments outlook was based on an assumption of no additional commercial bank lending after 1986. While recognizing the authorities' desire to reduce their reliance on commercial bank credit and thereby to reduce their overall debt service obligation, he nonetheless hoped that if Uruguay continued its good performance, the banks would be willing to consider any subsequent interest in, or need for, additional financing on the part of Uruguay, given the anticipated growth in lending by the multilateral institutions, notably the World Bank. Fund support--in whatever form deemed most appropriate--was also important for the multiyear rescheduling envisaged by the commercial banks.

He had been disappointed at the lack of information on structural policy change and structural adjustment matters in the staff report, the more so because the staff report involved a review of a stand-by arrangement and an Article IV consultation, Mr. Dallara said. There had been a brief allusion to important structural policy reforms in the areas of taxation, the social security system, and the foreign trade regime, which were slated to receive support from the World Bank. However, additional information would have been helpful. The staff had noted that Uruguay's highest tariff rates were still 55 percent, which signaled that further efforts could be considered, yet no information had been presented on what policy changes were being contemplated by the authorities. Furthermore, although the parastatals did not represent the burden to the economy of Uruguay that they did in other countries, little mention of them had been included in SM/86/95 (5/7/86), and no information had been provided on the authorities' policies regarding price adjustments of the public enterprises. It would be helpful to have additional information on structural matters in future reports.

The authorities had made significant, laudable progress in a number of important areas during the past year, Mr. Dallara concluded. Those efforts should be continued and, in some cases, intensified. Finally, he supported the proposed decision.

Mr. Foot commended the authorities for the progress made by Uruguay under its stand-by arrangement with the Fund. The first outcome of the authorities' efforts was evident in the modest recovery in employment. Moreover, the response of commercial banks and the international financial institutions to Uruguay's performance provided an encouraging overall picture.

He agreed with Mr. Nebbia, Mr. Romuáldez, and other Executive Directors who had noted that the authorities needed to make greater efforts to increase their recovery of loans to the private sector, Mr. Foot stated. Those efforts should be facilitated by the congressional enactment of the domestic debt refinancing law, and by the complementary establishment of a National Development Corporation, which would not involve any cost to the budget or to the Central Bank beyond the initial capital contribution.

The authorities also needed to curb inflation as rapidly as possible, while maintaining growth, Mr. Foot added. They had already taken some steps in the right direction, particularly by setting wages on the basis of prospective rather than actual inflation and deciding to abolish automatic indexation of social security benefits.

He had listened with interest to Mr. Sugita's comments on monetary growth, Mr. Foot continued. In some ways, there was a strong parallel between the experience of Uruguay and that of the United Kingdom in 1977. After the United Kingdom had adopted a Fund program, substantial capital inflows had led to a change in the exchange rate policy and a sharp rise in the domestic money supply and liquidity, which had been met only by an excessive decline in interest rates in the end. In such situations, money balances became a critical question and those balances needed to be reviewed constantly. Moreover, in those circumstances, it was difficult to set performance criteria, and the distribution between domestic monetary aggregates and foreign currency deposits was virtually impossible to forecast. He agreed with Mr. Sugita and Mr. Dallara on the need for caution in dealing with the domestic monetary aggregates.

The authorities needed to establish better control of credit creation, particularly that involving the Banco de la República, Mr. Foot commented. There were undoubtedly good historical reasons that the largest commercial bank in the country was not subject to legal reserve requirements, but he wondered whether there was any possibility of incorporating the bank into the normal financial structure of the country. Informal understandings between the Banco de la República and the Central Bank and a slowdown in credit creation were better than nothing, but the authorities should continue to strengthen their control over credit creation. Finally, he supported the proposed decision.

Mr. Jayawardena said that it was encouraging to see Uruguay implementing its Fund-supported program so well and that the authorities had even exceeded the program targets. They had been amply rewarded for their efforts: the negative economic growth of the recent past appeared to be bottoming out; the fiscal position had improved considerably, with a commensurate improvement in the balance of payments; inflationary expectations had been moderated; the external debt had been rescheduled; the exchange rate had been managed flexibly; Uruguay's access to financial markets had been retained; and general confidence in the country's open economy had developed.

The authorities' laudable efforts at containing inflation notwithstanding, he would feel more comfortable with a lower inflation target than that envisaged in the program, Mr. Jayawardena observed. He supported the proposed decision.

The staff representative from the Western Hemisphere Department remarked that although a number of the tax measures included in the Uruguayan program might seem to be of a piecemeal nature and not best suited to the structural needs of the economy, those measures had been adopted in a difficult political environment. The current administration had only some 40 percent of the seats in Congress and the lack of a majority had influenced the way in which the tax package had been put together. However, the authorities did not consider many of the tax measures as permanent features of the tax system; in particular, they did not intend to maintain beyond the end of 1986 the across-the-board increase of 5 percentage points in customs tariffs. They intended to replace those revenue sources either with better designed and more efficient taxes or by improved tax administration to minimize the need for such taxes. The authorities had requested technical assistance in that context from the Fiscal Affairs Department, and they were already implementing a number of reforms that had been previously suggested by that Department, both to improve tax administration and to shorten the lags in tax collection. The Fiscal Affairs Department had conducted a survey of the structure of the Uruguayan tax system and had found that it was basically well conceived in that most taxes were well drafted and broadly based, although the tax system did rely too heavily on indirect taxes.

The Fiscal Affairs Department mission had also identified another potential area in which the tax system could be improved, the staff representative continued. Uruguay did not have an income tax and countries at its stage of development could be expected to raise significant amounts of revenues from an income tax, which might also improve the structure of the system. However, the Uruguayans had experimented with an income tax in the past, having had one until 1974, when it had been abolished because of its low yield and its high administrative cost. The authorities had indicated that the establishment of an income tax would be ill advised at present and that it would only produce increased revenues over the longer term. On the whole, the tax structure of Uruguay did not suffer from the same deficiencies found in the tax structures of other countries in the region.

The corporate sector in Uruguay had been extremely hard pressed during the several years following the exchange rate move of November 1982, the staff representative indicated. Many of the firms that had borrowed heavily in foreign currency had experienced substantial losses. One of the measures in the current budget was a limitation on the amount of losses that could be used to offset profits earned, and therefore higher yields from the corporate income tax were expected. In addition, the removal of certain other deductions was expected to increase the revenue from corporate income taxes.

The adjustment that had been achieved in the fiscal sector over the past year had not come primarily from reductions of capital expenditure but, rather, had resulted from higher taxes, better public enterprise performance, and lower interest payments abroad, the staff representative observed. In fact, the authorities intended to increase public sector capital expenditures over time as the fiscal situation permitted. Nevertheless, the basic thrust of the authorities' strategy was to make room for private sector investment, which had been crowded out over the past several years by the high demands of the public sector. The authorities intended to reduce the public sector deficit and to allow the banking system to provide credit to the private sector. Another aspect of the strategy was to clarify the domestic debt situation and to restore general confidence in the hope that investment would improve. It was difficult to say whether the strategy would work, but the initial indications had been quite encouraging: a rebound had occurred in the last quarter of 1985, and there seemed to be an increase in credit demand for investment.

Monetary developments in 1985 had been disappointing, and the extent to which they had departed from the program targets had given cause for concern in the context of a program aimed at bringing down the rate of inflation on a sustained basis, the staff representative commented. It could be argued from a statistical point of view that there had been an increase in the real demand for money, but the basic question--still unanswered--was whether that demand would endure or whether it was only transitory. The balance of payments situation, and in particular the capital inflows, had played a part in the deviation of monetary performance from the programmed targets, but other factors also had played an important role. There had been an expansion in credit by the Banco de la República shortly before the initiation of the program, and the reductions in legal reserve requirements in August 1985 had added to the credit expansion. It had been against that background that judgments had been made as to the design of the program for the remainder of 1986.

The net domestic asset adjustment incorporated in the program had been introduced to safeguard the program against an undue expansion in credit, the staff representative went on. The figure of 65 percent had not been an arbitrary choice, but rather had reflected the system of legal reserve requirements and, hence, the nature of the money multipliers in Uruguay. The basic idea was that capital inflows should be monetized but they should not give rise to a secondary expansion of credit and a consequent increase in liquidity beyond the initial inflow.

The ratio of foreign currency deposits to total deposits of the banking system had remained high, the staff representative noted. However, there had been a certain leveling off in the process of foreign currency substitution. That slowing could be attributed in part to the announcement by the authorities of a stabilization program in June 1985, and to the elimination of the interest rate ceilings on domestic currency operations of the commercial banks in December 1985. If the recent trend toward foreign currency substitution were to be reversed, there would need to be a sharp reduction in the rate of inflation, the introduction of credible policies, and the provision of a policy framework that gave rise to confidence in holding domestic currency deposits.

During the course of 1985 and into 1986, there had been a sharp increase in the placement by the authorities of treasury bills denominated in foreign currency, the staff representative said. That development had occurred because Uruguay had maintained an open capital account and because the authorities had emphasized that they intended to continue that policy. It was true that money coming in could leave just as easily, and that certainly had occurred in the past.

Several Directors had commented on the need for more ambitious inflation targets, the staff representative recalled. The program was currently attempting to bring down the rate of inflation from 83 percent in 1985 to 45 percent in 1986. Whether more could be done was a question of judgment. Some of Uruguay's neighbors had embarked on more ambitious approaches to reduce the rate of inflation, but it was not clear whether a political consensus could be formed in Uruguay to bring down the rate of inflation to the zero levels that were being proposed by its neighbors. Nevertheless, the authorities did not plan to stop at the 45 percent rate, but would continue along that path during the rest of their administration.

The 15 percent guideline that the authorities had announced for the next wage increase was consistent with the program, provided that there was no recurrence of the wage drift seen in 1985, the staff representative added. The increase in wages of between 18 and 18 1/2 percent, decreed in March 1986, had encompassed all aspects of wage remuneration. Slippages in terms of the current wage round did not seem likely, but it remained to be seen how the authorities would make sure that the 15 percent increase actually held in the next wage round. If they could hold firmly to that 15 percent increase, it was likely that wage increases would be consistent with the inflation target.

When Uruguay had approached the commercial banks concerning the multiyear rescheduling arrangement, it had been understood that the country would not be asking for additional money on a pro rata or concerted basis, the staff representative confirmed. Nevertheless, Uruguay was receiving $45 million from a select group of commercial banks in the context of a cofinancing arrangement with the World Bank. The staff projections had taken into account the current situation and that might have led to a conservative estimate, but the commercial bank lending arrangements were, of course, subject to change.

The staff projections of export performance for 1986 and beyond were likely to be similarly conservative, the staff representative added. Through their management of exchange rate policy over the past several years, the authorities had regained and maintained their competitive position, but they had been confronted by a variety of external situations that had not been conducive to an increase in exports, including protectionism abroad and problems in neighboring countries. Although Uruguay's recent export performance had deeply disappointed the authorities, the export figures for the first four months of 1986 indicated that its performance was likely to be better than projected.

The Banco de la República had a long history, the staff representative recalled; it antedated the Central Bank, which had been created only in the 1960s, it maintained considerable institutional power, and its Board included representatives from many of the political parties. While it would be desirable, in the staff's opinion, for the Banco de la República to be treated like other commercial banks and to be subject to the same reserve requirements, there were severe political constraints in the implementation of such a goal. Nonetheless, the staff had been encouraged by the successful arrangements made by the authorities with the management of the Banco de la República, and a plan by which the bank would manage its excess reserves during the program period had been explicitly outlined.

Finally, the World Bank was at an early stage of its discussions on structural adjustment with the Uruguayans, the staff representative from the Western Hemisphere Department mentioned. It was expected that a structural adjustment loan would be in place by the end of 1986, and that the areas of structural adjustment to be emphasized would be the social security system, tax administration, and trade liberalization. It had not been possible to elaborate in EBS/86/101 (5/1/86) on the specific plans because they were still at an early stage of design.

Mr. Ortiz remarked that the growth of monetary aggregates would not lead automatically to a higher rate of inflation. For example, the growth of monetary aggregates in Japan had been much higher than the growth of nominal GNP in the 1950s and 1960s, but because financial savings had also grown and intermediation as a proportion of GNP had increased, the rate of inflation had not risen. Uruguay's economy had been demonetized in the past by high inflation and the collapse of previous exchange regimes. It seemed logical that with renewed confidence in the authorities' ability to manage a program, the increased monetization of the economy would be absorbed.

While it was true that in the past Uruguay had been subject to unstable effects of capital flows, the inflows of the late 1970s and early 1980s had been associated to a great extent with the so-called tablita approach to inflation, whereby exchange rates were fixed and a predeveloped rate of devaluation--less than the rate of inflation--was announced, with a resulting dramatic appreciation of the real exchange rate, Mr. Ortiz continued. The tablita approach had led to the later collapse of the exchange rate regime, but it was noteworthy that the real exchange rate had been stable in Uruguay over the past few months. Therefore, he did not see cause for concern about the growth of monetary aggregates in Uruguay.

The Deputy Director of the Exchange and Trade Relations Department commented that the key question for the assessment of monetary developments in Uruguay was whether they reflected permanent demand factors for the domestic monetary aggregates. The interpretation of Mr. Ortiz implied that all the expansion of the monetary aggregates to which capital inflows gave rise represented developments in demand for domestic cash balances. However, other aspects of the economy had to be kept in mind: for example, as many Directors had pointed out, the authorities' efforts to control the rate of inflation had not been completely successful. Had the monetary expansion in Uruguay indeed been demand determined it would be difficult to understand why the rate of inflation had not fallen even lower. It was true that the real exchange rate had been stable, but maintenance of a competitive real rate of exchange in a context of a relatively low rate of inflation was preferable to one in which prices rose rapidly. From that point of view, there were legitimate grounds for caution in interpreting the capital inflows as being totally demand determined. The question was empirical, not conceptual: if the monetary expansion arising from the balance of payments was in effect demand related, Mr. Ortiz's interpretation obtained; if that was not the case, other Directors' remarks on the need for sterilization of capital inflows were pertinent. The test of which interpretation was more accurate would revolve basically around the progress that was recorded in actually lowering Uruguay's rate of inflation.

Mr. Ortiz, responding to the question why, if the increase in monetary expansion was demand determined, there was not a greater reduction in the rate of inflation, said that the link between the exchange rate and prices and that between wages and prices could be responsible for continued inflation, independent of the elimination of the real causes of inflation. The recent experience of Israel and Argentina had shown that eliminating the real causes of inflation had not been sufficient to eliminate inertial inflation. Moreover, efforts to control inflation by a gradual reduction in the demand-determined growth of monetary aggregates could provoke a deep economic recession, and therefore, considerable caution was warranted.

The Chairman observed that M3, which incorporated the balances held by residents in dollar-denominated assets, had increased by almost 100 percent in 1985. Given the high rate of inflation in Uruguay, even if the true significance of the 100 percent increase in the M3 aggregate could not be ascertained, the underlying uncertainties about the stability of the demand element in that increase made it preferable for the authorities to err on the side of prudence.

Mr. Wijnholds noted that an interesting assumption had been made in the medium-term projections for Uruguay--that no new bank lending would be needed or forthcoming--and in addition, no request for new bank lending had accompanied the commercial bank multiyear rescheduling arrangement. Uruguay was unusual in the sense that it had been able to attract foreign capital by means other than commercial bank lending, in particular, by its ability to place treasury paper denominated in U.S. dollars. Given the long-term nature of that paper, it might be a preferable means by which Uruguay could attract capital rather than by new bank lending, because such capital might be cheaper and would have a fixed interest rate.

Mr. Nebbia reported that the authorities were satisfied with the performance of the Uruguayan economy thus far; much remained to be done, but they were encouraged by the positive signs that had been reflected by almost every indicator. The trends in evidence at the beginning of 1985 had been reversed. Inflation and the fiscal deficit were coming down at a steady pace, and there had been a marked turnaround in the capital account of the balance of payments, with a significant inflow of capital. The deterioration of economic activity had been stopped and signs of recovery were evident.

Uruguay's economic recovery had been taking place in spite of an adverse environment for its exports, Mr. Nebbia continued. Despite the authorities' efforts to strengthen the external account, manage the exchange rate wisely, and diversify their exports, they were faced with increasing protectionism in different markets, both for traditional and nontraditional products. The Common Agricultural Policy being pursued by the European Communities not only made it difficult for Uruguay to sell products in those markets, but Uruguayan products also had to compete with the heavily subsidized European products. Moreover, Uruguay was encountering difficulties in its efforts to introduce textile products into the United States; given the importance of textile revenues for the country, such difficulties did not make Uruguay's adjustment efforts any easier.

The losses of the Central Bank were an important component of the overall fiscal deficit of Uruguay, Mr. Nebbia remarked. The staff paper (EBS/86/101) and a number of Executive Directors had referred to the low rate of recovery in the private sector loan portfolio during 1985. The authorities, concerned about the lack of collection of those payments, had taken two major steps to correct the problem. First, legislation had been passed to allow the refinancing of domestic debt and to provide legal enforcement for the collection of the payments due. Second, the Central Bank, while retaining a supervisory role, had relinquished to a commercial bank the management of the collection of the private loan portfolio. It was expected that that arrangement would improve the collection of payments due and would consequently reduce the operating losses of the Central Bank.

The staff representative from the Western Hemisphere Department had rightly noted that the optimal target rate of inflation was a matter of judgment, Mr. Nebbia indicated. A reduction in the rate from 83 percent to 45 percent was indeed significant, and the so-called shock treatment that had been used in Argentina was not warranted in Uruguay, particularly in view of the good progress that had been made to date under the adjustment program.

The arrangements with the Banco de la República involved highly political issues and required considerable caution, Mr. Nebbia mentioned. The authorities believed that they had reached a satisfactory understanding with the Banco de la República, and that it would be politically counterproductive to formalize that arrangement.

Although the expansion of monetary aggregates had exceeded the targeted growth, the rate of inflation had been in line with the program target, Mr. Nebbia observed. Nevertheless, the authorities were prepared to sterilize the capital, if necessary, to avoid further pressure on the rate of inflation. Because the authorities were determined to reach the 45 percent rate of inflation, and subsequently to reduce it further, they would be monitoring closely any further monetary expansion.

The Chairman then made the following summing up:

Executive Directors were in general agreement with the views expressed in the appraisal in the staff report for the 1986 Article IV consultation with Uruguay.

Directors were pleased to note that performance under Uruguay's stand-by arrangement had been satisfactory; all the performance criteria had been met, and, in particular, there had been a larger than programmed reduction in the fiscal deficit. Directors also noted the strengthening of the external accounts and the emerging indications of a recovery in economic activity, but they expressed concern about the continued rapid rate of inflation and recent trends in wages.

Directors were encouraged by the authorities' intention to continue along the path of fiscal adjustment initiated in June 1985, and they welcomed the revenue measures that had recently been introduced. Directors stressed, however, that the attainment of the authorities' fiscal objective would also require close control over current expenditures, renewed efforts at improving tax administration, structural improvements in the tax system, and timely adjustments in public enterprise tariffs.

Directors expressed disappointment at the low rate of recovery during 1985 on the Central Bank's large private sector loan portfolio. They underlined the importance of reducing the quasi-fiscal deficit of the Central Bank, and urged the authorities to make every effort to increase collections on its loan portfolio.

A number of Directors expressed concern about the recent rapid expansion in the monetary aggregates, and they noted that a significant deceleration in their rate of growth was required in order to bring about a sustained reduction in inflation--an objective to which they believed that the authorities should attach the utmost priority. Directors observed that the targeted reduction in the public sector deficit should contribute importantly to that end. However, most Directors stressed that more active use would also need to be made of the monetary policy instruments and firm control would need to be exercised over the credit operations of the Banco de la República. Directors observed that sizable capital inflows related to the restoration of confidence in the economy had complicated the conduct of an appropriately tight monetary policy, and several Directors noted with approval the policy commitment to sterilize any future capital inflows.

Directors welcomed the recent elimination of the interest rate ceilings on the domestic currency lending operations of the commercial banks, as a result of which all interest rates in Uruguay had been freed from administrative control.

In the area of wage policy, Directors observed with some disappointment that during 1985 wages had increased at a faster rate than had been programmed. They therefore welcomed the authorities' decision to have future wage settlements guided by the programmed rather than by the past rate of inflation. Directors stressed the importance of the successful implementation of that policy for the attainment of the authorities' stabilization objectives and for safeguarding the prospects for employment.

Noting the restoration and maintenance of Uruguay's international competitiveness since the floating of the exchange rate in November 1982, Directors stressed the need for Uruguay to pursue vigorously the diversification of the export base. In that connection, Directors expressed support for Uruguay's floating exchange rate policy.

Directors commended the Uruguayan authorities for their commitment to an open exchange and trade system, and in particular for their maintenance of international current and capital transactions completely free of exchange restrictions. Directors found that stance especially praiseworthy in view of the current international environment of increased protection.

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

The Executive Board then took the following decision:

Review Under Stand-By Arrangement

1. Uruguay has consulted with the Fund in accordance with paragraph 4(d) of the stand-by arrangement for Uruguay (EBS/85/210, Sup. 1, 10/2/85) and paragraph 19 of the Memorandum

of Understanding on Economic Policy dated August 28, 1985 attached to the stand-by arrangement, in order to review progress made in the implementation of the program and to reach understandings as specified in paragraph 4(d) of the stand-by arrangement.

2. The letter and the attached Memorandum of Understanding on Economic Policies for 1986 dated May 9, 1986 from the Minister of Economy and Finance and the President of the Central Bank of Uruguay shall be annexed to the stand-by arrangement for Uruguay, and the letter and Memorandum of August 28, 1985 attached to the stand-by arrangement shall be read as supplemented and modified by the letter and the Memorandum of Understanding of May 9, 1986.

3. Accordingly, Uruguay will not make purchases under the stand-by arrangement that would increase the Fund's holdings of Uruguay's currency in the credit tranches beyond 25 percent of quota or increase the Fund's holdings of that currency resulting from purchases of borrowed resources beyond 12 1/2 percent of quota:

(a) During any period in which:

(i) the limit on the deficit of the nonfinancial public sector referred to in paragraph 7 of the memorandum annexed to the attached letter and set forth in Table 1 thereof; or

(ii) the limit on the net domestic assets of the Central Bank referred to in paragraph 8 of the memorandum annexed to the attached letter and set forth in Table 2 thereof;

are not observed; or

(b) During any period in which the data at the end of the preceding period indicate that:

(i) the limits on the outstanding stocks of public and publicly guaranteed foreign indebtedness referred to in paragraph 12 of the memorandum annexed to the attached letter and set forth in Table 3 thereof; or

(ii) the target for the net international reserves of the Central Bank of Uruguay referred to in paragraph 13 of the memorandum annexed to the attached letter and set forth in Table 4 thereof;

are not observed.

4. The Fund finds, pursuant to paragraph 4(d) of the stand-by arrangement, that no additional understandings are necessary on policies on interest rates, the exchange rate, wage determination, or public enterprise pricing.

Decision No. 8291-(86/90), adopted
May 28, 1986

2. MADAGASCAR - PURCHASE TRANSACTIONS - EMERGENCY ASSISTANCE AND COMPENSATORY FINANCING FACILITY

The Executive Directors considered a request by Madagascar for a purchase equivalent to SDR 16.6 million under the Fund's policy on emergency assistance related to natural disasters (EBS/86/104, 5/8/86; and Sup. 1, 5/27/86) and for a purchase equivalent to SDR 16.1 million under the decision on the compensatory financing of export fluctuations (EBS/86/105, 5/8/86; and Sup. 1, 5/27/86).

Mr. Alfidja made the following statement:

On behalf of my authorities, I would like to thank the Fund management and staff for their prompt response to the request for emergency assistance following the cyclone that struck the island of Madagascar on March 14-16, 1986 and caused damage to four provinces and the port of Toamasina. My authorities wish also to express their appreciation to the Executive Board for its prompt consideration of this request and that for a drawing under the compensatory financing facility. The staff paper (EBS/86/104, 5/8/86) has given a good summary of the extent of the damage caused by the cyclone and the preliminary estimated costs of emergency relief and repairs needed. Indications are now that the 1986 deficit of the overall balance of payments will substantially increase owing to losses in export earnings and higher imports. In order to meet, in part, this additional financial need and to reduce pressure on the external accounts, the Malagasy authorities are requesting an emergency purchase equivalent to 25 percent of their country's quota. At the same time, they are requesting a purchase amounting to about 24 percent of quota under the compensatory financing facility in respect of shortfalls in export earnings for calendar year 1985.

At the conclusion of the 1984 Article IV consultation with Madagascar and the second review of the stand-by arrangement in January 1986, Executive Directors had the opportunity to examine in detail the performance and prospects of the economy. Projections made then indicated that an improvement in the financial and economic situation of Madagascar could be expected in 1986. These forecasts had to be revised in the wake of the cyclone. Economic conditions in 1986 are now expected to remain difficult, with the overall position of the external accounts registering a larger deficit. The Malagasy authorities are confronting this unexpected challenge with added resolve. Measures are being taken not only to meet the short-term needs arising from the effects of the cyclone but also to fulfill the medium-term objectives of strengthening the basis for a noninflationary economic growth and a sustainable balance of payments position. The measures under consideration are detailed in the letter attached to EBS/86/104. They are being put together in an economic and financial program in support of which the Government of Madagascar intends to seek assistance from the Fund and other members of the international financial community, as well as from bilateral creditors and donors.

Concerning the proposed request under the compensatory financing facility, the staff report (EBS/86/105, 5/8/86) clearly shows that Madagascar has met all the relevant requirements. In particular, it provides details on the serious need for balance of payments assistance being experienced by the country. It also appears from the staff analysis that the export shortfall is of a temporary nature. Furthermore, the record of the relationship between the Fund and Madagascar over the past several years provides clear evidence that the test of cooperation is amply met.

To conclude, over the past few years, despite a series of natural disasters among other problems, the Malagasy authorities have pursued a comprehensive program of adjustment with the support of the Fund and the World Bank. The last financial program, which expired on April 22, 1986, was successfully implemented and all the performance criteria were observed. The present request for Fund assistance, if approved, will enable the authorities to meet part of the foreign exchange needs of the country and to proceed with the implementation of the structural reforms of the economy. I, therefore, urge the Executive Board to adopt the draft decisions proposed for both the emergency aid and the request for a purchase under the compensatory financing facility.

Mr. Rousset stated his full support for the two proposed decisions. The Fund resources would provide a timely means by which the Malagasy authorities could pursue the adjustment efforts that were starting to bear fruit. Without such resources, the adjustment efforts might be jeopardized by both the shortfall in the volume of exports for 1985 and the additional imports required to repair the damage caused by the cyclone. Given those circumstances, the rapid presentation of Madagascar's requests for purchases under the two facilities was welcome.

He hoped that the firm adjustment efforts being pursued by the authorities would be strengthened in the future by the stand-by arrangement under discussion, and that the new program would place the necessary emphasis on the structural measures needed to put Madagascar back on a path of growth, Mr. Rousset added. Moreover, such an orientation would greatly facilitate Madagascar's access to the structural adjustment facility.

Mr. Steinberg remarked that the combination of a request for emergency assistance and a request for a drawing under the compensatory financing facility was an infrequent occurrence. However, the situation in Madagascar had begun to deteriorate with the decline of export proceeds in 1985--for which the request under the compensatory financing facility was being made--and had worsened when a cyclone had struck the island and damaged the port facilities, thus necessitating an increase in imports--for which the emergency assistance was being requested.

Before the cyclone had occurred, the authorities had discussed with the Fund in 1985 the shortfall of export proceeds, Mr. Steinberg continued. The cyclone damage had actually lowered export projections for 1986 and thus had reduced the compensable amount under the compensatory financing facility to the suggested 25 percent of quota. The two requests for purchases did not seem to have a potential for double compensation; on the contrary, the total compensation suggested might be rather low to cover both direct and indirect losses suffered by Madagascar. Madagascar met the test of balance of payments need, with a deficit of SDR 145 million projected in the overall balance of payments for 1986.

The staff considered that Madagascar had met the cooperation requirement for the proposed purchase, below 50 percent of quota, under the compensatory financing facility, Mr. Steinberg noted. The previous two stand-by arrangements had ended with all agreed policy measures implemented and all performance criteria observed. The negotiations for a new stand-by arrangement, which had been interrupted by the cyclone, were expected to be renewed shortly, and the letter of intent provided evidence that appropriate policy measures could be expected.

Nevertheless, a word of caution was warranted, Mr. Steinberg continued. Although the previous two stand-by arrangements had been implemented successfully, the overall economic situation of Madagascar was not so bright. Preliminary results for the balance of payments in 1985 showed an increase in the current account deficit instead of the projected decline, and the international reserves at end-1985 had dropped to the low level of the equivalent of two weeks of imports. The external debt had been rising rapidly and the debt service ratio--nearly 50 percent--might dictate the need for additional debt rescheduling. The fiscal imbalance in 1985 had remained at 4.6 percent, about the same as in 1984. The real GDP growth in 1985, 2.4 percent, had been below the projected rate, and the rate of inflation had remained unchanged, at about 10 percent. The difficulties experienced in 1985, despite the Fund-supported program, had been attributed to external and weather-related factors. However, the bleak economic situation necessitated continued rigorous policies.

The staff papers did not present adequate evidence of Madagascar's ability to repay its debts to creditors in general and to the Fund in particular, Mr. Steinberg observed. The task of the coming negotiations with Madagascar was thus even more crucial to ensure that the country committed itself to correct its structural distortions and financial imbalances.

Mr. Song said that it was impressive to note that, since 1980, the Malagasy authorities had fulfilled their Fund-supported adjustment program and that they had successfully implemented all the policy measures and performance criteria. The cyclone that had struck Madagascar in March 1986 had caused damage to both infrastructure and production, as well as exacerbating the shortfall in export earnings. In view of those facts and in keeping with the Fund's practice with regard to the provision of assistance in cases of natural disaster, he could support the proposed decisions.

Mr. Finaish indicated that he could support Madagascar's requests for emergency assistance and for a drawing under the compensatory financing facility. It was clear that both requests met the conditions for such drawings.

The disastrous cyclone that had hit Madagascar in March had been particularly unfortunate, given that 1986 had promised to be a good year for the Malagasy economy, Mr. Finaish remarked. Although the delay in the negotiations for a new stand-by arrangement had been inevitable, it was important to complete them as soon as possible so that the effects of the disaster would not significantly retard the momentum of economic adjustment that had been achieved in the past few years. He therefore welcomed the news that a staff mission would be visiting Madagascar in the near future to complete the discussions on a new stand-by arrangement and on a possible request for a drawing under the structural adjustment facility.

Also welcome was the authorities' increased emphasis on the achievement of a better growth performance through structural adjustment, particularly in the area of pricing, Mr. Finaish continued. Such emphasis was warranted, given that Madagascar had had five consecutive stand-by arrangements with the Fund since 1980, under which important demand tightening had been achieved. Commensurate progress in structural policy measures to improve the medium- and longer-term growth potential of the economy was clearly needed. In that regard, the authorities' intention to engage in a comprehensive review of the tax system in order to reduce dependence on export-related revenue was particularly welcome. Useful steps to reform the public enterprises sector had also been taken, albeit at a slow pace.

Madagascar would continue to depend on substantial capital inflows and foreign assistance, particularly if the growth and development objectives over the medium and longer terms were to be achieved, Mr. Finaish added. It was therefore important for the authorities to intensify their efforts to maintain their good standing vis-à-vis aid and development institutions. The authorities needed to take steps to avoid the accumulation of arrears that could jeopardize the flow of further assistance from multilateral development institutions. Madagascar had maintained a good financial standing with the Fund, and it was hoped that the authorities would be able to maintain the same good relations with other multilateral institutions.

The information on Madagascar's previous purchases under the compensatory financing facility illustrated starkly the difficulties involved in medium-term export projections for shortfall calculations, Mr. Finaish noted. Although the staff was doing its best, such projections inevitably involved a considerable degree of judgment.

The amount of emergency assistance being requested--25 percent of quota--appeared consistent with the Board guidelines, Mr. Finaish commented. However, it would be useful to have an explanation from the staff on the general factors that had determined the amount of assistance in individual cases, particularly because in five of the ten emergency requests made since 1962, the amount of Fund assistance had exceeded the first credit tranche.

Mr. Grosche expressed his support for the two proposed decisions. It was clear that the request for a drawing under the compensatory financing facility met all the established requirements and that the request for emergency assistance was in accordance with the Fund's earlier practice in such cases.

Indeed, it was unfortunate that Madagascar had been struck by a cyclone just when the policies pursued under several Fund-supported adjustment programs had begun to bear fruit, and when the outlook for 1986 had been relatively good, including a projected improvement in the balance of payments, Mr. Grosche said. Nevertheless, with the authorities' unwavering commitment to the adjustment process, and with the expected external financial assistance, Madagascar should be able to deal with the immediate problems. Moreover, it should be able to reduce further its internal and external financial imbalances over the medium term.

The Board's guidelines on the provision of emergency assistance stipulated that the damage caused by a natural disaster would, in the absence of financial support from the Fund, result in a serious depletion of the member's external reserves, Mr. Grosche recalled. EBS/86/105 had not given a clear indication that Madagascar's external reserves would be seriously depleted, because Table 1 showed that reserves were expected to increase from about SDR 13 million in 1985 to about SDR 26 million in 1986. However, given that the table also included projections of a financial gap of SDR 144.6 million in 1986, a rather generous interpretation of the guidelines seemed warranted, and he could therefore go along with the amount proposed in the decision. Additional staff comments on those projections would be helpful.

Mr. Nimatallah observed that the Malagasy authorities had recently made some progress in containing aggregate demand, but in terms of growth, the restructuring of the economy, and the strengthening of the balance of payments, Madagascar's economic performance had fallen far short of expectations, despite the implementation of a series of successive stand-by arrangements with the Fund. Madagascar's performance had been hampered by the slow pace of structural reforms in the country, the slow progress in restructuring the economy and in diversifying the export base, the lack of tangible progress in rehabilitating the public sector enterprises, the continuation of marketing and pricing rigidities, and the lack of action to improve the allocation of resources and to reduce inefficiencies.

Because of the lack of structural reforms, economic developments had not reflected the country's potential, Mr. Nimatallah remarked. Given that real economic growth had been negative on average for the past five years, together with a high rate of population growth, the per capita income of Madagascar had seriously deteriorated and the unemployment problem had worsened. Real GDP was the same in 1985 as it had been in 1971. That deterioration had been accompanied by severe balance of payments pressures, a high average rate of inflation, and a sharp buildup of external indebtedness. Such a situation was not sustainable even in the absence of weather-related calamities.

The growth in external debt was a cause for concern when taken in conjunction with the continued deterioration in Madagascar's capacity to service that debt, Mr. Nimatallah added. The Saudi Fund for Development had helped Madagascar in financing certain projects, but unfortunately Madagascar had not been repaying the Saudi Fund, which was disrupting the revolving character of those resources. Madagascar's difficulties in servicing its debt had already been reflected in the staff's most recent medium-term projections, which indicated that even at the end of the decade large financing gaps would remain. In order to attract more resources, however, Madagascar had to improve its debt-servicing capacity, which required higher real economic growth, which, in turn, necessitated rigorous structural adjustment efforts.

It was urgent for the authorities to move rapidly and decisively to restructure the economy, Mr. Nimatallah emphasized. Toward that end, Fund-supported adjustment programs alone, although necessary, were not sufficient; they needed to be supplemented by increased World Bank involvement. He had been surprised to note the relative absence of World Bank involvement in Madagascar: with the exception of the recently concluded agricultural sector adjustment credit, no adjustment program supported by the World Bank was currently in place. Given the nature of the economic problems facing Madagascar, the agricultural sector adjustment credit was not sufficient. Perhaps the staff or the World Bank representative could explain the lack of World Bank programs, given the nature of the economic problems facing Madagascar. The authorities should also take advantage of the Fund's structural adjustment facility within the framework of increased World Bank involvement.

In the period ahead, it was essential for the authorities to place more emphasis on fundamental structural reforms with a view to improving the efficiency of the Malagasy economy in general and that of the public sector in particular--within the framework of a growth-oriented approach, Mr. Nimatallah went on. It was useful to recall that Madagascar was not an isolated case, particularly in the light of a UN special session on African economic development that was currently under way. African nations needed resources, but resources alone could not accomplish the task; high-quality management was also necessary. To attract the necessary resources, African countries needed to have good policies and good management. Moreover, the availability of those resources gave rise to a circle that could not be broken if success was to be achieved: there had to be consistent debt servicing of the resources, which was not possible without growth, which, in turn, could not be sustained without appropriate structural adjustment policies.

Despite prolonged use of Fund resources, Madagascar's income had declined and its balance of payments position had weakened, Mr. Nimatallah concluded. Moreover, adverse external factors, together with inappropriate policies and a lack of structural reforms, had greatly diminished the effectiveness of the Fund-supported programs. Thus, a meaningful and lasting improvement in the Malagasy economy required strong Fund-supported adjustment programs, as well as programs supported by the World Bank, to strengthen supply-side policies that were not restricted to the agricultural sector. The authorities should accelerate and strengthen their adjustment process in order to gain access to additional Fund and Bank resources. Finally, he supported the proposed decisions.

Mr. Mtei stated that he fully supported Madagascar's requests for emergency assistance and for the use of Fund resources under the compensatory financing facility. The two requests were well justified and deserved the full support of the Executive Board. The cyclone that had struck the port of Toamasina and surrounding provinces in March had caused extensive damage to human life and economic installations. The authorities were faced with a critical problem of providing the affected population with emergency assistance--food, medicine, and temporary shelter--which had undoubtedly aggravated the Government's weak financial situation and the balance of payments position.

The damage to the economic installations had been serious, since Toamasina was Madagascar's major port and handled a large proportion of its export and import traffic, Mr. Mtei continued. The port itself, together with other physical infrastructure, such as roads and bridges leading to the port, urgently needed repairs if economic life was to be restored rapidly and further deterioration in the overall financial and economic situation was to be halted. It was estimated that Madagascar's overall import requirements would have to rise to meet the needs for repairs, emergency food, shelter, and medicine. Furthermore, the destruction to the port facilities prevented Madagascar from exporting its commodities on time or in the quantities that might otherwise have been shipped. Export earnings had thus been reduced, which exacerbated the country's current account deficit in the balance of payments.

The international community had not responded with the desired timeliness or generosity to Madagascar's emergency situation, Mr. Mtei noted. Faced with that situation, the authorities were correctly taking a comprehensive overview of their reconstruction efforts. Attempts were being made to mobilize assistance through the Consultative Group meetings sponsored by the World Bank. A follow-up Fund-supported adjustment program should be put in place promptly to respond more effectively to the current difficult financial situation, and it was hoped that such a program would help catalyze additional resources from donors. It would be helpful to have staff comments on the time frame in which the adjustment program could be made fully operational.

Madagascar met all the conditions for use of Fund resources under the compensatory financing facility, Mr. Mtei considered. First, the balance of payments situation had worsened since the cyclone had struck Madagascar. Second, the calculation of the shortfall in export earnings posed no problems, and the shortfall had been caused largely by factors outside the control of the authorities. The weakness in the commodities market for both coffee and vanilla, together with weather-related factors, had been largely responsible for the shortfall. Finally, Madagascar met the test of cooperation; the authorities had been pursuing adjustment programs supported by the Fund since 1980. Moreover, they had been concluding discussions with the staff on a new stand-by arrangement when the cyclone had hit Madagascar. Although the cyclone had prompted a postponement of those discussions, the authorities recognized the need for continued adjustment efforts and would soon be requesting Fund support for those efforts.

Mr. de Groote expressed his support of the Malagasy authorities' requests for emergency assistance as a result of the cyclone of March 1986, and for a purchase under the compensatory financing facility. The natural disaster had caused extensive damage not only to houses and public buildings but to the country's productive base, and thus the economic implications were considerable. The cyclone had struck just when the country's adjustment efforts had begun to bear fruit: the precyclone projections for 1986 had indicated a better economic situation than in previous years, giving Madagascar a chance to consolidate the gains realized from the adjustment policies effected since 1980. Madagascar would require additional external financing to meet the cost of repairing the damaged infrastructure and equipment vitally needed to increase output capacity, restore a sustainable balance of payments situation, and enhance growth prospects.

The March cyclone had imposed two additional conditions that had to be met if economic stability was to be achieved in the coming years, Mr. de Groote continued. First, the formulation of economic policies in the framework of a possible stand-by arrangement and use of structural adjustment facilities had to be concluded as soon as possible. The 1986 program should emphasize structural measures as well as demand-management policies. The authorities had shown a welcome willingness to collaborate with the Fund. However, as Mr. Steinberg and others had noted, the staff papers could have been more explicit on Madagascar's ability to repay the Fund. Second, the decline in real imports of 44 percent between 1980 and 1985, in combination with the cyclone damage, would prevent the authorities from being able to cope with their difficulties despite their pursuit of prudent adjustment policies. The financial support of the Fund and the international community would continue to be needed in the coming years to fund the balance of payments gap. The aid mobilized during the recent Consultative Group meeting was welcome and timely, and was an example of the cooperative efforts advocated by Mr. Nimatallah.

He had no difficulty in supporting the proposed decision on the request for a purchase under the compensatory financing facility, Mr. de Groote added, since Madagascar met all the requirements for such a purchase.

Mr. Romuâldez, expressing his sympathy with the authorities and the Malagasy people over the losses that they had suffered in the wake of the March cyclone, observed that the provision of emergency assistance in such situations was an appropriate way in which the Fund could help its members. Indeed, without such assistance, the adjustment efforts that Madagascar had been undertaking could be irreparably thrown off course. At the same time, however, Madagascar had a heightened responsibility to sustain its adjustment efforts. He was reassured by Mr. Alfidja's statement that the authorities had begun to take measures not only to address the shorter-term needs arising from the effects of the cyclone, but also to fulfill their medium-term objectives. Madagascar had shown a welcome intention to resume as soon as possible the negotiations for a new stand-by arrangement and the use of the structural adjustment facility, which had been interrupted by the cyclone. He viewed the emergency assistance under consideration as akin to an early drawing under the proposed sixth stand-by arrangement between Madagascar and the Fund. Staff comment on the status of the negotiations would be helpful.

In general, the tests for a lower tranche drawing under the compensatory financing facility had been met, Mr. Romuâldez said. Madagascar had a clear balance of payments need and had been cooperating with the Fund. Moreover, the shortfall--net of the stock adjustment--had arisen largely because of events beyond Madagascar's control and, on the basis of the methodology for calculating a shortfall, it could be expected to be temporary. Of course, only time would tell whether the shortfall actually proved to be temporary. Nevertheless, it was noteworthy that Madagascar's three previous drawings under the compensatory financing facility--in 1980, 1982, and 1984--had been, ex post, larger than warranted, apparently because export earnings had stagnated since 1981. Against the background of that experience, it was all the more important for agreement to be reached as soon as possible on policies that could be supported by a new stand-by arrangement and by use of the structural adjustment facility.

He would welcome elaboration by the staff on the extent to which the balance of payments financing gap for 1986 had been closed, and, more important, what the medium-term outlook was, Mr. Romuáldez added. The Managing Director's summing up of the most recent Article IV consultation with Madagascar (EBM/86/4, 1/8/86) had indicated the grave concern expressed by Executive Directors at the large balance of payments financing gaps envisaged through 1990 because of the heavy debt-service burden, the sluggish growth of exports, and the unfortunately low projected capital inflows. Finally, he supported the proposed decisions.

Mr. Dallara said that he supported Madagascar's requests for emergency assistance and a drawing under the compensatory financing facility.

Madagascar met all the criteria associated with the use of the compensatory financing facility, Mr. Dallara indicated. However, he had some serious reservations about the way in which the current boom in coffee prices, caused by the drought in Brazil, appeared to be generating windfall compensation under the compensatory financing facility. Nevertheless, Madagascar unquestionably merited support and its shortfall had been caused by a variety of circumstances, not just by developments in coffee prices.

Madagascar's request for emergency assistance met the various policy considerations and criteria, Mr. Dallara continued. Madagascar clearly did not have sufficient short-term resources to cope with the natural disaster that had struck. In certain circumstances, such assistance needs could be met by the compensatory financing facility or by a stand-by arrangement. Even though the emergency assistance request was accompanied by a requested drawing under the compensatory financing facility, it appeared to be justified by the need to proceed promptly with reconstruction, the relatively low level of Madagascar's exchange reserves, and the generally weak underlying balance of payments situation. The Malagasy authorities had made continuous efforts to cooperate with the Fund over the past several years. Moreover, the cooperation tests for both requests were met by the authorities' clear expression of their intent to continue that cooperation in the form of a new stand-by arrangement.

There was a welcome breadth in the policy discussions, including the authorities' intent to pursue further reductions in the fiscal deficit and to continue credit restraint, Mr. Dallara added. To establish a more viable future for the economy of Madagascar, the authorities planned to initiate measures in several policy areas, including a comprehensive review of the tax system, rehabilitation programs for 16 public enterprises, modification of the import licensing system, accelerated depreciation of the exchange rate, further price decontrol, and, finally, rehabilitation of the agricultural sector with the help of the World Bank. It was hoped that the authorities would soon request further use of Fund resources in support of a comprehensive program. The medium-term prospects were sufficiently bleak to suggest that without intense, broad-based international support, centered on Madagascar's own efforts, there were only slim prospects for the country to achieve sustainable growth at rates higher than the rate of population growth with a viable external position. Thus, any additional World Bank support for Madagascar's efforts would be welcome. Staff comments on the prospects for such support would be helpful.

As Mr. Steinberg and Mr. de Groote had rightly noted, there was a lack of analysis of Madagascar's ability to repay the Fund and, more generally, of the debt service implications of the decisions under consideration, Mr. Dallara observed. In approving the decisions, the Board would be taking the unusual step of providing resources in the aggregate that were slightly more than 50 percent of quota, without having a comprehensive program in place in Madagascar. Although the circumstances warranted that step, it was noteworthy that, despite Madagascar's generally impressive adjustment efforts, it faced a difficult medium-term balance of payments situation. An earlier staff report (EBS/85/270, 12/9/85) had noted that Madagascar would have a high debt service ratio for the remainder of the decade and had pointed out that even if the remaining gaps after rescheduling could be covered by concessional borrowing, the resulting increase in external indebtedness still seemed insupportable. Nevertheless, the Fund was on the verge of increasing to over 200 percent of quota its holdings of Madagascar's currency subject to repurchase. Although EBS/86/105 contained a statement that Madagascar was current in its obligations to the Fund and that the staff was aware of no reason to doubt that the country would continue to remain current, the analysis of Madagascar's ability to repay the Fund should instead have made clear what the additional borrowing implied in terms of debt service obligations and should have highlighted what might be needed in terms of policy actions and other external support to enable Madagascar to meet its debt service obligations during the years ahead.

Mr. Jayawardena recalled that Madagascar, an island economy vulnerable to the vagaries of weather, had suffered previously from cyclone damage and cycles of drought and floods. In recent years, the authorities had been taking strong adjustment measures, including structural changes, under a series of Fund-supported programs that had been successful in correcting financial imbalances and laying the first foundations for viable economic growth. Unfortunately, just as some of the positive results of the recent measures were about to materialize, a severe cyclone had set back the economy by at least 2 percentage points of GDP, and had caused damage that would require an estimated $40-50 million to rehabilitate. Given the relatively small, inadequate pledges of donor assistance to help Madagascar, it was entirely appropriate for the Fund to provide emergency assistance, while negotiations proceeded for the continuation of a Fund-supported adjustment program. He thus fully supported the proposed decision on emergency assistance.

The staff paper on Madagascar's request for a drawing under the compensatory financing facility had clearly established the shortfall, even allowing for a substantial adjustment for stock building due to exogenous factors, Mr. Jayawardena remarked. Although it was not easy to predict future activity in commodity markets, he agreed with the staff's evaluation.

Madagascar met the other criteria for a drawing under the compensatory financing facility. The factors causing the shortfall were clearly beyond the control of the authorities. The balance of payments need was clear, and there was no doubt regarding Madagascar's cooperation with the Fund. Hence, he supported the proposed decision.

The staff representative from the African Department noted that an analysis of the medium-term balance of payments, prepared in the context of the most recent consultation with Madagascar, had been considered by the Executive Board in January 1986 (EBM/86/4). The staff would have preferred to present an updated medium-term balance of payments analysis for the current discussion, but the desirability of an update had been outweighed by the urgent need to prepare the requests for emergency assistance and a drawing under the compensatory financing facility. A medium-term balance of payments projection would, however, be prepared for the next report related to Madagascar's use of Fund resources.

With respect to the ability of Madagascar to repay its debt, particularly to the Fund, the staff representative stated that the authorities had been prompt in discharging their obligations to the Fund, that they had placed great emphasis on remaining current with the Fund, and that the staff had no doubts that they would continue to do so in the future. Nevertheless, as Mr. Finaish and Mr. Nimatallah had indicated, Madagascar had incurred arrears with other institutions. The staff had consistently insisted on the need to liquidate those arrears in a nondiscriminatory fashion. Moreover, in the program that would be supported by a stand-by arrangement with the Fund, it was intended to include further reductions in arrears, although it would be impossible to eliminate the arrears in 1986, given the financial constraints.

A variety of factors had guided the staff in the determination of the amount of emergency assistance for Madagascar, including the amount of expenditure required in foreign exchange to meet the immediate relief needs, the staff representative commented. The authorities had estimated that they needed approximately SDR 39 million in foreign exchange to pay for repairs and medical relief and, of course, there were other expenditures that would be paid in local currency. The amount of the emergency assistance compensated for only a small part of the authorities' immediate needs in foreign exchange. Some aid, albeit not on a large scale, had been received from other donors. In addition, the World Bank was considering providing emergency assistance to Madagascar in the amount of $10 million to supplement earlier emergency assistance amounting to $15 million, which had been provided after a cyclone had struck Madagascar in 1984. The Fund had not provided emergency assistance at that time.

Responding to Mr. Grosche's question about whether reserves were increasing and why, the staff representative said that the projected reserves for 1986 were not SDR 25.9 million, and that a correction would be issued to rectify the typographical error in the staff papers. In fact, the balance of payments had come under severe pressure in 1985 and reserves had declined by SDR 19.5 million. However, in the context of the new stand-by arrangement that was being negotiated, the staff intended to program some increase in reserves in order to reach a more comfortable level.

The involvement of the World Bank in Madagascar had come much later than that of the Fund, the staff representative recalled. It had been much easier to implement stabilization and demand management measures than to initiate structural measures. Moreover, there were many difficulties in Madagascar, such as a lack of statistics and unreliable data; thus, the World Bank had needed to make numerous studies before undertaking structural measures. In 1982, the World Bank had envisaged a structural adjustment program, but because of all the difficulties it had abandoned that attempt, and since then had been providing Madagascar with sectoral programs for transportation, industry, and agriculture. The agricultural sector adjustment credit of $60 million had been approved one month earlier. The World Bank was still considering a second sectoral adjustment loan for industry, but was not currently considering a structural adjustment program. Nonetheless, Mr. Nimatallah had rightly noted the need for additional World Bank involvement in Madagascar, and it was hoped that more adjustment measures would be initiated to deal with the deep-seated problems facing the country.

A mission would shortly depart for Madagascar to negotiate the new stand-by arrangement, the staff representative indicated. He hoped that it would be possible to come to the Board with a proposed stand-by arrangement by end-August 1986.

It was likely that Madagascar would request assistance under the structural adjustment facility, the staff representative commented. The authorities wanted to reschedule their debt with official creditors, and they intended to have a stand-by arrangement with the Fund. Discussions on the structural adjustment facility would probably be carried out after those on the stand-by arrangement.

Madagascar was faced with an initial financing gap of SDR 257 million, the staff representative remarked. Aid mobilized during the meeting of a Consultative Group for Madagascar held in Paris in April 1986, together with resources from the World Bank and from the Fund, would reduce the financing gap to about SDR 135 million. The staff would examine the balance of payments projections for 1986 to ensure that they were as realistic as possible. If the financing gap would indeed be about SDR 135 million, much of that gap would be financeable by rescheduling official debt. If after rescheduling there were insufficient resources to close the financing gap, then there would be no choice but to reduce imports from the amount projected.

Madagascar's medium-term outlook remained difficult, the staff representative from the African Department concluded. However, the staff believed that the far-reaching measures that the authorities intended to take in the context of the next stand-by arrangement, together with the support of the World Bank's sectoral and structural measures, would contribute to an improved medium-term outlook.

Mr. Dallara said that he understood that the urgency of bringing Madagascar's request to the Executive Board had precluded the preparation of a comprehensive update of the medium-term balance of payments projections; however, what troubled him was the lack of an explicit analysis of Madagascar's ability to repay the Fund. The need for such an analysis had been discussed and agreed by the Board (EBM/85/170, 11/25/85). The intent of the authorities was not at issue--it was recognized that the authorities would make every effort within their capacity to repay the Fund--but their capacity or ability to repay the Fund was at issue, particularly since the Fund's resources were not being provided on a highly concessional basis. Hence, a staff analysis of the member's ability to repay the Fund was an essential part of the staff reports on requests for such assistance.

Mr. Nimatallah expressed his concern about the separation between the stand-by arrangement negotiations and discussions of a program under the structural adjustment facility. As Mr. Dallara had mentioned, Madagascar needed to be able to repay the Fund, but more generally, Madagascar needed to put itself on a course of sustained growth, and a combined effort could help to attract more resources. It was desirable to have World Bank involvement, and his authorities had promised to be involved extensively if the stand-by arrangement and the structural adjustment facility program were combined. With access only to resources under the stand-by arrangement, Madagascar might indeed have difficulty repaying the Fund, and limited resources would delay Madagascar's efforts to realize its economic potential. His remarks should not be seen as favoring a delay in the stand-by arrangement but, rather, they indicated his desire to speed up negotiations on the structural adjustment program.

The staff representative from the African Department replied that a long delay was not envisaged between the discussion on the stand-by arrangement and that on the structural adjustment facility--it might be possible to discuss in October 1986 the policy framework paper, as well as the program for the first year under the structural adjustment facility, in combination with the review of the stand-by arrangement. The authorities knew little about the structural adjustment facility at present and needed to prepare themselves for the discussions. Unfortunately, the cyclone had interfered with the timetable. The World Bank also needed additional time to prepare for such discussions.

The staff representative from the Exchange and Trade Relations Department, responding to a question on the amounts of emergency assistance granted since the 1982 review by the Executive Board, remarked that there had been four such cases, including Madagascar. In three cases--one of which was Madagascar--the amount of the assistance had been equal to 25 percent of quota; in the remaining case, it had been 23 percent. Thus, the amount of assistance had been broadly in the same range for all four cases, as was also the proportion of the emergency purchase to the effect of the natural disasters on the balance of payments--about 40 percent.

The staff representative from the Research Department, noting remarks about the overestimation of shortfalls related to previous drawings by Madagascar, acknowledged that accurate forecasting of exports was a difficult matter. However, efforts were always being made to try to improve forecasting techniques.

Mr. Alfidja agreed with Mr. Nimatallah that the external resources to be made available to Madagascar should be combined with resources intended to help implement the needed structural reforms. However, the issue was being confused by the references to the structural adjustment arrangement. First, the promised additional resources for structural reform had not been forthcoming. Second, there seemed to be a tendency to consider the structural adjustment facility as a kind of extended Fund facility under a different name. It was difficult to characterize the structural adjustment facility, because no request under that facility had yet been brought to the Board for consideration. As the staff representative from the African Department had rightly noted, the Malagasy authorities would need some time to familiarize themselves with the mechanism of the structural adjustment facility.

Finally, the comments made on Madagascar's arrears by Mr. Nimatallah and Mr. Finaish had been well taken, and he would convey them to the authorities, Mr. Alfidja indicated. At the same time, it was noteworthy that the authorities were indeed convinced that it was in Madagascar's interest to remain in good standing with friendly countries and multilateral financial institutions.

The Chairman remarked that Madagascar had made progress in effecting demand management policies in recent years. For example, the authorities' fiscal measures had resulted in a reduction in the fiscal deficit from the previous 15-16 percent of GDP to the current 4 1/2 percent. Nonetheless, the current account had remained weak over the past three years, the medium-term external position was difficult, and the general outlook was not favorable. It seemed that Madagascar's previous programs had not elicited a sufficient supply-side response, and thus a structural adjustment arrangement seemed warranted. However, while the discussions on the program for the structural adjustment arrangement were in progress, it was necessary to finalize the discussions on the stand-by arrangement so as not to lose the opportunities for demand management improvements, which were important complements to any successful structural adjustment program.

While he shared Mr. Dallara's concerns about Madagascar's ability to repay the Fund, the Chairman observed that the Fund did implement its access policy cautiously. As Madagascar had made some net repurchases, its net use of Fund resources had not increased unduly. Nonetheless, Mr. Dallara's remarks had been well taken.

The Executive Board then took the following decisions:

a. Purchase Transaction - Emergency Assistance

1. The Government of Madagascar has requested a purchase equivalent to SDR 16.6 million.

2. The Fund notes the intentions of the Government of Madagascar as stated in its letter dated April 30, 1986, and approves the purchase in accordance with the request.

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

4. Madagascar maintains restrictions on payments and transfers for current international transactions as last described in EBS/85/270 and in SM/85/331. The Fund notes the intention of the authorities to progressively remove the exchange restrictions, and in the meantime, the Fund grants approval for their retention until October 31, 1986.

Decision No. 8292-(86/90), adopted
May 28, 1986

b. Purchase Transaction - Compensatory Financing Facility

1. The Fund has received a request from the Government of Madagascar for a purchase of SDR 16.1 million under the Decision on Compensatory Financing of Export Fluctuations (Executive Board Decision No. 6224-(79/135), adopted August 2, 1979, as amended).

2. The Fund notes the representations of Madagascar and approves the purchase in accordance with the request.

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

Decision No. 8293-(86/90), adopted
May 28, 1986

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/89 (5/23/86) and EBM/86/90 (5/28/86).

3. ZAIRE - STAND-BY ARRANGEMENT - EFFECTIVE DATE

1. The Fund notes the arrangements described in EBS/86/76, Supplement 4, with respect to the financing of Zaïre's estimated

balance of payments deficit in 1986 and finds that the arrangements are satisfactory.

2. Accordingly, the stand-by arrangement for Zaîre in EBS/86/76, Supplement 2, shall enter into effect on May 28, 1986. (EBS/86/76, Sup. 4, 5/22/86)

Decision No. 8294-(86/90), adopted
May 27, 1986

4. CENTRAL AMERICAN MONETARY COUNCIL - TECHNICAL ASSISTANCE

In response to a request from the Central American Monetary Council for technical assistance in the research field in connection with the preparation of a financial programming framework for the five member countries of the Council, the Executive Board approves the proposal set forth in EBD/86/149 (5/19/86).

Adopted May 23, 1986

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/139 through 85/143 are approved. (EBD/86/150, 5/19/86).

Adopted May 23, 1986

6. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAP/86/117 (5/21/86) is approved.

APPROVED: February 19, 1987

LEO VAN HOUTVEN
Secretary