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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 00/54

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Executive Board Attendance

S. Fischer, Acting Chairman
E. Aninat, Acting Chairman

Executive Directors	Alternate Executive Directors
	A.S. Alosaimi
	D. Ondo Mañe
T.A. Bernes	J.A. Chelsky, Temporary
A.G. Carstens	H. Oyarzábal
	A. Del Cid-Bonilla,Temporary
R.F. Cippà	W. Szczuka
	R.J. Singh, Temporary
B. Esdar	D.H. Kranen, Temporary
A.M. Jul	A.G. Zoccali
	H. Vittas
	J. Santos, Temporary
	C. Harinowo
	S.K. Keshava, Temporary
	J. Jonáš, Temporary
	S. Zádor, Temporary
O.-P. Lehmussaari	Å. Törnqvist
K. Lissakers	P.A. Brukoff, Temporary
	I. Mateos y Lago, Temporary
A. Mirakhor	M. Daïri
	T. Belay, Temporary
	L. Pelei, Temporary
	E. Kornitch, Temporary
S. Pickford	
M. Portugal	R. Junguito
A.S. Shaalan	A.F. Al-Faris
G.F. Taylor	
	Jin Qi
	A.Y.T. Wong, Temporary
J. de Beaufort Wijnholds	E.J.P. Houtman, Temporary
	H. Toyama

S.J. Anjaria, Secretary
A.S. Linde, Acting Secretary
R. Gudmundsson, Assistant
A. Tiffin, Assistant

Brazil—Stand-By Arrangement—Review
Staff representatives: Ter-Minassian, WHD; Seade, PDR

Uruguay—Stand-By Arrangement
Staff representatives: Traa, WHD; Brachet, PDR

Also Present
IBRD: S. Bery and D. Rosenblatt, Latin America and Caribbean Regional Office. European I Department: M.C. Deppler, Director; J.S. Kahkonen. External Relations Department: G. Hacche, Deputy Director; F. Baker Meio, R.R. Brauning, M.B. Chatah, R. Chote. Fiscal Affairs Department: A. Cheasty. IMF Institute: E.C. Tanner. Legal Department: B.D. Dimitrachkov. Middle Eastern Department: P. Chabrier, Director; D. Burton, Deputy Director; A.G.G. Bennett, E.H. Gardner, A. Mazarei, K. Nashashibi, J. Zhou. Monetary and Exchange Affairs Department: A.M. Leone, M.K. Moore. Policy Development and Review Department: C. Brachet, N. Calika, A. Musalem, M. Rossi, J. Seade. Research Department: B. Chadha, L. Lall, H.K. Poirson. Secretary's Department: P. Gotur, B.A. Sarr. Western Hemisphere Department: C.M. Loser, Director; M.E. Bonangelino, Deputy Director; D.J. Goldsbrough, Deputy Director; T.M. Ter-Minassian, Deputy Director; K. Honjo, J.C. Jaramillo, E.R. Jenkner, C. Keller, G.A. Mackenzie, C.A. Paiva, A.M.B. Ramos, G.J. Schwartz, B.M. Traa. Office of the Managing Director: A. Bauer, D.A. Citrin, S. Tiwari. Advisors to Executive Directors: J.C. Estrella, S.S. Farid, O. Himani, J.M. Jones, M.F. Melhem, W. Merz, H. Mori, J.N. Santos, T. Turner-Huggins. Assistants to Executive Directors: S.A. Bakhache, S. Bonomo, J.G. Borpujari, R. Burgess, I.- K. Cho, M.J. Fernández, T. Hadded, M.R. Hajian, K. Harada, M.S. Hililan, S. Hinata, I.C. Ioannou, A. Kapteijn, S. Le Gal, Liu Z., A. Maciá, Y. Moussa, D. Nardelli, K. Ongley, Peh K.H., L. Redifer, A.A. Rojas, C.-P. Schollmeier, J. Sigurgeirsson, T. Skurzewski, Sugeng, Tong Y., M. Walsh, E.S. Weisman, M. Yépez.

1. REPORT BY FIRST DEPUTY MANAGING DIRECTOR

The First Deputy Managing Director reported on his recent travel to Egypt and Bulgaria. In Egypt, he had met with the president to discuss the current economic situation in the context of the Article IV consultation. He had been accompanied by Mr. Burton, of the Middle East Department, and the Executive Director for Egypt, Mr. Shaalan. The Fund resident representative, Mr. Mecagni, had provided useful assistance.

There had been two main topics on the agenda during the meeting with the president, the First Deputy Managing Director noted: the overvaluation of the exchange rate, and problems with fiscal deficit data for the fiscal year 1998/99, which had ended in June 1999. The deficit had originally been estimated at 1.3 percent of GDP, but had been revised to 4.2 percent of GDP. In addition, further clarification was still required for an additional amount representing 1.7 percent of GDP.

The exchange rate overvaluation was not a result of any specific measure taken by the authorities, and owed to the fact that the Egyptian pound had been fixed against the dollar since the start of the 1990s, the First Deputy Managing Director remarked. Domestic inflation had not exceeded inflation in the United States, but the pound had appreciated in line with the dollar, and had therefore substantially strengthened against the euro. As Egypt traded more with Europe than with the United States, the Egyptian pound had appreciated by 37 percent in real effective terms since 1995.

The problem with the fiscal data had arisen because the activities of the National Investment Bank, which financed some of the government's investments, had not been included in the budget, the First Deputy Managing Director continued. Investment spending had considerably increased recently, with a series of "mega" projects underway, including the Toshka irrigation scheme in the desert Southwest of Aswan.

During the meeting with the president, the minister of the economy, and Mr. Shaalan, the First Deputy Managing Director had raised the following five issues: the exchange rate overvaluation; the fiscal data error; privatization; the strength of the banking system; and the need for trade liberalization. The president had said that all those issues were on the authorities' agenda. He had agreed that the exchange rate was overvalued, leading to concerns about import competition from European goods, and a number of alternatives for dealing with the overvaluation had been discussed.

On the fiscal data, the president had indicated that he was going to make an announcement later in the day of what had happened, the First Deputy Managing Director continued. The announcement had been made, and did not seem to have had any negative impact. The minister of the economy had previously contacted several investment analysts to explain the situation to them, and the government had made a real effort to communicate effectively. The action of the president had clearly been the right way to proceed.

On the financial sector, the First Deputy Managing Director said that he had emphasized the usefulness of participating in the Financial Sector Assessment Program

(FSAP). While the authorities were aware of the benefits of such an assessment, they were concerned about confidentiality and the possibility that the Board would insist on publication. A similar concern had been expressed during discussions on the FSAP with the GCC countries.

On privatization, the president had said that the process had recently been accelerated, the First Deputy Managing Director observed. Some cement companies had been privatized , and the authorities were about to sell part of the telephone company. The president had also taken note of the advice to sell some banks at en early stage, and indicated that trade liberalization would be pursued. Overall, the meeting with the president had been highly useful.

The First Deputy Managing Director said that he had later met with the governor of the central bank and with the prime minister to report on his meeting with the president, and to discuss whether there might have been data problems for earlier years. They had indicated that they planned to examine the issue.

Mr. Shaalan wished to confirm that the meetings with the president and the prime minister had been highly useful, as part of the conclusion of the Article IV consultation. The authorities had appreciated that the First Deputy Managing Director had taken the time to provide them with the views of the Board and the staff of the Fund.

Turning to his visit to Bulgaria, the First Deputy Managing Director said that he had restated the Fund's support for the reform efforts of the government. The program of meetings had been rather intense, including discussions with the president, the prime minister, the deputy prime minister, the finance minister, and a group of parliamentarians, as well as a lecture at a local university on the reform process.

The First Deputy Managing Director remarked that, notwithstanding a few points related to tax reform—the creation of a unified revenue agency, for example—the most frequent comment from officials had been that they had overperformed on the budget in each year since 1997, and that, in the light of the forthcoming elections and the need to demonstrate the benefits of economic reform, tax cuts were being considered for the coming year. The view of the staff, including that of the Fund resident representative, Mr. Stella, had been that the authorities could cut taxes significantly without missing their deficit targets. The authorities had also indicated that they wanted to spend more on investment, and the staff had considered that there was sufficient room in the budget to do so. In addition, there were a number of projects that were to be financed externally which the staff deemed worthwhile.

In response to the authorities' concerns that the benefits of reforms had not yet become apparent to the public at large, and that positive economic growth had not prevented an increase in unemployment, the First Deputy Managing Director had pointed out that there was a set of lags that were the bane of all policy makers, including the lag between the implementation of structural reforms and growth, the lag between growth and employment, the lag between steps to strengthen the banking system and the resumption of lending, and the lag between the passing of measures to improve the investment climate and the realization of investments. Nevertheless, the fact that the economy was growing at a rate that was likely to reach 5 percent in 2000 provided some reassurance that, by staying the course, the benefits of reforms would soon be evident. In addition, the authorities could consider the possibility of increasing targeted social spending, provided there was sufficient room in the budget for that purpose.

With regard to the authorities' plans to implement tax cuts and increase expenditures, the First Deputy Managing Director had indicated that, while such a measure seemed appropriate in macroeconomic terms, the key issue was how those plans were going to be implemented, and a review mission of the staff was expected discuss various alternatives with the authorities in the following month. One issue that had led to some discussion had been that of the energy prices and, in particular, the authorities' decision to freeze electricity and heating prices for approximately one year, in response to concerns about the impact of higher prices on households. Given that the country had a high energy intensity of production, the First Deputy Managing Director had suggested that such a measure was inefficient, and that it would be preferable to target subsidies to the people who would most be hurt by the higher prices, rather than providing a generalized subsidy by freezing prices.

The commitment to the country's reform efforts was also emphasized in the context of meetings with a group parliamentarians and with university students, the First Deputy Managing Director remarked. It had been a pleasure to visit a country where the staff's advice and the Fund-supported program were so strongly appreciated.

The First Deputy Managing Director wished to express his gratitude to the authorities of Egypt and Bulgaria for setting up a busy schedule of meetings and making room for those meetings at reasonably short notice, and for the great courtesy of the reception in each country.

Mr. Wijnholds said that his Bulgarian authorities had been especially pleased with the First Deputy Managing Director's visit to the country, which had given him an opportunity to witness the popularity that the Fund enjoyed.

With regard to the authorities' tendency to present conservative budget estimates, Mr. Wijnholds indicated that a similar practice had been successfully followed in the Netherlands. Announcing a tax decrease because economic results turned out to be better than initially expected was always a welcome measure.

Mr. Wijnholds thanked the First Deputy Managing Director for his visit to Bulgaria. He assured him that the authorities were committed to following the Fund-supported program, and looked forward to the continuing strong cooperation between Bulgaria and the Fund.

2. BRAZIL—STAND-BY ARRANGEMENT—REVIEW

The Executive Directors considered a staff paper on the fifth review under the Stand-By Arrangement for Brazil (EBS/00/82, 5/3/00; Cor. 1, 5/26/00; Sup. 1, 5/30/00; and Sup. 1, Cor. 1, 5/31/00).

Mr. Portugal submitted the following statement:

> Brazil has successfully completed four program reviews displaying a better than expected economic performance and complying with all quantitative performance criteria and with most structural benchmarks. For this fifth review now under consideration by the Executive Board, once again economic developments have been better than projected and all quantitative performance criteria and most structural benchmarks have been achieved as well. Brazil has repaid, partly ahead of schedule, all the funds borrowed under the SRF and the bilateral facility with the Bank for International Settlements (BIS) and the Bank of Japan (BOJ). Most importantly, Brazil has managed to limit the variability in the rate of GDP growth in the recent period of global market turbulence compared to other countries.
>
> This positive performance may be attributable to three main factors: the generally prudent macroeconomic policy that had been followed prior to the crises and the important structural reforms that had been implemented since 1994; the strong and prompt policy response and the commitment demonstrated by the government in reacting to the crisis; and the timely and significant financial support of the international community.
>
> During periods of strong expansion of liquidity in the international capital markets which preceded the financial crises of the 1990s, Brazilian macroeconomic policy was directed at maintaining domestic demand at a sustainable level, with the Central Bank relying on a variety of instruments to contain the expansion of domestic credit and to avoid the transmission of easy external liquidity conditions to the domestic monetary stance. Such a precautionary policy enabled the economy to avoid a much sharper contraction in GDP growth when the country was hit by abrupt contractions of external financing both in 1995 and in 1997-99. Similarly, the deep and comprehensive structural reform program that has been implemented by the government since the launching of the Real Plan in July 1994 has increased the country's resilience to crises.
>
> As the financial crisis hit Brazil in 1998, prompt and vigorous policy responses by the government helped to minimize the income loss. After the floating of the Real in January 1999, the substantial turnaround in the fiscal position and the maintenance of a prudent monetary policy under a new framework of inflation targeting managed to contain the exchange rate depreciation and the inflationary pass-through.

The substantial and readily available financial support by the Fund, other multilateral institutions, and the governments of industrial countries was essential to help restore confidence and to allow for the voluntary roll-over of short-term credit lines by private creditors. My Brazilian authorities wish once again to thank the Fund and all the institutions and governments that trusted and helped our country when conditions looked bleak.

Economic performance has been consistently improving and turning out much better than anticipated. Real GDP recorded a positive growth of over 1 percent in 1999 compared to a deceleration of less than 1 percent in the previous year and against initial projections of a decline of between 3 to 4 percent. The recovery trend has continued in the first quarter of 2000 with real GDP growing at 3.08 percent compared to the same period of 1999, with a rebound in industrial activity and exports leading the process.

Despite the nominal depreciation of the Real of nearly 50 percent, a sizeable terms of trade deterioration, a drought that affected agricultural production, and substantial adjustments in international and domestic oil prices, the inflation pass-through was minimized, and inflation remained at a one-digit level and within the government's inflation target. The broadest national consumer price index (IPCA) rose by less than 9 percent in 1999, and has declined to 6.8 percent for the 12-month period ended in April.

There was a major turnaround in Brazil's fiscal performance last year. The primary result of the consolidated public sector shifted from near-equilibrium in 1998 to a surplus equivalent to 3.1 percent of GDP in 1999, a result achieved against a background of low domestic demand. The overall public sector deficit (PSBR) fell from 9.5 percent of GDP in 1999 to 4.6 percent of GDP in March 2000. The overall public sector primary surplus accumulated up to March 2000 amounts to R$13.6 billion, equivalent to 3.3 percent of GDP, compared to a program target of R$7.2 billion. Net public debt –which is recorded on an accrual basis and captured the full effect of the depreciation of the Real on external public debt and domestic public debt indexed to the U.S. dollar– rose to R$516.6 billion at end-1999, slightly above the indicative target of R$509 billion. But as a percentage of GDP it remained at 47 percent, well below the 50 percent figure initially projected. In the first quarter of 2000, net public debt reached R$527.2 billion, well below the indicative ceiling.

The improvement in the primary surplus of the central government reflected not only a wide range of tax policy and tax administration measures, but also a substantial effort to contain non-interest expenditures. Expenditure restraint was especially pronounced on the federal payroll and on capital spending, together with efforts to rationalize the public administration and prioritize public expenditure programs. The first round of reforms of the social security system approved in 1998 has allowed some moderation in the real growth of social security benefits.

An important aspect of the fiscal adjustment effort is that a sizable improvement was recorded in the primary balance of other levels of government. States shifted from a deficit equivalent to 0.4 percent of GDP in 1998 to a surplus of 0.15 percent of GDP in 1999. This reflects the strict enforcement of borrowing limits to the states, and of the fiscal targets included in their debt restructuring agreements with the federal government. Public enterprises also recorded a substantial improvement equivalent to nearly 1 percent of GDP in 1999, reflecting not only increased revenues but also efforts to contain expenditures.

At the same time, the government endeavored to protect social expenditures, which in Brazil amount to over 20 percent of GDP, a large share by international standards. Embedded in the Brazilian social security system there is a large and well-functioning social safety net for the rural poor and the elderly. Of the 18.3 million Brazilians who receive social security benefits, 7.9 million are rural workers, and elderly or disabled people who never contributed to the system. High priority has also been given by the Federal government to primary education and basic health care, complementing the actions of states and municipal governments under whose responsibility these two areas lie. Expenditure on education in Brazil corresponds to 4.8 percent of GDP, which again compares well with international standards. The share of seven to fourteen-year-olds in school increased from the 89 percent in 1994 to 96 percent of the population in that age range in 1999, while the number of students completing primary and secondary education increased by 50 percent and 67.8 percent respectively in the same period. Between 1996 and 1999 resources allocated to basic health care increased by 208 percent. Improving asset distribution in rural areas through land reform has also been a major government priority in the social area. Since 1995, more than 373,000 families have been settled in some 13 million hectares of land, some 70 percent more than what had been achieved in the previous 30 years. In spite of all these efforts, reducing poverty and inequity of opportunities remains a great and yet unresolved challenge in Brazil as it is in most societies around the world, especially in developing countries. There are deep rooted historical and structural causes for poverty in Brazil that, unfortunately, cannot be overcome in the short-run. The government, however, is committed to the international goal of reducing poverty by half by 2015.

The Central Bank has followed a cautious monetary policy under the inflation targeting framework, keeping its intervention interest rate in the overnight market (SELIC) at 19 percent from September 1999 to April 2000. The rate was reduced to 18.5 percent in April and, since then, has remained unchanged.

The Central Bank has also made significant further progress in strengthening the financial system. A number of actions were taken to improve the functioning of credit markets, and to facilitate the narrowing of the relatively wide banking spreads. The regulatory and supervisory framework was further strengthened by issuing new regulations on capital requirements for interest rate risk and on a forward-looking loan classification system, and by beginning global consolidated inspections of banks.

Public sector banks are being subject to the most extensive structural reform effort in Brazilian financial history. So far, 10 state banks have been liquidated, 14 have been transformed into development agencies that are forbidden to carry liabilities with the public, 13 banks have been or are in the process of being privatized, and 5 have been recapitalized. This structural change will have lasting results for the finances of subnational governments, as state banks were the major source of deficit financing for most states. A first full audit of the two major federal banks is now under way, as well as studies to design better solutions for agricultural and housing financing, two of the main functions carried out by these federal banks.

The Central Bank and the Treasury have taken steps to improve public debt management and the functioning of the secondary market for public debt. The World Bank has been providing technical assistance both to the Treasury and the Central Bank on these issues. The average maturity of total outstanding public debt in the market has risen and the share of fixed-rate securities in total federal domestic securitized debt has increased from 1 percent in March 1999 to 13 percent by end-April 2000.

The external situation has improved with a reduction in the current account deficit, maintenance of strong inflows of foreign direct investment, and renewed access to foreign financing with issues of medium- and long-term debt. Since April 1999, Brazil has placed 10 successful foreign issues totaling US$12.3 billion. The current account deficit narrowed markedly, from US$33.6 billion in 1998 to US$24.4 billion in 1999, and further to US$23.8 billion in the 12 months to April 2000.The narrowing of the deficit was produced by both a substantial reduction in the trade deficit, despite a 13 percent decline in the terms of trade, and an improvement in the services account. Export volumes rose by nearly 8 percent in 1999. There was also substantial, efficient import substitution. Import volumes declined by 15 percent on average in 1999, despite the 1 percent increase in GDP. In the period January-April of 2000, exports in terms of value grew by 18 percent while the imports' growth rate was 10 percent in the same period. The current account deficit has been more than fully financed by net foreign direct investment (FDI). Gross total external debt remained broadly stable at under US$242 billion (43 percent of GDP) by end-1999, while gross public external debt amounted to US$ 97 billion, some 17 percent of GDP. Net international reserves (NIR) stood at US$24 billion at year-end and have continued to rise in 2000. By end-April, NIR stood at around US$27 billion.

Important advances continued to be made in the area of structural reforms. The constitutional amendments for the administrative reform and most of its implementing legislation have been approved by Congress. An important reform of the social security system for private sector workers, which introduced actuarial principles in the current pay-as-you-go system by linking pension benefits to age, contributive history of each worker and life expectancy at the time of retirement, is now in place. Three bills regulating private and public complementary pension plans are proceeding in Congress. A fiscal responsibility law covering all levels of government has been approved by Congress and sanctioned by the President. A description of the far-reaching innovations introduced by this law is detailed in Box 8 of the staff report. Substantial progress was also made in the area of labor market reforms; the most important of these were the end of wage indexation, the improvement of the attractiveness of temporary labor contracts, and the introduction of the possibility of temporary layoffs.

The government is committed to continue following the current set of economic policies in 2000. The main aims of economic policy this year are to consolidate the recovery in output growth and the decline in unemployment, to keep inflation within the announced target, to further strengthen the economy's resilience to external shocks, and to proceed with the structural reform agenda. Absent serious external shocks, the government is confident that GDP growth can come close to 4 percent in 2000.

The program for 2000 continues to weigh heavily on fiscal adjustment. The primary surplus of the public sector is targeted to rise to the equivalent of 3.25 percent of GDP. The overall public sector deficit (PSBR) will be kept under 4 percent of GDP and the ratio of net public debt to GDP should show a further decline. The budget for 2000 envisages a primary surplus for the central government equivalent to 2.6 percent of GDP. To facilitate the containment of primary spending, a constitutional amendment was also approved by Congress in March to reduce by 20 percent the earmarking of federal revenues to certain types of expenditure. Also, the government enacted a budget execution decree limiting commitments of selected discretionary expenditures at a level below the corresponding appropriations in the budget approved by Congress.

The finances of states are expected to benefit from higher revenues resulting from the recovery of economic activity, whereas on the expenditure side the administrative reform approved in 1999 will provide greater scope for reducing personnel expenditures as required. Public enterprises are expected to maintain a sizable surplus of over 0.5 percent of GDP.

Monetary policy will aim to achieve a gradual decline in inflation to 6 percent by year-end as a target, with a range of tolerance under the inflation targeting framework. The government intends to continue its policy of gradually increasing the share of fixed-rate securities in domestic public debt, further raise its average maturity, and gradually reduce the foreign exchange indexed debt, as market conditions allow.

The government will continue its efforts to obtain congressional approval of the remaining legislation for administrative reform and social security contributions by retired civil servants, and to advance the discussion for the reform of the indirect taxation system aimed at removing distortions and making uniform across the nation the base of the state-level VAT. A broad-based consensus has already been achieved with the states on this reform. Negotiations are now under way with members of the House tax reform committee to remove the other main obstacle to move ahead the legislative process in this area, which is the intention of some law makers to include in the constitutional text a provision on non-cumulativity of tax that might lead to future legal disputes. It is important to realize, however, that in democratic and complex societies like Brazil it is normal and expected that the process of political consensus building on such difficult topics as tax and social security reforms should take substantial time and energy. The fiscal results for this and next year, however, are not depending on these reforms.

The external trade balance is expected to continue to improve this year, shifting into a substantial surplus as a result of sustained export growth at a higher pace than the projected pick up in imports. The current account deficit is projected to decline to around US$23 billion (about 3 1/2 percent of GDP), and to be more than fully financed by net FDI. Renewed access to international capital markets allowed the government to issue US$3.4 billion in sovereign debt in 2000, more than half of the public sector external financing requirements for this year.

My authorities welcome the fact that the staff has endorsed their request for revising the NIR floor and establishing it at the level of US$25 billion. They consider this to be essential to ensure a good implementation of the program. Last year, a relatively high NIR floor and an NIR baseline that did not materialize –given lower than projected balance of payments results and the worse than expected conditions in international capital markets– have led to an unwarranted downward pressure on the exchange rate, as the existing NIR floor appeared to require the Central Bank to buy reserves from the market. The revised NIR floor of US$25 billion proposed in the program for the second half of this year gives sufficient protection to Fund resources currently exposed to Brazil's risk. As before, the authorities are committed to increase NIR from their current level as allowed by market conditions.

It is almost 18 months since the SBA with Brazil was approved. The program has faced a number of initial obstacles, but has been kept on track and has produced better than expected results because, at each difficulty, the staff, management and the Board were prepared to continue extending their support to the program and because the Brazilian authorities, in each case, reacted promptly and forcefully with additional or corrective measures. I believe that this program is a demonstration of how much international cooperation and strong domestic ownership can achieve together, even in a hostile environment. My authorities remain conscious of the many risks that still remain ahead, especially in the external area. They are convinced that the best way to deal with these risks is through continued and firm adherence to the current policies, and they are totally committed to do so.

Mr. Faini submitted the following statement:

The Brazilian program is a testimony to the fact that the forceful implementation of sound policies has a clear payoff in terms of growth and stability. Brazilian authorities should be commended for their commitment to fiscal consolidation and monetary prudence. The fiscal targets have been met, sometimes with a considerable margin. Similarly, inflation has remained well within the target tolerance band. The Staff should also be praised for designing, more than a year ago, in the midst of a turbulent period, a program that has so far stood up very well to the test of time.

The substantive improvement in the short-term outlook for the Brazilian economy should not however breed complacency. We agree with staff that there are several downside risks to the Brazilian program, not all of which come from the external environment. More crucially, it is important to stress that the improvement in the economic situation provides a key and almost unique opportunity for Brazil to consolidate past macroeconomic achievements and reduce the vulnerability of its economy to external shocks. This opportunity should not be lost. Brazilian authorities must forcefully pursue their agenda of structural reforms, particularly on the fiscal side, with a view to putting their fiscal accounts on a definitively sustainable path and to being able to withstand even major exogenous shocks. We welcome in this respect the enacting by Congress of the Fiscal Responsibility law. From Box 8, we learn that this law mandates the withholding of discretionary federal transfers to states that do not collect efficiently their own taxes. We have a few queries for staff in this regard. First, to what extent does the law provide, in addition to a set of general and laudable principles, adequate tools for its effective enforcement? More specifically, will the Federal Government withhold discretionary transfers also to states and municipalities that exceed their limits on personnel spending? Finally, how is the efficient collection of taxes determined? Second, in light of the emphasis placed in the law on the need for a balanced current budget (the so-called golden rule), what are the assurances that capital spending will be wisely determined? These are all, we believe, important issues. More generally, there is a need to strengthen the effort to put the social security system on a sound footing and to reform the tax system. The latter is at present a source of many distortions and inefficiencies, which are bound to take a toll on growth. We are glad to learn from Mr. Portugal's comprehensive and informative BUFF that Brazilian authorities are firmly intentioned to press ahead with this reform agenda.

The need to persevere with, if not redouble, the effort on the structural front also extends to the labor market. We welcome the renewed emphasis on the reform of the labor markets, with a view to strengthening its flexibility and its resilience to shocks. We should stress that the shift to a flexible exchange rate regime in no way diminishes the need for labor market reform. Indeed, in a flexible exchange rate regime, unfavorable exogenous shocks will be mostly reflected in exchange rate rather than in wage fluctuations, if the labor market lacks flexibility. In turn, severe fluctuations in the exchange rate may complicate the monetary authorities' task of maintaining price stability. A reduction in the monopoly power of sectoral unions is an essential step in ensuring that the evolution of wages be more attuned to aggregate economic conditions in the country.

Brazilian authorities are, quite rightly, concerned about the social implications of adjustment. They have increased minimum wages by 11 percent, well in excess of inflation, and plan to create an anti-poverty fund financed by the earmarking of a number of taxes. It cannot be overlooked however that Brazil already has on the books a plethora of social programs, which are extremely expensive (20 percent of GDP), but seem so far to have failed to make a significant dent in the level of poverty. Rather than create a new anti-poverty fund, it would perhaps be wiser to target existing programs more effectively. We would at least expect the creation of this new fund to be accompanied by an in-depth review of existing schemes. Staff's opinion on this matter would be greatly appreciated. Moreover, the choice of earmarking tax revenue seems to run counter to the strategy of giving additional flexibility to the budget. At the same time, though, there are reasons to believe that the increase in the minimum wage may be effective in fighting poverty. We learn from staff that more than 20 percent of the working-age population receives incomes below or equal to the minimum wage. This figure is somewhat smaller than the poverty headcount, suggesting that the minimum wage covers households that are typically below the poverty line. We agree therefore with the supportive thrust of Box 4 in the staff report, although we would like to know from staff whether they are aware of more rigorous analyses of the poverty and macroeconomic effects of a higher minimum wage. To conclude on this point, I would also emphasize that Brazil's recent history shows that prudent macroeconomic policies, and in particular the maintenance of a stable and low inflation rate, have proved to be the most effective instrument against poverty. Indeed, between 1994 and 1997, poverty fell in Brazil by almost 10 percent.

The widespread optimism about Brazil's short-term outlook should not make us lose sight of the fact that there are still a number of vulnerabilities in the economy. The level and the composition of public debt are one of them, highlighting the need for prudent debt management. Public sector debt is projected at 45 percent of GDP in 2000, considerably above the pre-1998 level. While the total external debt is projected to decline in the same period, the share of short-term debt will slightly increase. We can expect that, if the upward trend of US interest rates continues, it will be increasingly difficult for the authorities to issue long-term, dollar-linked bonds at attractive rates. We also note that the authorities intend to reduce the stock of foreign exchange-indexed debt. This move is in our view appropriate in order to reduce vulnerability. It would also help de-link monetary and fiscal policies and increase the flexibility of monetary policies. Moreover, the presence of a large stock of exchange rate-indexed debt may impart an undue restrictive bias to monetary policy. At the same time, we would also emphasize the importance of a gradual approach. Markets may still be unwilling to reduce substantially their holdings of foreign exchange indexed-debt and any attempts to force this trend on the market may be counterproductive. Finally, we would note that the real has fallen to a level that, according to the Fund projections, should have been reached only in 2005. Some analysts are expecting an even weaker level further ahead. Should this unfavorable trend persist, it would suggest the need to update the sensitivity analysis on net public debt. It would also provide an additional motive to take advantage of the current macroeconomic developments and aim for a larger effort in terms of fiscal consolidation.

Finally, according to staff, Brazil's economic statistics are adequate for the purpose of surveillance. This assessment errs perhaps on the optimistic side. Brazil's program shows that available data have not always been adequate, at least in the context of the use of Fund resources. The lack of quarterly data clearly hampered the monitoring of the program. Similarly, annual national accounts are available only with an exceedingly long lag of more than six months. We should recall in this context that Brazil is the only country with a Fund arrangement that has not yet subscribed to the SDDS. We understand that authorities are tackling the problem and urge them to make all efforts to address it speedily and forcefully.

With these remarks, this Chair fully supports the completion of the fifth review and wishes the authorities all the best in their future endeavors.

Mr. Mirakhor submitted the following statement:

I thank the staff for an excellent report. As Mr. Portugal indicates in his comprehensive and helpful statement, recent economic performance in Brazil has exceeded expectations. While the much-improved external outlook has clearly helped, the quality and strength of the authorities' adjustment efforts in the context of the Fund-supported SBA have played a decisive role in shaping the outcome. In contrast to earlier fears of a sharp contraction in activity, GDP growth in 1999 has been positive, unemployment has declined, and inflationary pressures have been contained despite sizeable exchange rate adjustment, administered price increases, and supply shocks. In the external sector, in spite of a large terms-of-trade decline, the trade deficit has narrowed significantly. More recent data indicate a much improved external position on the strength of export growth and as a result of renewed access to international capital markets. This has allowed Brazil to repay all drawings from the SRF and the bilateral support package, and to consider treating the present arrangement henceforth as precautionary. The authorities deserve strong commendation for these accomplishments.

This picture of robust adjustment owes itself to the authorities' efforts to engender a marked turnaround in fiscal performance and to extend adjustment to all levels of the government. The improvement in the primary surplus of the central government has reflected a range of tax policy and tax administration measures and the authorities' concerted efforts in containing non-interest expenditures. Also noteworthy is the progress recorded in implementing an ambitious structural fiscal reform agenda. In this regard, the passage of the fiscal responsibility law is highly encouraging. Effective implementation of the strictures contained therein would be particularly important in consolidating and sustaining efforts at achieving a solid fiscal framework resilient to external shocks. Monetary policy has also been handled skillfully, with the BCB having successfully made the transition to an inflation targeting framework. Moreover, the conduct of interest rate policy has helped strengthen the exchange rate.

The broad macroeconomic objectives of the government's economic program for 2000 appear to be achievable, provided that, as the staff note, "policy commitments under the program are strictly observed." The authorities' excellent track record on policy implementation so far gives confidence that their commitment to the program will remain undiminished. This well-deserved policy credibility can be bolstered significantly by a firm resolve to address the issue of prioritization of social spending, particularly on health and education, and reform of the tax and social security systems.

The rigorous implementation of fiscal policy will require alacrity in responding to revenue shortfalls with adjustment in the discretionary components of federal spending. The authorities' intentions are highly encouraging in this regard. Moreover, the authorities are remaining alert to movement in international petroleum prices and intend to review domestic prices of oil products in June 2000. The task of achieving the fiscal target would be helped should developments and prospects for international oil prices and exchange rate warrant adjusting domestic petroleum prices. While this may complicate the objective of further reducing inflation, the demonstrated effectiveness of monetary policy gives confidence that any resulting temporary blips in domestic prices will be ameliorated.

The government's fullest attention and firm resolve will hopefully assure that structural fiscal reforms would not be delayed as a result of crowded congressional agenda; securing a consensus on key reforms of the social security system and indirect taxation is especially important. The staff correctly note that, while these structural reforms are not strictly necessary to ensure the achievement of fiscal targets this year, undue delays could affect unfavorably market perceptions and could complicate the task of economic management.

The adoption of the formal inflation targeting framework has proceeded in an exceptionally smooth manner due, in large part, to forceful fiscal adjustment that has helped attenuate the passthrough effects of exchange rate and other price adjustments. We note the ongoing efforts of the BCB to refine the analytical tools for the framework and commend it for its commitment to transparency, prudence in the management of interest rates, and a clean float. We join the staff in endorsing the authorities' efforts to improve regulation and supervision of the financial system and to enhance the efficacy of credit and financial markets. It is especially important to rapidly conclude the second audit of federal banks which would set the stage for defining a strategy for restructuring. The authorities should also be encouraged to continue with their efforts to privatize most of the remaining state banks, including the BANESPA.

In light of Brazil's remarkable and robust comeback from a situation of crisis only a year and a half ago on the strength of sound policies that were executed with skill and determination, we have no hesitation in agreeing to the completion of the fifth review under the program. The authorities' full commitment to the policy framework of the program promises to place the economy on a sustainable, noninflationary growth path with lasting benefit to the population.

Mr. Shaalan and Mrs. Farid submitted the following statement:

Brazil's economic performance under the adjustment and reform program initiated following the crisis of 1998 has significantly exceeded initial expectations. The authorities' sustained implementation of the fiscal consolidation program and their cautious conduct of monetary policy, together with an improved international environment, should be credited with these positive results. We particularly welcome the recent strong pick up in manufacturing exports which has contributed to the emergence of a trade surplus despite relatively high oil import prices and the continued sluggishness in commodity exports prices. A significant surplus in the overall balance of payments has also facilitated the full repayment, partly in advance, of SRF and other drawings. The authorities have also indicated their intention not to make any further purchases from the Fund for the remainder of the program. We commend the Brazilian authorities for their achievements.

Looking ahead, like staff, we see the risks to the achievement of the 2000 program objectives stemming primarily from possible external shocks, particularly those that could emanate from economic developments in the U.S. economy. Either a hard landing or a steeper than anticipated increase in U.S. interest rates could have adverse ramifications not only for Brazil but for other Latin American economies as well. On the domestic front, the attainment of the 2000 fiscal targets will be key. This will require tight expenditure control on all government levels and the curtailment of discretionary federal spending to compensate for the increase in nondiscretionary spending legislated after the presentation of the initial budget. The timely review of oil price developments and the adjustment of domestic oil prices, as needed, will also be critical in this respect. Maintaining a sufficiently tight fiscal policy in the face of rising U.S. interest rates would help keep domestic interest rates from rising excessively.

On monetary and exchange rate policy, the BCB's performance over the past year provides confidence that interest rates will continue to be managed flexibly in the period ahead to assure the achievement of the inflation target. Important progress has already been made in improving banking regulation and supervision and the functioning of credit and financial markets. We welcome the authorities' intention to continue these efforts. Given the additional work that now needs to be done in conjunction with the in-depth audit of the major federal banks in preparation for their restructuring, a postponement of the announcement of a comprehensive strategy for federal bank restructuring is warranted. We hope, however, that the authorities will proceed with the restructuring and privatization of the remaining state banks without delay.

It is essential for Brazil to maintain the momentum of structural reforms, particularly in the fiscal area, if market confidence in the sustainability of the fiscal adjustment is to be maintained and strengthened, allowing further declines in domestic interest rates. Experience since the start of the reform program has shown that the pace of progress in fiscal reforms represents the focal point whereby markets asses Brazil's commitment to its adjustment program. We therefore welcome as an important step forward the recent passage by congress of the Fiscal Responsibility Law. As the staff note, however, there are a number of important practical steps that still need to be taken in order to assure its effectiveness. These include setting appropriate public debt ceilings for the different governments, putting in place strong enforcement mechanisms to enforce those ceilings, and providing subnational governments with the capability to comply with the accounting and reporting requirements of the law.

We also urge the authorities to persevere in their efforts to complete their tax and pension reform agendas.

To conclude, we are in broad agreement with the staff appraisal and support the completion of the fifth review. We thank Mr. Portugal for his helpful statement and for his reaffirmation of Brazil's commitment to its strong reform program. We wish the Brazilian authorities continued success.

Mr. Bernes submitted the following statement:

I thank the staff for a well-written report on Brazil's fifth review under the SBA. I would also like to commend the authorities for their stewardship in guiding Brazil through very trying economic circumstances, with the solid policy advice of staff, to the point where further purchases under the SBA are no longer necessary. I welcome the authorities' decision not to draw the available tranche, and to treat the remainder of the program as precautionary. This is the appropriate course of action given the progress that has been made.

At the time of the last review of Brazil's program, this chair expressed worry over some subtle slippages emerging with respect to policy implementation that had the potential to destabilize progress unless corrective action was taken expeditiously. Happily, most of these risks were not realized, owing in large measure to the policy fortitude exhibited by the authorities.

Notwithstanding, there is significant value in having someone stationed in a "crow's nest" at all times, to be on the lookout for turbulence ahead, and to make sure that the economy remains on course. The authorities have to remain committed to the policies supported by the arrangement, despite their intention not to draw further on the program.

In particular, vigilance needs to be maintained with respect to the prospects for inflation under the inflation targeting framework. Inflation came in slightly above the year-end target for 1999, and there are several upside risks to the forecast for 2000. First, international oil prices have increased since the BCB's March decision to reduce interest rates. At the time of this decision, the BCB indicated that the primary reason for the reduction in rates was the OPEC agreement to increase oil output (which had been announced that day). Lower oil prices did indeed result during April, but prices have since retraced these steps.

Second, while the 11 percent increase in the minimum wage might not lead to serious direct increases in inflation per se, I am concerned about the signal this sends in terms of the government's commitment to its inflation objective. Credibility is an extremely important aspect of successful inflation targeting. The increase in the minimum wage is 5 percentage points above the end-2000 inflation target, and there is a risk that this could fuel inflation expectations.

Third, the inflation profile remains vulnerable to movements in the real. As the staff note in paragraph 39, the inflation outcome for 2000 is conditional on Brazil's currency risk premium remaining unchanged. The recent widening in Brazil's Brady-bond spreads likely reflects an increased aversion to Brazilian assets. Given that U.S. interest rates are likely to rise further this year, I would expect some depreciation of the real as the year progresses.

The development of the inflation targeting framework itself appears to be progressing well, although I wonder how much progress is being made with respect to legislative reform of the central bank statute to provide a legal basis for the operational independence of the central bank?

With respect to fiscal policy, I welcome the authorities commitment to achieve the 3.25 percent target for the primary surplus of the consolidated public sector. I wonder, however, if there is scope for a somewhat tighter fiscal policy, given that estimates suggest a broadly neutral fiscal impulse in 2000? Over-performing on fiscal consolidation in 2000 would not only support the inflation-reduction effort, but it would preemptively help to manage the risks arising from the further recognition of past liabilities referred to in paragraph 36.

One of the greatest risks facing the overall outlook is likely to be the impact of rising U.S. interest rates on confidence in Brazil, on the cost of external financing, and as noted above, on the real. While not as heavily as in recent years, Brazil plans to tap international financial markets for about US$37 billion in medium- and long-term debt in 2000. A higher risk premium on Brazilian assets would increase the vulnerability of this plan, and might lead to lower-than-expected FDI inflows.

Moreover, as shown in Figure 5, no real progress has been made in reducing the level of U.S. dollar indexed debt, which stands at just under US$60 billion. This remains a problem, since it puts the fiscal accounts at risk to a mutually reinforcing cycle of deterioration in confidence and in the currency.

Finally, the issue of export subsidies and the Proex scheme remains a troubling concern. Proex is used to subsidize exports in contravention of WTO obligations, and it gives rise to large future financial obligations for the government's budget. Once again, I would urge the authorities to eliminate export subsidies, especially those that give rise to a large contingent drain on the public finances in the future.

Mr. Harinowo and Mr. Sugeng submitted the following statement:

The Brazilian economy has once again displayed an excellent performance. Having successfully completed four program reviews, its performance since the fourth review has broadly exceeded expectation. A strong rebound marked the economy in the first quarter of 2000 with the industrial sector was to be the driving force. Inflation was in check, moving within the range of the inflation targeting framework. External position strengthened, in particular propelled by the inflows of foreign direct investment, reflecting improved business confidence. All these factors, supported by a positive turnaround of export performance, have enhanced Brazil's capability to make loan repayments to the Fund, the BIS and the Bank of Japan. The authorities and the staff certainly deserve our praise for all these achievements.

Indeed, as Mr. Portugal indicated in his preliminary statement, Brazil's economic progress achieved so far is an important factor for triggering the continuation of the economic improvement in the years to come. Consistency in implementing the program has successfully enhanced international confidence, thus provided room for the country to gain access to the international market as well as to attract capital inflows, particularly in the form of FDI. Looking ahead, while we continue to have a strong confidence on the economy, we need also to attend to the downside risks.

An increasing trend of US interest rates has certainly provided an additional challenge to the authorities. Having succeeded in achieving a stabilized and growing economy, the authorities have a further need to boost the incipient economic recovery which requires the lowering of the domestic interest rate. This need is certainly greater especially under the increasing demand for wage increases. However, this may complicate the objective of the inflation targeting framework, especially under the environment of increasing interest rate abroad. Under the inflation targeting framework, interest rate policy should be mainly guided to achieve inflation target. Similarly, in an environment of depreciating currency, the need to have a prudent interest rate policy is certainly greater. While it is always difficult to strike a fine balance between the two objectives, we believe that the authorities will continue to implement a prudent interest rate policy.

Under such an environment, a prudent stance of the fiscal policy in the immediate future continue to be called for. Undue easing of the fiscal efforts may bring about adverse impacts on macroeconomic stability. Therefore, we welcome the authorities' commitment to target the primary balance of the federal government for a higher surplus than the previous one. To this end, we are also encouraged by the authorities' plan to review domestic oil prices in mid-year in the light of development to date and the prospect for world oil prices and exchange rate. While any change in the policy certainly warrants a closer examination, an upward adjustment is indeed important to make the fiscal position sustainable in the long-run. The central bank's track record in taming the inflation in the past will certainly help in absorbing the undue pressure on the inflation. As the measure will show the government's ability to deliver primary surpluses, we can expect that the market will respond it positively which will further enhance the government's credibility. On the expenditure side, the authorities' strong resolve in controlling federal spending has borne the intended results. We believe that the authorities will make a continued efforts in this area. Therefore, with the previous excellent performance on the fiscal sector, the authorities will undoubtedly deliver the intended surplus. In fact, the achievement on the fiscal sector is also an important element for the authorities to attain a lower outstanding external debt in 2000, that is 36 percent of GDP compared with 43 percent in the previous year.

As for the structural reform, we praise the authorities' great efforts in strengthening the legal basis in many aspects of the economy, in particular in the fiscal area. Mr. Portugal clearly pointed out the complexities in achieving a consensus in the more difficult topics such as tax and social security. However, he also indicated that this does not affect the achievement of the fiscal target of this year. In the area of privatization, however, the pace of the implementation has appeared to slow down. Key auctions of several enterprises in the financial sector service, for instance, have been somewhat delayed. This may be due to the unfavorable market conditions or other administrative limitations. However, we continue to believe that with its strong resolve, the authorities will be able to overcome this problem in time so that it will not unduly impact the year 2000's budget.

Finally, we support the conclusion of the fifth review of the program and wish the Brazilian authorities every success in reaching their goals in the period ahead.

Mr. Barro Chambrier submitted the following statement:

Brazil's performance under the program has been impressive and the authorities should be commended for their consistent and fruitful efforts. Indeed, almost all the targets set by the program have been met. Key macro-economic indicators such as growth, inflation, unemployment, budget balance and external current account have shifted in the right direction in 2000. Owing to a cautious fiscal and monetary stance, inflation has been kept under control. With regard to poverty reduction, we are encouraged by the steadfast efforts of the authorities, as described in Mr. Portugal's preliminary statement. We are impressed with the comprehensive programs aimed at reducing poverty by half by 2015, as well as inequity.

Overall, the economy looks strong and its general strength is reflected in the early repayment of some of the country's multilateral and bilateral debt, and in the authorities' stated will to consider the SBA as precautionary. We broadly agree with the thrust of the staff's analysis and recommendations, and support the proposed decision. However, in spite of the significant progress achieved since the financial crisis, there are still areas of vulnerability in the generally bright picture of the Brazilian economy.

In effect, regarding inflation, rising international oil prices and interest rates still constitute a threat. Similarly, although it boosted the country's external competitiveness and exports, the depreciation of the Real may also trigger inflationary pressures.

In the fiscal area, a threat remains with regard to the balance of the consolidated budget, due to a looser discipline at the state and local level, especially on the debt and expenditure sides. This raises the critical issue of the capacity of central government to enforce budgetary discipline on the lower tiers of government. Regarding debt, we note that the actual level of government liabilities hinges on pending court decisions, which generates some degree of uncertainty.

On the structural front, we encourage the authorities to pursue their efforts in reforming the social security system and welcome the sound budget management principles and measures imbedded in the Fiscal Responsibility Law (FRL). However, the reform of indirect taxation, notably the introduction of the VAT, is somewhat lagging. With regard to the labor market, while welcoming the reform efforts, we note that rigidities still exist and we hope that the Congress will speed up the reform towards a decentralized collective bargaining system. In this connection, more flexibility in hiring and layoff can help to rationalize the utilization of labor force, with a view to better coping with shocks as underlined by Mr. Faini. Furthermore, the existing oil-pricing mechanism needs to be refined, as inferred in Box 3 in the staff report.

On the external front, as a leading exporter of agricultural commodities, Brazil remains vulnerable to exogenous shocks; indeed, they may translate into a loss in the terms of trade and a subsequent weakening of the trade balance. In this connection, the increasing inflow of FDI to Brazil beyond the necessities of privatization, as described in Box 2, is indicative of the renewed international confidence in the country's prospects.

Furthermore, with regard to the social sector, the government's commitment to tackling poverty is noteworthy. Specifically, we note that the reduction in discretionary expenditure does not affect social programs aiming low-income groups. In this respect, as noted in Box 4, the effect of minimum wage as an instrument of the fight against poverty is mixed, especially as that effect can be mitigated by high inflation. Moreover, in the struggle against poverty, we think that the capacity of sub-national governments to deliver basic social services and the efforts to reach out the poor need to be strengthened. All in all, the outcome of the fight against poverty looks mixed; indeed, in spite of the fact that Brazil allocates a fifth of its GDP to poverty alleviation, social indicators still remain somewhat disappointing. However, Like Mr. Portugal, we believe that spending on such sectors as education and health needs time to materialize in actual reduction of poverty.

. We wish the Brazilian authorities every success in their continuing efforts.

Mr. Kelkar submitted the following statement:

I commend the staff for a lucid and comprehensive report which along with the helpful preliminary statement from Mr. Portugal provides a detailed account of the positive developments in the Brazilian economy in recent months. It is encouraging to note that the recovery of the economy has been better than expected and the prospects for the year 2000 are bright. As compared with 1 percent decline projected for 1999 in July 1999 and almost 4 percent in March 1999, real GDP registered a positive growth of around 1 percent. The economic recovery led initially by a strong performance in the agricultural sector has broadened to include the industrial sector. This will make the recovery sustainable. The inflationary impact of the depreciation of the real following its float in January 1999 has remain rather limited, although the staff report has highlighted a substantial change in the relative prices of tradable versus nontradable goods. The authorities will have to maintain a firm stance of the fiscal and monetary policies and continue with their policy of resisting wage indexation to contain inflationary pressures. The authorities have so far acted promptly to respond to unforeseen developments and taken corrective measures as and when required. I am sure that they will persevere with the policy framework of the program to ensure achieving a sustainable high growth in the medium-term while maintaining price stability and strengthening the external sector. The improved external performance has allowed the authorities to repay, partly ahead of schedule, all the funds borrowed under the SRF and the bilateral facilities and treat the SBA henceforth as precautionary. The authorities deserve to be commended for the remarkable progress achieved during the last one and a half years.

Fiscal policy has remained one of the main pillars in the present policy framework to ensure macroeconomic balance, investor confidence, and sustainable social security system. I am happy to note that the primary surplus of the consolidated public sector in 1999 has exceeded the program target. As noted by Mr. Portugal, the improvement in the primary surplus of the central government reflects not only a wide range of tax policy and tax administration measures, but also a substantial effort to contain non-interest expenditures. The improvement in the primary balances of other levels of government is also a welcome development. The authorities will have to closely monitor the developments in international oil prices and take remedial measures, if required, to avoid an adverse impact on the petroleum account of the Treasury and primary surplus, though it may have an inflationary impact in the short run. The floor on the primary surplus as a part of the approved budget for 2000 will maintain the momentum of fiscal consolidation. As noted by the staff, the authorities would, however, be required to limit certain discretionary expenditures below the budgeted levels to achieve the primary surplus target. The plan to achieve a sharp reduction in the overall public sector deficit (PSBR) from a level of 9.5 percent of GDP to around 3.1 percent in 2000 will depend to some extent on the exchange rate level and SELIC rate.

I welcome the passage of legislation on fiscal responsibility which will significantly enhance the legal framework for improvements in fiscal transparency, governance, and accountability. As noted by the staff, the effectiveness of this important structural fiscal reform measure will depend on the follow-up steps taken by the authorities. These include the levels at which the public debt ceilings will be set, the enforcement mechanisms for these debt ceilings and the preparedness of the subnational governments to comply with the accounting and reporting requirements of the law. I welcome the reform of the pension system for the private sector workers which will further strengthen the social security system. Like the staff, I also feel that quick action on the pending structural fiscal reform agenda will improve market perception about Brazil even though none of the pending reforms is required to ensure the achievement of the fiscal targets for 2000.

I am encouraged to note that the substantial increase in public sector net debt, envisaged at the time of the last review, from a level of 42.3 percent of GDP in end-1998 to 52.2 percent of GDP by end-1999 did not materialize. Despite a sharp depreciation of real in 1999, and indexation of a large proportion of public debt to the overnight inter-bank rate, the net public debt to GDP remained around 47 percent by end-1999. The sensitivity analysis presented in the staff report suggests that primary surpluses higher than 2.5 percent assumed in the baseline scenario might be needed to secure reduction in the debt-to-GDP ratio in the medium term under a combination of lower GDP growth rate, higher interest rates and a more depreciated exchange rate. The authorities should continue with their efforts for reduction in foreign exchange-indexed public debt as a proportion of total public debt. Also the efforts to lengthen the average maturity of public debt and reducing its sensitivity to exchange rate developments should continue to remain an area of priority for the authorities.

The deterioration in the external debt service (as a percentage of export of goods and nonfactor services) as shown in Table 5 of the report to a level of 143.4 percent in 1999 from a level of 53.3 percent in 1996 is not encouraging. The deterioration in debt service is mainly due to very high amortization payments in 1999. I am encouraged to see a change in the trend in 2000 when the external debt service is expected to come down to around 93.7 percent.

The authorities have cautiously managed their monetary policy under uncertain environment in improving investor confidence, stabilizing the exchange rate and containing the inflationary impact of sharp depreciation of the real. The authorities have tried to maintain a balance between supporting economic recovery and reducing cost of funding for the government through a decline in interest rate and preventing an excessive depreciation of the real. The transition to a formal inflation targeting framework has also been successful. The authorities should continue to limit their intervention in the foreign exchange market to counter only disorderly market conditions.

Brazil has benefited considerably from the reform carried out in the banking sector and supporting institutions over the past few years. The efforts of the authorities in strengthening prudential regulations and improving bank supervision, tightening capital adequacy standards, improving loan classification system, making significant progress in restructuring banks, and taking other measures have helped in shielding the financial sector from adverse events.

In conclusion, our chair supports the completion of the fifth review and wish the Brazilian authorities success in their future policy endeavors.

Ms. Lissakers submitted the following statement:

The strengthened policy framework put into place by Brazilian policy-makers in the wake of the crisis has underpinned a vigorous recovery surpassing expectations. The real economy is performing well, fiscal results are above target, international capital market access is being restored, and the staff report points to further favorable news in the period ahead. The authorities' steadfast efforts have significantly contributed to these positive outcomes. In addition, we strongly welcome the authorities' decision to repay their SRF and bilateral drawings and to treat the program as precautionary.

Notwithstanding this very positive picture and good economic prospects, the authorities face a challenging agenda in establishing a sound foundation for enduring medium-term growth. In particular, despite the significant progress in stabilizing the fiscal situation after the crisis, national savings remain low and medium-term fiscal prospects will not be fully secured until further improvements in structural fiscal policies and the composition of fiscal spending. Until then, market confidence is likely to remain highly sensitive to setbacks, and fiscal policy will continue to burden monetary policy, thus limiting the scope for reductions in high real interest rates, which impede a dynamic private sector-led recovery. Further, unlike some of the Asian economies recovering from crisis, Brazil will remain vulnerable to external developments given large and continued current account deficits as well as low reserves relative to short-term debt.

Against this background, let us comment briefly on a few areas.

The authorities appear on track to meet, if not exceed, the primary balance target for this year. But we would urge caution on a number of fronts. This outcome is perhaps too dependent on better-than-expected growth and extraordinary measures. The fiscal environment remains difficult given the need to improve the system of pricing and tax oil products and the recent minimum wage decision. In paragraph 36, staff only hints at potentially costly fiscal developments, and we would appreciate further elaboration on this point.

The passage of the Fiscal Responsibility Law is a watershed, and we hope the FRL will be vigorously enforced at the Federal, as well as at the state and local level. The results to date appear mixed, despite efforts by the government, and we are concerned that complacency could be setting in some quarters. The momentum for tax reform and caps on state and municipal worker compensation appears to be flagging. Given the enormous resources dedicated to retired civil servants, comprehensive reform of the social security system for these workers is essential for freeing up resources for essential social spending within the fiscal envelope.

While we appreciate that the authorities face acute spending pressures from many quarters, the best response would be to improve the composition and targeting of fiscal spending to better meet social needs. There is substantial room for improvement. Box 5 highlights the authorities' efforts to maintain, at a minimum, spending relative to GDP for the 22 programs identified by the IDB and World Bank. But could staff tell us whether Brazil is maintaining each program at a constant level relative to GDP or whether other programs besides the four largest are being cut? For example, it is our understanding that in 1999, Brazil spent significantly less than budgeted for the Ministry of Environment. Could staff address the issue of Brazilian environmental spending and also elaborate on the prospects for congressional action on the proposed anti-poverty fund?

The inflation-targeting regime appears to be serving Brazil well, and we welcome that the analytical underpinnings and transparency of the regime are being further fleshed out. We join staff in urging the authorities to refrain from significant intervention in the exchange market, consistent with the requisites of the inflation-targeting regime. The recent weakening of the Real, heavily influenced by recent court rulings, and the constraints on the BCB in further reducing the SELIC only highlight again the need for firmness in other areas of economic policy-making.

The staff rightly praises the BCB for its work in improving the regulation and supervision of the financial system. With inclusion of a new requirement for interest rate risk, the standards for minimum capital requirements are quite comprehensive. The new forward-looking loan classification system is a major advance. If vigorously implemented, the nine risk categories will promote a much stronger credit culture. The corresponding provisioning requirements are conservative and will reinforce incentives to properly price credit risk. With adoption of the new regulations, many of the previously identified gaps in consolidated supervision appear to have been closed. The new regulations are demanding. We would appreciate staff views on the capacity of the banks to implement these more sophisticated standards and the capacity of the Central Bank to supervise the new requirements.

We would also be interested in some elaboration on how the new regulations will be applied to the public sector banks. The staff report notes that the Central Bank is now giving priority attention to examining the federal banks, Banco do Brasil and Caixa Economica Federal, with indications there are significant problems in their loan portfolios. These two banks account for almost 40 percent of the Brazilian financial system. Bringing these Federal Banks up to the new supervisory standards is likely to require substantial changes in their operating practices and, from the hints in the staff report, recapitalization resources. Given the systemic importance of these institutions we can accept the staff recommendation to postpone the structural benchmark on announcement of a comprehensive strategy for the federal banks until the end of 2000. However, we would appreciate some comments from staff or Mr. Portugal about the direction this strategy is likely to take.

On page 69, staff notes that an assessment of Brazil's compliance with Basle Core Principles was undertaken earlier this year. We would appreciate it if staff could elaborate on its findings, and we would ask Mr. Portugal whether Brazil has any intention to furnish the Board with, let alone publish, a stand-alone or ROSC summary of the technical mission's findings? The privatization of BANESPA is overdue and other state banks should be dealt with expeditiously.

More generally, Table 1 indicates that Brazil's observance of quantitative performance criteria was significantly better than for structural benchmarks. We urge the authorities to redouble their efforts in meeting all structural benchmarks in the period ahead, and we attach considerable importance in this regard to Brazil's intention to subscribe to the SDDS. We have long felt that the small share of trade in Brazil was symptomatic of a relatively closed economy that could benefit from the competitive pressure of greater openness. Brazil is making progress in this regard, but with an average tariff of 14 percent, more progress in promoting openness, deregulation, and liberalization is needed. Finally, we noted with interest the discussion of labor market reforms, including possible measures that could lead to decentralizing collective bargaining. It is my understanding that the empirical evidence is inconclusive on whether centralized or decentralized bargaining is superior from an efficiency perspective, but the Fund seems to be strongly promoting the latter. Could staff comment on this issue in the context of Brazil?

Mr. Pickford and Mr. Burgess submitted the following statement:

The Brazilian economy continues to make steady progress, thanks in large part to sustained and determined policy adjustment. We join others in commending the authorities for their economic management, and we welcome in particular the early repurchase of the drawings from the SRF and the decision to treat the remainder of the SBA as precautionary. These decisions send a strong positive signal to the market.

Policy priorities

Nevertheless, the economy remains vulnerable to sudden fluctuations in investor confidence and to unexpected domestic and external shocks. This vulnerability stems, of course, from the large stock and short maturity of government debt, and from Brazil's relatively large external financing needs—both of which are likely to persist for some considerable time. In this context, there are two issues which we believe should remain at the top of the government's policy agenda:

the first is the need to make further progress with the structural fiscal reforms necessary to ensure the longer term sustainability of the government's finances. Market concerns are likely to remain so long as pension and tax reforms—two of the key elements in this process—remain bogged down in Congress;

the second is the need to extend the maturity and improve the composition of public debt. We very much welcome the advances highlighted in Box 7 of the staff report. But this effort needs to be sustained. The average maturity of federal local currency securities has increased but remains relatively short at 9 months (with the average duration shorter still at 5 months). The recent cancellation of fixed rate issues is a concern. While we recognize that the steepening of the yield curve through May made these fixed rate issues more expensive, any sustained switch to floating or dollar-indexed issuance would introduce additional risks.

Fiscal policy

The passage of the Fiscal Responsibility Law (FRL) marks a major step forward in the management of Brazil's public finances. In our view, a high level of transparency and public accountability are likely to prove as effective as the penal sanctions currently under consideration in ensuring the effectiveness of the FRL. In this respect, we look forward to the introduction of a system of explicit (and, we hope, simple) oil taxation to replace the current implicit taxes and subsidies. We also have some concerns in terms of transparency about the proposed anti-poverty fund. In addition, it is not clear whether the introduction of such a fund would affect the pace of debt reduction and, if so, whether this would necessarily represent the most efficient way to finance social spending. We would be interested in staff's assessment of the proposed fund.

Monetary policy

Like others, we welcome the advances - in particular the BCB surveys of inflation expectations - which have been made with inflation targeting. Our understanding is that the publication of the quarterly inflation report and COPOM minutes are proving useful in informing the markets of the authorities' intentions.

As Mr. Bernes notes, there are a number of upside risks to the inflation forecast which points to a need for continued vigilance. However, against these risks we note that domestic demand remains sluggish, real incomes continue to decline (albeit at a more moderate rate), and unemployment remains relatively high. We are relatively optimistic, therefore, that the inflation target for this year can be met.

Other issues

We note the presence of some lingering weaknesses in Brazil's statistical base, and in particular the delays in preparing estimates for nominal GDP which, as the staff paper notes, has complicated fiscal planning. We look forward to these issues being addressed as Brazil prepares to subscribe to the SDDS.

Finally, we endorse the staff recommendations concerning financial sector issues and trade policy.

Mr. Morais submitted the following statement:

It is clear that Brazil is implementing a successful program. The recovery has gathered momentum, public finances have strengthened, inflation is declining, and export performance has improved markedly. It is also to be noted that institutional reform is a key part of the new economic landscape that is taking shape in the country. The continued commitment of the authorities to pursue their reform agenda gives reason to believe that the objectives set for the remainder of 2000 will be achieved. The general strength of the economy is reflected in the authorities' intention to treat the Stand-By Arrangement as precautionary.

The strong fiscal effort has been important in keeping the program on course. This should continue in order to consolidate the macroeconomic gains that have been made and reduce the vulnerability of the economy to external shocks. In this connection, the fiscal responsibility law is a step in the right direction. It is also important to reach agreement on reforms of the social security system and on tax reform. However, Mr. Portugal makes the important point that these are complex issues to deal with, and time will be needed to build the necessary consensus. In the meantime, the authorities believe that the fiscal targets for this year will be achieved through appropriate expenditure restraint.

The inflation targeting framework seems to be working well, and the steps being taken by the BCB to refine its forecasting tools should contribute to improved monetary policy decisions. Like the staff, we believe that the authorities will continue to manage interest rates and the exchange rate flexibly, which is necessary for the successful operation of the inflation targeting framework.

The strengthening of the privatization effort is welcomed. It is not clear, however, why only a small part of foreign direct investment is related to privatization, as pointed out in Box 2, although the scheme covers a broad range of activities. This being said, the increasing flow of foreign direct investment into Brazil is an indication of market confidence in the authorities' economic policies.

On the issue of poverty reduction, the government is making commendable effort through its many social programs, which amount to over 20 percent of GDP. However, there is still much work to be done in this area, including better targeting of social expenditures. As noted in Box 5, performance in health and education is not commensurate with social spending levels. Also, income distribution remains highly skewed. Against this background, we welcome the government's commitment to the international goal of reducing poverty by half by 2015.

Finally, we support the completion of the fifth review of the program and wish the authorities success in their future endeavors.

The Deputy Director of the Western Hemisphere Department, in response to Mr. Bernes's question on whether a more restrictive fiscal policy stance would have been appropriate for 2000, pointed out that the current stance was neutral, when measured by the cyclically adjusted primary balance. In terms of the operational balance, according to the staff's estimates, the stance for 2000 was more restrictive, shifting from a deficit of 3.3 percent of GDP in 1999 to a deficit of 1.4 percent of GDP in 2000. There were no signs of excess demand in the economy, inflation was on a declining trend, and although the recovery was sustained, there was no evidence of a tightening of capacity utilization. From a demand management point of view, there was thus no clear-cut case for a tighter fiscal stance. Also, the decline in the debt-to-GDP ratio was expected to be stronger than the program target, although it might not fall to 45 percent of GDP, depending on the behavior of interest rates and the exchange rate. The ratio would likely be below the program target by end-2001. On balance, it seemed appropriate for the authorities to maintain a target of 3.25 percent of GDP for the primary surplus of the consolidated public sector in 2000. Nevertheless, a better result could not be excluded, based on the trends observed so far, which indicated that the primary surplus as a percentage of GDP for the first quarter of 2000 exceeded the annual target. Much would depend on the behavior of the states and municipalities, which had so far significantly overperformed compared to the program targets.

On the issue of the possible contingent liabilities for 2000 and for the medium term raised by Ms. Lissakers, the Deputy Director remarked that the two main liabilities identified by the staff had to do with the court claims for the severance of workers, and with the recapitalization needs of the federal banks. With regard to the first, the supreme court was considering claims regarding the readjustment of the balances held by workers in individual accounts under the severance payments scheme, to adjust for changes in inflation that had not been taken into account in the stabilization plans of the late 1980s and early 1990s. It was impossible to quantify the potential liabilities at the current stage, as that depended on how many claims the supreme court accepted. Two of the claims had been rejected so far, but a proliferation of claims could be expected if the court set a precedent by ruling favorably on one claim. In any event, the cash impact of the liabilities would be spread over a significant period, because the balance of those workers concerned would be updated only at the time of their retirement or their dismissal. With regard to the recapitalization needs of the federal banks, reliable estimates of those needs were not yet available. The central bank was currently engaged in a comprehensive audit of the Banco de Brazil, and part of the claims were within the consolidated public sector. Any recapitalization of the federal banks would be recouped, at leat in part, through higher prices when those banks were to be divested.

In response to Ms. Lissakers's question on the authorities' environment-related expenditures, the Deputy Director observed that the rate of execution of the budget for 1999 amounted to 98.5 percent, and that the total amount of spending on the environment at the federal level had reached 640 million reals in 1999. The staff did not have information on spending at the state and local levels, where the information on the functional distribution of expenditure was generally significantly delayed. With regard to social spending, the staff did not yet have data on consolidated public sector spending in the social sectors for 1999. At the federal level, social spending had been maintained at about 13 percent of GDP. As a percentage of total spending of the federal government, spending in the social sectors had increased from under 64 percent in 1998 to over 65 percent in 1999, and was expected to increase further in 2000. Total spending on the 22 core programs had been maintained in real terms in 1999, and was budgeted to increase by 3 percent in real terms in 2000.

With regard to the anti-poverty fund mentioned, in particular, by Messrs. Pickford and Faini, the Deputy Director explained that it was currently under discussion in the senate. Even though its functioning was still not precisely defined, the staff had been informed that, until mid-2002, the anti-poverty fund would be financed through the maintenance of a

0.38 percent tax on financial transactions—which had been expected to be reduced to 0.3 percent—without any impact on the primary balance or on the public sector debt. Thereafter, it would be financed with the interest on the accumulated privatization revenues, and would, ceteris paribus, lead to a reduced primary surplus. However, it was worth bearing in mind that the reduction in the primary surplus would depend on the extent to which spending by the anti-poverty fund would be additional spending, and to what extent programs currently covered with other receipts would be transferred to the fund. The net public debt would remain unchanged, as the public sector would be accumulating a financial asset through the privatization revenues invested in the fund. Nevertheless, to the extent that the primary surplus would be lower, the debt would be higher than would have been the case if interest payments had been saved. In that regard, the creation of the anti-poverty fund did not reduce the need for the authorities to continue their efforts to improve the cost effectiveness of existing social programs, and to ensure better targeting to lower income groups.

In response to Mr. Faini's question on the Fiscal Responsibility Law (FRL), recently signed by the president, and the sanctions for noncompliance with the law, the Deputy Director said that it was necessary to distinguish between institutional sanctions on governments that did not comply with the law—which included the cessation of discretionary transfers and guarantees from higher levels of government to noncomplying lower level governments— and the prohibition of new borrowing for those governments. All the indications were that the federal government intended to enforce those provisions of the law, although such an intention would need to be confirmed in practice. In addition, a law that envisaged individual administrative and—in the more severe cases—criminal sanctions against budgetary officials who did not comply with the law had been approved by the lower house, and was currently being considered by the senate.

With regard to the efficiency of tax collection, as defined by the law, the Deputy Director indicated that it was determined on the basis of whether the individual jurisdiction was levying and collecting the taxes that were assigned to it. On the issue of the golden rule in the FRL, she considered that it might not be sufficiently stringent if the authorities needed to rely on positive budgetary savings in order to finance part of their investment program. Also, there was no reason why, in principle, investment in physical capital should be preferable to investment in human capital, for example. Moreover, there were several examples of misclassification of current spending as capital spending. Nevertheless, the law contained a number of provisions that should prevent such problems from arising. In addition, the government was making a major effort, in its multi-year plan, to select investment projects of high priority with appropriate rates of return and to evaluate the performance of those projects.

In response to Mr. Bernes's question on the status of the legislative reform of the central bank statute, the Deputy Director remarked there was currently a legal basis for the operational independence of the central bank, namely, the presidential decree that had established inflation targeting as the framework for monetary policy. In order to strengthen the legal basis of its independence, the central bank had prepared, with the support of the government, a revised draft law to that effect. However, it was the joint view of the central bank and the ministry of finance that the current political climate was not ideal, and that the proposed law should not be presented to congress before end-2000 and the forthcoming municipal elections. The government wanted to submit the draft only when it had reasonable assurances that it would emerge from congress intact.

On the issue of compliance with Basel core principles raised by Ms. Lissakers, the Deputy Director indicated that the assessment of the technical assistance mission— conducted jointly with the World Bank—was that bank supervision in Brazil was fundamentally sound, in spite of the departure of some central bank staff members owing to modifications in the social security pension system. Recruitment efforts had been under way, leading to a 12 percent increase in staff, and a highly competent new director with a strong background in banking supervision had been appointed. A number of banks had been selected for in-depth supervision and field audits, and audits of the federal banks were currently being conducted. Concerning the extent to which banks were prepared to comply with the new regulations on risk and the classification of loans, there had been a slight delay in their enforcement, meaning that they would be effective by end-June 2000.

With regard to the labor market, the unanimous view of labor markets specialists and experts from the World Bank was that the decentralized model of collective bargaining was appropriate in the case of Brazil, the Deputy Director said. At the present time, there could be only one union representing the workers in each municipality, which did not provide sufficient flexibility for collective bargaining. One of the provisions that the authorities were trying to put forward in the reform of the labor legislation was to allow some scope for competition between different unions. The purpose of that provision was not to weaken the labor movement, but rather to make the bargaining process more adaptable to the individual circumstances of different sectors and enterprises.

Mr. Portugal thanked the staff for their report and the technical advice they had provided to the authorities. With regard to the anti-poverty fund, he agreed with Directors who considered that this was not the most efficient way to finance social spending, and that it would have been preferable to better target existing social programs. The proposal regarding the establishment of that fund had not been an initiative of the executive, but of influential law makers in congress, including major supporters of the government. The previous Managing Director's speech during the 1999 Annual Meetings, which underscored the new emphasis on fighting poverty in Fund-supported programs, had been misinterpreted as an encouragement to immediately increase social spending in the country, and the government—the finance minister and his economic team, in particular—had been accused of not having as much social conscience as the Fund. From that moment, the authorities' strategy had been one of damage control.

The banks would be capable of implementing the more sophisticated regulations on interest rate risk and loan classification, and the central bank was capable of supervising the new regulations, Mr. Portugal confirmed. The issuing of those regulations had been a careful process that involved public hearings, contacts with each individual bank, discussions with the federation of banks. For that reason, it had taken more time than initially expected to complete the exercise, and implementation was taking place gradually.

On the issue of the new strategy for the two large federal banks, it was the authorities' intention to apply the new regulations to both private and public banks, Mr. Portugal said. The central bank was currently conducting a detailed and comprehensive audit of the two federal banks, and had committed 150 staff to that project. The authorities also intended to publish, within two or three weeks, a summary of the reports that had been prepared on the four official banks, and which presented some alternatives, including the idea of a separation of the development functions of those banks—such as the financing of agriculture and low income housing—from their commercial activities, and perhaps a transfer of those functions to separate development agencies. Nevertheless, it was still too early to comment on the final outcome of those efforts.

Mr. Carstens made the following statement:

At the outset I would like to commend the authorities for the strong performance of Brazil's economy since the time of the fourth review of the Fund's program, and the encouraging perspectives for the rest of the year. This performance can be attributed mostly to the decisive policy actions undertaken by authorities, since the external environment has been mixed. Certainly the Brazilian economy has benefited from a strong US economy, but at the same time the price of oil has remained at levels higher than expected, and conditions for emerging economies in world capital markets have deteriorated during the last months, in light of the perspectives of high US interest rates and the supposed imminent landing in the US economy—which we all hope it will be soft. Staff should be commended, not only for the high-quality report, but also for forging a constructive working relationship with authorities.

A strong Brazilian economy is desirable, not only for the benefit of the population of such country, but also due to the major influence Brazil exerts over the region and the emerging markets in general. Therefore, I am quite pleased that the clout of doubts about the perspectives of the Brazilian economy expressed at this Board at the time of the fourth review of the program have basically dissipated. At that time there were concerns about the slow response of exports to the depreciation of the real, the then perceived complacent response of monetary policy to the rapid depreciation of the currency that was observed from May to October of last year and to the lack luster progress in structural fiscal reforms.

Since then, exports have vigorously bounced, making an important contribution to GDP growth; the BCB maintained a tight-leash monetary policy preventing further depreciation on the currency and inducing a fall of inflation without choking the growth of the economy; lastly, on the fiscal side, not only Brazil complied with the performance criteria, but they have passed through Congress reforms that establish an appropriate framework to potentially institutionalize fiscal discipline in the country. Here I am referring mostly to the Fiscal Responsibility Law, the Enabling Legislation for the Administrative Reform and the different facets of the social security reform.

Given all these positive developments in recent months, it does not come as a surprise the strong closing that the Brazilian economy had during the fourth quarter of last year, rendering a positive rate of growth, an inflation of under 9 percent for 1999 as a whole, a substantially reduced current account deficit, and more importantly, an outcome in the public finances that is consistent with a non-explosive path of public debt.

The social policy framework has been preserved for the year 2000 and in some instances it has been enhanced. This factor, together with the expectation of a mildly supportive external scenario, makes it believable the expectation of a much higher rate of growth in the economy, lower inflation and interest rates, improved external sector and further consolidation of public finances in a multiyear horizon. Having in the back of my mind this very positive outlook for the Brazilian economy in the year 2000, I would like to make some comments about specific aspects of the policy framework.

We have seen that export growth has been key in promoting growth in Brazil. In light of this I completely share the staff's view that a concerted effort should be made to strengthen the competitiveness of Brazilian enterprises within a more open trade regime.

I strongly support the agreement reached in the context of the program for a moderate floor on net international reserves, coupled with the commitment by the authorities to endeavor to increase significantly such reserves from current levels and to avoid an intervention in the forex market to support the real. A question that arises in this context is how the BCB intervenes in the market to accumulate international reserves? It would be important for such intervention to occur in a fashion that allows market participants to distinguish intervention with the objective of strengthening of reserves from intervention with the objective of pursuing a particular level of the exchange rate. Comments by the staff would be welcome.

I also welcome the debt management strategy of the Brazilian authorities. In particular, I find quite appropriate the decision of gradually retiring the forex indexed domestic debt, a policy that certainly will mitigate any appreciation pressures on the real.

On the fiscal side, I would urge the authorities to double efforts in three particular aspects: (i) in the implementation process of the Fiscal Responsibility Law, the Enabling Legislation and furthering the social security reforms. All these measures are key for the long term sustainability of the public finance, which is at the end of the day the essence of Brazil's economic problems; (ii) it is necessary the strengthening of the revenue side, since the authorities have depended on spending cuts to achieve fiscal objectives, which from experience I can say that there is always the risk for such expenditures to rebound with quite some virulence in the future; (iii) finally, in the area of social spending, it would be desirable for the government to emphasize efforts to make more efficient the delivery of services and their targeting, and resist all temptations to fall in the trap of designating entitlements for specific causes, including poverty alleviation.

In the area of financial sector reform, I welcome the concerted effort to review in detail the situation of the major federal banks, and support the proposal for the postponement to the truly comprehensive strategy to restructure once and for all such banks.

I would join Mr. Faini and others, in suggesting efforts by Brazil to improve the timeliness of data and comply with the SDDS.

Before closing, I would like to pose a specific question to the staff and Mr. Portugal: A key element in the extremely successful anti inflationary policy of Brazil has been the surprisingly low pass-through of the exchange rate depreciation to price increases. Now that the economy is growing at a faster pace and that employment and real salaries are improving, isn't there the possibility for a higher pass-through that would require a stricter monitoring of exchange rate developments by the Central Bank?

In any case, I would like one more time to commend the Brazilian authorities for the capable policy management during difficult times, and wish them the best for the future. Also, I would like to thank staff for the excellent material produced and Mr. Portugal for his comprehensive buff.

It goes without saying that I support the completion of the fifth review of the program.

Mr. Wijnholds made the following statement:

There seems to be nothing but good news coming out of Brazil these days, and the authorities deserve to be commended for this. I was rather critical at the time of the last program review, but Brazil's consistent policy implementation and the way it has taken corrective action in overcoming the various obstacles—constitutional challenges, trade shocks etc.—must be recognized. Most welcome perhaps is the overperformance in the fiscal area, one of the main sources of the original imbalances. Brazil's recent partial early repayment of the SRF, and their intention to treat the rest of the program as precautionary, is testimony to the success of the Fund program.

I have but a few remarks, all of which have to do with the main objective in the Fund program, namely reducing the macroeconomic imbalances and Brazil's vulnerability.

First, on debt management, I believe the message to the authorities is to remain vigilant and continue to lengthen maturities and reduce the degree of indexation. Sound debt management will reduce Brazil's vulnerability, reduce contingent fiscal liabilities and could even lead to a decline in the very sizeable annual interest payments which weigh heavily on both the budget and the balance of payments.

I note that the average maturity of securitized federal debt has increased, but only marginally so and the average maturity still stands at a rather precarious 8 to 9 months. As for the dollar indexed debt, my understanding is that this dollar indexed debt is still largely being rolled over (roll over rates at roughly 90 percent). Thus, this only leads to a very gradual reduction in the stock of dollar-indexed debt and continues to shield private sector participants from exchange rate risk. I realize that it will take some time for the private sector to get used to hedging instruments and exchange rate volatility but I believe a more rapid pace of de-indexation would be desirable. The total amount of exchange rate and interest rate indexed debt still stands at roughly 75 percent, only some 10 percentage points lower than at the end of last year. I also note that even though this stock of indexed debt is essentially past intervention which is now being rolled over, it still has an exchange rate effect if it is not rolled over. This is also the way it is perceived by the markets. Finally, on debt management, I welcome the fact that the government has not issued any new debt with put options and that the amount of fixed rate instruments is being increased.

My second remark concerns the fiscal area. Like others, I welcome the adoption of the fiscal responsibility law. This will be a potentially important tool for prudent budget management. I look forward to the complementary law which will establish penalties for government officials who fail to comply with the requirements of the FRL, although the most important one is probably already contained in the Fiscal Responsibility Law itself, namely that discretionary transfers to lower levels of government will be reduced. Transparency of fiscal targets and actual outcomes will be important in this regard.

My third remark is a rather technical one and pertains to Brazil's vulnerability, or perhaps I should say an element of its perceived vulnerability. The staff report mentions a ratio for reserves to short-term external debt of roughly 50 percent. At first sight, this ratio looks (grossly) inadequate, at least if you believe in the Guidotti-rule, which argues that full coverage of short-term debt is necessary for emerging markets. My understanding from staff, however, is that the debt figures for Brazil are inflated when compared to other countries due to their comprehensiveness and the inclusion of supplier/buyer credit. This is indeed evident when comparing the staff report figures to the data that is published in the joint database of the BIS/World Bank/IMF/OECD for external debt. According to this database, where the data is comparable across countries, Brazil's reserve coverage of short-term debt was nearly a 100 percent mid-1999, and not the 50 percent mentioned in the staff report. I think this highlights the importance of being very precise about how we present such ratios in staff reports, especially if we were to publish such ratios. Markets are also increasingly focused on these vulnerability indicators and we will have to ensure that these are comparable across countries. Incidentally, on statistics Mr. Faini is right that Brazil's program shows that available data have not always been adequate. But I believe it is not correct to say that Brazil is the only country with a Fund arrangement that has not yet subscribed to the SDDS. SDDS participation is of course an eligibility criterion for accessing the CCL.

Finally, a remark on the proposed renewed lowering of the NIR floor. I was critical of this at the last meeting and am again not entirely convinced this time. The argument is that to the extent that actual NIR is below a future program floor the market is aware of the need for the central bank to buy reserves in the market. As such it has a one-way bet, even under a floating exchange rate regime. I would think, however, that the only way there is a one-way bet is if the central bank indeed has an explicit exchange rate target in mind; otherwise it would not be so concerned about a possible exchange rate depreciation. More generally, the arguments raised in the paper raise general policy questions about the way we set NIR floors, their purpose and how we react if actual reserve levels approach the floor. If we accept the one-way bet argument we could essentially not set NIR floors above actual reserve levels, which is of course the opposite of what we do in many programs. Given, however, that Brazil's reserves are rising and not falling I do not want to pursue this here. We can perhaps come back to it in our discussion on Fund conditionality.

In closing, let me reiterate my compliments to the Brazilian authorities for their successful program implementation and encourage them to stay the course for the remainder of the program.

Ms. Lissakers said that it was correct to point out that, in the case of Brazil, the debt coverage was more comprehensive than for some countries, and that this was one of the arguments for trying to have a standardized database like the SDDS, highlighting the importance and value of countries subscribing. With regard to the joint database data on external debt, she wondered whether they came from the table showing the residual maturity or the contractual maturity.

Mr. Wijnholds said that he had used the table showing the residual maturity.

Ms. Lissakers considered that, even after taking into account the differences in debt data coverage, Brazil remained highly vulnerable on the external financial side, given the size of its short-term debt and including private sector debt that needed to be rolled over year after year. That was reflected in the high interest rate spreads on Brazilian debt instruments.

Mr. Carstens said that, having explicitly supported the agreement between the staff and the Brazilian authorities on the NIR floor, he wished to react to Mr. Wijnholds's comments on the issue. With regard to the point on the one-sided bet, it was important for market participants to know that the central bank could intervene in both directions, not just buying reserves, but also, at some point, selling reserves. Lowering the agreed level of NIR sent a signal to market participants that the authorities had the potential to intervene to defend the exchange rate, if necessary. Also, the agreement between the staff and the authorities was complemented by the latter's strong commitment to increase international reserves beyond their current level. The authorities had demonstrated during the previous few months that they were not planning to intervene strongly in the markets, and that they would rely mostly on interest rates to resist inflationary pressures and pressures on the level of the exchange rate. No fully floating exchange rate regime existed anywhere, and it was appropriate for the authorities to use some of their reserves to counter unhealthy dynamics in the foreign exchange market at specific points in time.

Mr. Wijnholds said that he agreed that one should not exclude the possibility that the Brazilian authorities should, in extreme circumstances, step in to defend the exchange rate, and observed that this was the main purpose of having international reserves. It was also correct that a perfectly clean floating regime did not exist. Nonetheless, there was a risk that the authorities would have the tendency to intervene too quickly to support the exchange rate, instead of more effectively using interest rates—especially under an inflation targeting framework.

The Acting Chairman remarked that the issues of the NIR floor and of inflation targeting were not Brazil-specific, and could more appropriately be addressed in the context of the upcoming review of Fund conditionality.

The Deputy Director of the Western Hemisphere Department indicated that the record of the authorities in the previous few months was one of a clean float, and that they had made practically no intervention in the foreign exchange market. There was an understanding that if they should intervene on any significant scale, they would promptly consult with the staff about an appropriate monetary policy response. Also, it was worth bearing in mind that the NIR floor was high, and was expected to increase in the course of the year, at least until end-June 2000, before stabilizing at a level which—at $25 billion—could not be considered low.

The coverage of debt in Brazil was comprehensive, the Deputy Director continued. Supplier credits represented debt, and it was therefore appropriate to include them in the data on external debt. The authorities were able to include information on supplier credit, because they had previously had a wide-ranging system of capital controls, and had maintained registration requirements for all capital and borrowing operations. The statistics were thus more complete than might be the case for other countries with different registration systems.

Mr. Lehmussaari made the following statement:

The Brazilian authorities must be commended for the swift economic recovery that has followed the serious crisis that hit the country less than two years ago. A positive GDP growth for 1999 and the relatively strong expected growth for this year have clearly outperformed expectations. Furthermore, recent figures indicate that the inflation target could be reached for this year and also fiscal results for the first quarter were very encouraging. Meanwhile, structural reforms have been undertaken with important legislation such as the Financial Responsibility Law.

These impressive results can be attributed to a well designed program and the authorities' continuous efforts to carry out prudent economic policies. The most encouraging news is that the country has managed to repay their purchases under the SRF. Moreover, I very much commend the authorities' intent to treat the SBA as a precautionary facility.

I support the completion of the this review, but I would like to make some observations on a few issues which I consider important. Those are external vulnerabilities, the current account deficit and the public debt.

As regards external vulnerabilities the staff's paper presents interesting tables describing key indicators of external vulnerability. The staff paper itself emphasizes macroeconomic developments but unfortunately very little is said about external vulnerabilities. I am not saying that the staff is not addressing downside risks to macroeconomic developments which are well spelled out in the report, but what I have in mind here is whether the Brazilian economy today is better placed to face crises than it was a couple of years ago, or is it only that economic performance is improving while the core of the economy remains vulnerable to shocks as before.

The data on vulnerabilities should be a matter of concern. For example, both the total external debt and the debt service as a per cent of GDP have increased substantially since pre-crises. Moreover, table 6 indicates that the ratio of the short-term external debt to gross reserves has grown markedly from 60% in 1998 to a projected 111% in 2000, while a short-term external debt as a per cent of the GDP has also increased significantly. These figures indicate to me, that no improvement has taken place on this front and, that Brazil appears to be as vulnerable to external shocks as before the crisis. Maybe the staff would like to comment this vulnerability issue.

With respect to external accounts, there is still a lingering current account deficit, which is roughly equivalent to 4.5% of GDP. This is somewhat surprising, given the recent large devaluation of the Real, which led to a substantial improvement in competitiveness. According to the staff, unit labor costs in US dollar terms declined by about 35% during 1999. This does not compare well to some of the Asian emerging markets where similar developments have led to a turnaround in the current account. Obviously, there is a question whether the existing current account deficit is self-correcting or if it is somehow more structural in nature. Is this current account path sustainable in the long rung given the already high and increasing level of foreign indebtedness?

An important source of current account financing has recently been FDI. Given the potential impact of the tightening of monetary policy in the US, this source of financing could diminish with obvious implications. In this connection there have already been signs of a reduction in FDI in April.

On the public debt, I welcome improvements in public debt management, as described in box 7. Improvements aimed at increasing liquidity and attempts to lengthen the overall maturity of the public debt are all steps in the right direction. While, the level of debt remains high, the overall maturity profile is still relatively short and is very exposed to foreign exchange and interest rate fluctuations. Here again, the recent tightening of US monetary policy could hurt Brazil's ongoing financial adjustment. In this context it is important to note that in fact the spread on Brazilian Brady Bonds or so called capitalization bonds has recently widened by almost 200 basis points.

Moreover, there have been reports of a suspension in placing fixed-rate instrument, which is to be compensated for by issuing US Dollar indexed securities. This is not a favorable development. I would strongly urge the authorities to continue their efforts to build up their domestic bond market since the short duration and foreign exchange exposure of public debt remains one of Brazil's main vulnerabilities. One of the options in this regard could be issuing inflation indexed bonds at a moderate scale.

Finally, I would like to comment on the improved relations within the Mercosur group. I welcome this development since the revival of the Mercosur group can play a very important role in enhancing economic development of the region.

Mr. Jonáš made the following statement:

I would like to commend the Brazilian authorities for their substantial progress toward recovering from last year's financial crisis and addressing the problems that caused it.

But despite these good results, Brazil is still quite vulnerable to adverse external developments. And sure enough, an adverse development is already at hand: U.S. interest rates are rising, increasing financial market turmoil. Higher interest rates and their consequences could make it harder for

Brazil to achieve its program targets. The authorities have no choice but to continue resolutely implementing their program.

Perhaps the most crucial ingredient of program success will be the authorities' conduct of fiscal policy. When the fourth review was being discussed, many Directors were concerned that the fiscal targets had not been sufficiently adjusted to accommodate stronger than expected growth, making the fiscal stance too lax. They were worried that the authorities planned to spend any additional revenues, and suggested applying such revenues instead to public debt reduction. In the end, events justified these concerns. In December every level of government posted a sizeable primary deficit due to a relaxation of spending constraints, and the additional revenues wound up spent.

Last year's situation is repeating itself again this year. Fiscal revenues are so far higher than expected, and the primary surplus was well over its original target in the first quarter. Unfortunately, the budget recently approved leaves the primary surplus target for the year unchanged, and reacts to the higher revenues with higher expenditures. Moreover, some nondiscretionary spending has not been provided for in the approved budget, which increases the risk that fiscal targets will not be met. The authorities had to issue a budget execution decree to keep the primary surplus at least at the budgeted level. This step is commendable, but fiscal policy has been made somewhat less transparent, since authorized commitments will later have to be held below their officially appropriated levels. In addition, there is a good chance that the practice of limiting approved appropriations will be challenged.

The Treasury's petroleum account is another source of uncertainty. According to the main staff report, the authorities expect that it will not be necessary to adjust domestic oil prices this year, while in the supplement, the staff informs us that a decision will be made in June to adjust domestic oil prices. In light of recent increase in international oil price, this would be needed. The petroleum account ran up a deficit of over BRL 400 million in the first four months of this year, making it seem unrealistic to expect that the annual targeted surplus of BRL 3.5 billion can be obtained without any increase in domestic oil prices.

Of course all is not bad on the fiscal front, and I want to emphasize how much we appreciate the achievements of the authorities in strengthening the fiscal finances. At all levels of government the conduct of fiscal policy is now much more disciplined, and the recently approved Fiscal Responsibility Law is an important assurance that this progress is being institutionalized. It would seem that Brazil is at last breaking free from the fiscal profligacy which was an unfortunate by-product of the 1988 constitution.

But despite these improvements in the policies of the present, the policies of the past have left Brazil's public accounts still very weak and vulnerable to adverse developments, especially higher interest rates. I wonder if the latest increase in US interest rates, and the market's expectation of further increases ahead, has not rendered the assumptions of the staff's central scenario in too optimistic. Figure 7's sensitivity analysis of fiscal developments appears reassuring, since it shows that even higher than expected interest rates can result in a decline in net public debt. On the other hand, it is very reasonable to expect that higher-than-projected interest rates be accompanied by pressures on the exchange rate, and some slowing of real GDP growth. The combined effect of all these deviations from the central scenario for net public debt could be more negative, and require a stronger fiscal adjustment. I wonder if the staff could tell us the central scenario's assumptions about U.S. interest, and also tell us more about the sensitivity of domestic interest rates to changes in US interest rates?

Having commented extensively on monetary policy and the inflation targeting framework at the last review, I can be brief. First, we are glad the authorities were able to meet their relatively ambitious inflation target for 1999, and that the doubts we expressed during the fourth review did not materialize. Second, it is also encouraging that the central forecast shows inflation remaining well within the target band in 2000 as well. Monetary policy is being kept appropriately cautious, and given recent external developments, should continue so for the foreseeable future.

This being said, I am somewhat surprised by the staff's decision to reduce the NIR floor. The authorities are committed to continued accumulation of the NIR, but seem at the same time to worry that the original path of NIR is too ambitious, which could lead to inappropriate downward pressures on the currency. However, the concerns that justify reducing the NIR floor seem inconsistent with the staff's observation, in 40, that "the risk of a substantial appreciation of the exchange rate is reduced by the authorities' objective of securing some accumulation of international reserves." But on the basis of actual NIR developments and balance-of-payments projections, I do not understand much the authorities' contention that the original NIR floor is too high. NIR presently total $27 billion, over $6 billion above the original floor for end-March. The staff expects NIR to increase further over the rest of the year, finishing above $30 billion. Given the fact that the NIR floor is presently exceeded by a wide margin and is not presently very binding, it does not make much sense to relax this floor even more.

With these remarks, I support the completion of the review.

Mr. Carstens suggested that, in response to Mr. Lehmussaari's concern that the interest rate spread on Brazilian debt had increased by 200 basis points, it would be appropriate to treat such information with caution. The Mexican debt interest rate spread had increased by approximately the same amount, notwithstanding the investment grade that had recently been granted to Mexico. However, the return on Mexican debt had not increased. In light of its fiscal surplus, the United States was retiring long-term and expensive debt, and its interest rate—which was considered a risk-free rate—had been decreasing, accounting for the increase in the spread. Therefore, particular circumstances in the U.S. Treasury bond market and positive developments in U.S. public finances had been affecting the interest rate spreads, rather than risks related to emerging market economies.

Ms. Jin made the following statement:

> At the outset, I would like to thank the staff for their detailed report and Mr. Portugal for his informative preliminary statement. The performance of the Brazilian economy has, in general, surpassed anticipation during past reviews, and the fifth review has, once again, shown this to be the case. I would like to join other speakers in commending the Brazilian authorities for their remarkable achievements and balanced macroeconomic management. As indicated by Mr. Portugal, the critical factors contributing to the remarkable accomplishments include the consistent and prudent macroeconomic policies, key structural reforms implemented prior to the crisis, the strong and prompt policy response and firm implementation of the adjustment program during the crisis, and the timely and sufficient financial support from the international community. In addition, the strong domestic ownership of the adjustment program and the practical approach built into the program design have also played their part. Although it might not be the time to form a conclusion, Brazil's current success justifies the importance of such elements.
>
> The Brazilian government has demonstrated its confidence by the partial early repurchase under the SRF facility, and repayment of other multilateral and bilateral borrowing, as well as its intention to treat the remainder of the current stand-by arrangement as a precautionary one, which we fully support.
>
> Looking ahead, even though the program for the rest of the year looks positive and feasible, we, like staff and other speakers, note that there are some potential downside risks (mainly external) emerging from the hard landing of the U.S. economy, the possible increase in oil prices, and higher interest rates in the international market. However, the newly phased-in inflation targeting mechanism, supported by the tight fiscal policy, has served Brazil quite well in keeping inflation within the targeted band. A delicate balance has been struck among all internal and external factors. Therefore, caution and flexibility should be maintained. In this regard, we welcome and endorse staff's flexible and cooperative approach in accepting the authorities' request to lower the NIR floor in order to leave more room for program implementation.

A strong fiscal effort has been the centerpiece in keeping the program on course and for rebuilding confidence. The consistent pursuit of a prudent, tight fiscal policy and continued structural reforms have started to pay off. We note the overall fiscal performance through the end-April 2000 has met the quantitative criteria with a large margin, and the passage of the Fiscal Responsibility Law in April has provided institutional discipline over fiscal management at different government levels. It is understood that the budget for the year 2000 is conservative and the government is ready to take timely remedial measures, if slippages occur, providing another layer of protection. Given that some unfavorable external developments may have a negative impact on Brazil's fiscal position, it is desirable to implement the budget for 2000 in a cautious manner and with appropriate expenditure restraint. Meanwhile further structural fiscal reform measures and the detailed implementation mechanism under the Fiscal Responsibility Law need to be put in place as soon as possible.

Based on the better-than-expected performance of Brazil's economy and the authorities' firm commitment to the adjustment program, this chair fully supports the completion of the fifth review and wishes the Brazilian authorities further success in their economic consolidation endeavors.

Ms. Jul made the following statement:

I would like to commend the Brazilian authorities for their forceful determination in accelerating the reforms necessary to overcome the crisis of 1999. One specific point in that regard is that, notwithstanding the intensification of the fiscal effort, and notwithstanding the sharp depreciation of the real, the cost in terms of output loss has been small, while acceleration of inflation has been lower than expected by financial markets. This confirms that fiscal consolidation need not always translate into a growth-impairing phenomenon, particularly when, as in the case of Brazil, important progress in the structural reform front is also taking place. We join others in welcoming the early repurchase of the drawings under the SRF and the decision of the authorities to treat the remainder of the Stand-By Arrangement as precautionary. Those actions send strong positive signals regarding the successful implementation of program.

It is also significant that the authorities have been able to gather the necessary political support to secure passage of the numerous reforms contemplated in the program. A strengthening of economic activity will help broaden support for the government and generate a virtuous circle of continuing reforms leading to further growth. The latter constitutes the only way to achieve a sustained reduction in poverty and inequality. Complacency must be avoided as, in the current context, performance with regard to most aspects of the program has been better than envisaged. The upcoming municipal elections, in October 2000, present a critical test for the authorities to show their determination to withstand pressures to increase expenditures.

The Brazilian economy embeds a large potential for growth which, when fully unleashed, will represent an important positive development for both the regional and the world economies. As any other large economy, Brazil faces a temptation to follow an inwardly-oriented growth strategy. The pace of globalization leaves no scope for such a path, particularly for an emerging market country. The policy framework of the present program aims at creating the appropriate conditions for sustained growth in a context of full integration to global markets. It is worth noting in that regard that the successful real devaluation of the currency should not result in a reduction of incentives to increase competitiveness through productivity gains. It remains, therefore, an important task for the authorities to further progress in the areas of privatization, deregulation, and liberalization of markets to enhance productivity and external competitiveness. The impressive level of foreign direct investment observed in recent years augurs well for future growth. Similarly, the priority assigned to statistical and regulatory harmonization in the context of MERCOSUR will strengthen the process of economic convergence and integration.

On the fiscal front, performance through May 2000 has been strong, with an accumulated primary surplus larger than the program target for the first semester. This opens the possibility to build a positive carryover to the second semester, when targets are more stringent and political needs more demanding. We fully share the view that the fulfillment of fiscal targets is critical to enhance investor confidence. In that regard, it is crucial to proceed with tax reform in order to revert the decline in the tax ratio that, in 2000, has forced reliance on additional expenditure restraints to achieve the fiscal targets. Concerns also arise from the significant adjustment in the minimum wage in real terms, from the fact that the present level of the exchange rate has already exceeded the one envisaged in the staff report for 2005, and from the fact that oil prices remain higher than projected in the program. In addition, implicit liabilities may be large, all of which could put additional pressures on the fiscal accounts. I would welcome staff comments on the tax ratios embedded in the projections through 2005, and on the level of investment that is considered necessary to sustain the rate of GDP growth at 4 percent, and on the role to be played in that respect by public investment. The Fiscal Responsibility Law recently introduced is a welcome development. However, as noted by the staff, the law provides only a general framework, whose overall efficacy will depend on several decisions yet to be taken, including on debt ceilings and on the degree of observance of its different provisions.

On the monetary front, the authorities should be commended for the successful introduction of an inflation targeting framework which has contributed to the achievement of a substantial real devaluation of the currency. The low level of capacity utilization at the time of the devaluation, together with the deflationary pressures in some regions of the world also helped in that respect. However, social and political pressures for salary increases have been raised, as evidenced, for example, during the discussions on the setting of the minimum wage. The authorities currently have a key nominal anchor to help shape inflationary expectations, and it will be critical to enhance the credibility already gained. That calls for prudence in managing the interest rate. Despite the negative impact on growth of its relatively high present level, the less than favorable external environment—confirmed by the monetary tightening in the United States—and the most recent firming of oil prices advise against a premature loosening of interest rates.

On the external accounts, some points are worth highlighting. The trade balance to date in 2000 suggests that the trade surplus may be smaller than projected in the program, reflecting in part a further worsening of the terms of trade. That brings us back to the productivity issue, and perhaps also to the constraints created by the high finance costs prevailing in the economy. Second, the positive evolution of the capital account, which is projected to more than cover the current account deficit in 2000, points to strengthening investor confidence in the Brazilian economy. That is evidenced by the increasing foreign direct investment that is not associated with privatization, as well as the sharp decline in short-term capital outflows. In that respect, however, I would like staff to comment on the persistence of short-term capital outflows through 2004, and how they relate to the increase in private sector short-term debt which will exceed 10 billion U.S. dollars over this period. Third, as noted by other speakers, Brazil remains vulnerable to external shocks in view of the size, composition, and maturity of public debt, and the level of reserves relative to the short-term debt. With regard to the coverage of the public domestic debt, I would welcome additional information by the staff, as it used to be a debt that would be refinanced over night.

In the key area of structural reforms, we welcome the progress observed in the labor markets, in particular regarding the introduction of temporary contracts and temporary layoffs, and the actions taken in the financial sector, especially concerning supervision and prudential regulations. The decision to privatize the remaining state banks, including the state bank of São Paulo, is encouraging. However, given the size of the federal banks and their potential systemic impact on the rest of the financial system, it is important to move ahead forcefully and to adopt a comprehensive strategy for those banks.

Finally, we would appreciate staff comments on the future scope of the privatization drive in Brazil. Are there any other areas—beyond state banks, electricity generation plants and minority shares in Petrobrás—that are earmarked for privatization in the future?

With these comments, we support the proposed decision and the completion of the fifth review, and wish the authorities continued success with the implementation of the program.

Mr. Alosaimi made the following statement:

As pointed out by previous speakers, economic developments in Brazil are highly encouraging. I welcome the early repayment to the Fund and the authorities' intention to treat the rest of the Stand-By Arrangement as precautionary. The authorities are to be commended for that outcome, which could not have been achieved without their continued firm implementation of the Fund-supported program. That progress notwithstanding, Brazil remains subject to a number of risks, including those related to increases in international interest rates, and to developments in the economies of its MERCOSUR trading partners. In that regard, I am reassured by Mr. Portugal's statement that the authorities are fully committed to achieving the program objectives. To that end, cautious monetary policy is called for. Higher international interest rates would make it more risky to reduce domestic interest rates, despite the improved outlook for inflation. The authorities would need to err on the side of caution given the importance of establishing the credibility of the inflation targeting framework. In that connection, the overall soundness of the banking system and the ongoing strengthening of the regulatory reform should facilitate the conduct of monetary policy and help achieve the inflation target.

It should be noted that while maintaining higher interest rates could put pressure on the fiscal position, fiscal performance so far is reassuring. The degree of budget execution which limits discretionary expenditures, and the conservative projections for the combined primary surpluses of states and municipalities provide an additional safety margin. In view of the uncertainties, however, the authorities need to monitor fiscal developments closely and stand ready to take corrective steps, if needed.

It is also essential to advance structural reform. While the recent passage of the Fiscal Responsibility Law is a welcome step, further efforts are needed to achieve final approval of the constitutional administrative reform, and accelerate tax reform. Strengthening efforts on the privatization front is also necessary to reduce debt and enhance confidence.

Turning to the external sector, I join the staff in welcoming the efforts to ease trade tensions within MERCOSUR. In that regard, increased efforts to raise domestic demand and broaden the recovery in Brazil will be useful. It is also important to increase openness vis-a-vis the rest of the world. On the capital account, the large inflows of foreign direct investment and Brazil's improved access to international capital markets bode well for the future.

With these remarks, I support the completion of the review, and wish the authorities further success.

Mr. Toyoma made the following statement:

First, it is commendable to see the current Brazilian economy recovering soundly, as signaled by 1999's higher-than-expected growth, the inflation rate remaining well within the target band in spite of the depreciation of the real, and a decreasing unemployment rate. These fruits resulted not only from the existing world economic upturn, but also from the authorities' prudent macroeconomic policy implementation under the SBA. These efforts deserve our appreciation.

But, as staff correctly pointed out, there are some possible external factors that could yield economic shocks, such as a hard landing on the part of the U.S. economy, or rising world oil prices. The Brazilian economy remains vulnerable to these risks. A U.S. economic hard landing would affect external demand and harm Brazil's external position. Also, the U.S. interest rate rise would result in depreciation of the real, boosting inflation pressure, (or lead to an increase in interest rates, thereby reducing investment and slowing economic recovery). An increase in world oil prices could require the authorities to adjust the price of domestic oil, boosting inflation pressures as well, and hampering the external position.

According to the staff paper, devoid of these risks, the 4 percent rate of growth of GDP projected in the program can be achieved. This is admirable, but the problem becomes how the authorities should tackle these difficulties when and if these economic shocks occur.

Inflation targeting and establishment of a fiscal responsibility law would reduce the authorities' policy discretion and assure tight policy implementation, the effectiveness of which this chair basically agrees upon. Under pressure of depreciation of the real caused by a rise in the U.S. interest rate, or in oil prices, the tight fiscal and monetary policies aimed at reducing inflation pressure, keeping the inflation rate within the target-band, and maintaining market credibility for the authorities' anti-inflation policies, are all useful tactics for lowering the expected market inflation rate and for avoiding a change for the worse.

On the other hand, policy stances against inflation that are too rigid could hamper the authorities' shock-absorbing function on both the monetary and fiscal fronts. The relationship is akin to two sides of one coin. Does staff think that the Brazilian economy remains at the stage where inflation and fiscal expansion will easily reemerge if less rigid policy stances are adopted against economic shocks? Otherwise, the authorities may have room to implement more flexible measures - possibly fiscal stimulus or monetary easing? Staff's comments would be appreciated.

One comment on the fiscal responsibility law. It has adopted the golden rule, similar to Japan's system, and staff's explanation of how this law assures effectiveness of capital spending on both the cost and benefit sides, is commendable.

We appreciate Box 6 in the staff report that shows further improvements on the part of the authorities' analytical tools of inflation estimation with proper transparency. Also, the explanation of the possible change of the estimated inflation path under the interest and exchange rate change is clear. However, while the descriptions of the framework itself are sufficient, staff's assessment of the authorities' actual policy implementation is relatively weak.

As this chair suggested at the last meeting, the authorities have indicated their intention to treat the arrangements as precautionary in the future. We take this to be a positive sign of economic recovery in the market.

With these comments, in light of Brazil's remarkable economic recovery and the authorities' solid policy implementation, this chair has no hesitation in supporting the completion of this review. We hope to see further efforts on the part of the authorities, and wish them every future success.

Mr. Singh made the following statement:

Like other speakers, we wish first of all to commend the Brazilian authorities for their successful response to the crisis. Despite sometimes difficult circumstances, they have demonstrated their resolve to implement the right policies and reforms and to keep the program on track. We welcome the early repayment of the SRF purchases and the authorities' decision to consider the remaining part of the SBA as precautionary. We have therefore no problem to support the proposed decisions. As previous speakers have already pointed out, however, challenges and risks remain.

On the monetary side, although the inflation rate has decelerated from its level during the fourth quarter of 1999, we would encourage the authorities to stick to their cautious stance. In addition to external shocks, such as an interest rate hike in the U.S. or a further oil price increase, domestic shocks could have adverse inflationary consequences. In this respect, the inflationary effects of the upcoming rise in government-managed prices, as well as the expected real adjustment in the minimum wage, should be closely watched.

Turning to fiscal policy, we welcome the primary surplus of the consolidated public sector the authorities have achieved last year and the primary budget surplus of a bit more than 3 percent of GDP they target for 2000. Such primary surpluses will contribute to stabilize the debt-over-GDP ratio and lead to a virtuous circle of lower interest rates and lower debt service.

These significant budget surpluses will, however, also trigger political pressure to spend, as the country will be moving out of the crisis. In this respect, the approval of the Fiscal Responsibility Law (FRL) by the Congress is a useful step, as it will help the authorities contain public spending, especially at lower levels of government, and achieve a sustained fiscal adjustment. The effectiveness of the new law will of course depend on the degree of its implementation, which still remains to be seen.

On the revenue side, substantial reform is also called for. In this respect, it is welcome that the projected fiscal revenues for the year 2000 rely somewhat less on emergency measures than the year before. The Brazilian tax system remains, however, overly complicated and distortionary. The authorities should consider undertaking a thorough reform of the tax system and progress in the implementation of the VAT would, therefore, be highly desirable.

In the area of social policy, while we welcome every effort to fight poverty and inequality in Brazil, such as the establishment of the anti-poverty fund, we share Mr. Faini's concerns about the quality of public social spending. Brazil already spends 20 percent of its GDP on social programs. The problem may be, therefore, not so much a lack of money, than a lack of focus. We would thus strongly encourage the authorities to improve the targeting of their social programs in such a way that the poorest of the poor can be reached.

Finally, on the structural front, the reform agenda is still long. We would just like to mention here the importance of completing the social security reform as soon as possible and welcome the progress the authorities have achieved in the financial sector, notably in improving banking regulation and deepening the government bond market.

As regards the social security reform, we note with some concern that progress is mixed. While the reform of the private sector has proceeded, the approval of the social security contribution for retired civil servants is still pending. The reform of social security is one of the most challenging reforms on the structural agenda and should be tackled as soon as possible. In this respect, the delays imposed by a crowded congressional agenda ahead of the recess and of the municipal elections raise some concerns.

In the financial sector, we note that the Brazilian authorities have increased efforts to establish a sound capital market. The access to liquid financial markets is an important element for firms to remain competitive. The improvements brought to the government bond market are therefore very welcome. We particularly welcome the authorities' efforts to lengthen the maturity of government debt and to replace small and illiquid issues with larger ones. The introduction of new regulations on capital requirements for interest rate risk and a forward-looking loan classification system are also positive steps and the rights of minority shareholders should be enhanced with the passage of a new bill.

To conclude, the Brazilian authorities have still a number of challenges to face in the future and we wish them full success in dealing with them.

Mr. Palei made the following statement:

I agree with the Staff assessment of Brazil's performance under the Stand-By Arrangement and congratulate the authorities on their better than expected recovery. In addition to output growth, price developments seem to be well under the control of authorities and access to international financial markets has been regained. Both exports and imports are growing fast with visible improvements in the current account deficit. The latter is covered with large net FDI inflows. Favorable economic developments allowed early repurchases under the SRF and repayment of the bilateral funds. The authorities' decision to treat the stand-by arrangement as precautionary is a clear indicator of their confidence in future economic developments and, like other speakers, I welcome it. At this stage of the discussion I would like to comment on some of the remaining challenges for the Brazilian authorities.

Among the current challenges for the Central Bank is the application of strengthened regulations and supervision of the banking sector. As Mrs. Lissakers has pointed out, the successful restructuring of the banking sector requires adequate institutional capacity. Banking reform requires institutional capacity not only from the Central bank, but also from commercial banks to comply with new regulations. In a broader sense an upgraded institutional capacity is required in the commercial banks for better evaluation and pricing of the credit risks. The task of the Central bank is not limited to making the banking sector in Brazil more resilient to possible future shocks, but to transforming it into an efficient intermediary in the credit market. Financial intermediation has to be rediscovered by many of the Brazilian commercial banks which over the previous years got used to high yields on government securities while being protected by the authorities from major risks, and probably were less concerned about efficient credit allocation. The still extremely large spreads between the lending rates and the costs of funds for the banks show that there is room for improvement in this area. It would be useful to understand if the Central Bank envisages any measures to facilitate the capacity building in the banking sector.

I welcome the attention paid by the authorities and the staff to public debt management and monitoring of the external debt. I agree with Messrs. Pickford, Burgess, and Wijnholds that the debt issues should remain in the core of the authorities' attention. The improvements in the structure of the debt with respect to maturities, floating vs. fixed rate instruments, currency composition, and the use of indexation are a matter of priority. Most of the currency and interest rate risks are still the responsibility of the authorities and a gradual, but steady reallocation of risks is called for. In addition to reducing the external vulnerability of the Brazilian economy, changes in the debt structure would also stimulate the bank restructuring and financial intermediation.

I agree with the view that, in Brazil, despite recent advances, the Central bank will remain seriously constrained in its conduct of monetary policy as long as the uncertainty with respect to fiscal performance remains high. Accordingly, I share the concerns of the staff with respect to some of the risks to fiscal performance in 2000. Overall, I tend to agree with most of the comments on the fiscal situation made by Messrs. Bernes and Jonáš who emphasized the costs of using temporary and distortionary solutions over an extended period of time. Furthermore, it seems to me that faster recovery and better than expected revenue performance in Brazil warrants use of the extra fiscal resources for faster reduction of the debt. The Brazilians could probably follow the path mentioned this morning of Bulgaria and the Netherlands in overperforming in the fiscal area while not committing themselves to overly ambitious targets.

Mr. Portugal's comments on the difficulties of carrying out the government's strategy are well taken and, given the very high degree of program ownership of the program, I continue to believe that the Fund should accommodate the authorities' choices of the pace and the sequence of particular steps in the fiscal area. However, on the background of strengthening the economy, the Fund in its public statements could be more outspoken about the desirability of more decisive reforms and about the differences, if any, in the authorities' views and those of the staff. Under favorable circumstances, this could be done without jeopardizing confidence in the authorities' overall commitment to the reforms.

I would like to join Mr. Faini and other directors in expressing reservations about the creation of a new anti-poverty fund in Brazil. The already high level of social expenditures and financing of this fund by earmarking the distortionary CPFM tax at a high level of .38 percent through June 2002 make this undertaking rather questionable. I appreciate Mr. Portugal's frank comments on the reasons for creating the anti-poverty fund. However, the IMF could, again, be clear about its attitude to the initiative. The Board discussion would be an appropriate occasion to make the point.

I note that, according to the staff, the authorities are committed to reviewing domestic oil prices in June and to adjusting them if the need arises. However, an approval of the required constitutional amendment and subsequent introduction of an automatic adjustment mechanism should remain among the top priorities on the reform agenda.

Finally, like most of the speakers, I value highly the authorities' progress toward the SDDS subscription.

To conclude, Mr. Chairman, I would like once again to congratulate the Brazilian authorities on their remarkable achievements. I am sure that authorities in other emerging countries will find many useful lessons in the Brazilian adjustment to severe financial crisis. They can also learn from the smooth introduction of inflation targeting, the transparency in carrying out economic policies, and the tackling of fiscal federalism and debt management. I wish the authorities continued success.

Mr. Esdar made the following statement:

I congratulate the Brazilian authorities for the economic success based on their comprehensive implementation of the reform program. The recent budget execution decree is proof of the preparedness to react immediately if deviations and unforeseen developments should occur. The authorities are to be commended for the fact that Brazil can now be presented as a success story in the Fund's contacts with the outside world.

On fiscal policy, I share the view expressed by Ms. Lissakers, Mr. Jonáš , and others that it is crucial to stick and adhere to the fiscal consolidation policies. As Mr. Pickford has put it, it will be crucial to address fiscal issues in a more structural and substantive way in the medium-term.

On monetary policy, I strongly commend the skillfulness of the Brazilian central bank. However, I perceive inflation risks to be slightly more severe than the staff and the Brazilian authorities do. That point has also been made by Mr. Faini, Mr. Bernes, and others.

Substantial progress has been made in the area of banking supervision and regulation, but I share the view that it is crucial to go ahead with the restructuring of the two public banks, which still have a significant amount of nonperforming loans in the housing and agricultural sectors.

On the social sector, although it is unpopular to criticize additional expenditures on social policies, like Messrs. Faini, Singh, Palei, and others, I see room for improving the efficiency and targeting of those expenditures.

With regard to statistics, like Mr. Faini and Ms. Lissakers, I consider it crucial that Brazil—in its own interest—joins the SDDS as soon as possible.

On trade, I agree with Directors who have welcomed efforts to pursue regional integration while MERCOSUR, but like Ms. Lissakers, I consider there is still room for further opening of the economy, and for a more liberalized trade system.

Finally, while I strongly appreciate receiving information on the good economic performance of Brazil, such good information should not be classified as strictly confidential, but as confidential, especially given that we currently receive significantly worse information on a confidential basis.

With these comments, I congratulate the authorities and commend them on their intention to treat the Stand-By Arrangement as precautionary henceforth.

Ms. Mateos y Lago made the following statement:

I shall be very brief, as there is really not much to add to the excellent report provided by the Staff for this review, and even less to the comprehensive discussion we just had.

Let me just commend the Brazilian authorities for their commitment to achieve the program targets despite a number of policy setbacks, and in the absence of major improvements in the international background.

Obviously, as noted by most previous speakers, there remain significant risks, both on the domestic and external fronts, which means the authorities should not rest on their laurels and let the momentum for sound macroeconomic management and structural reform falter. But I am reassured by Mr. Portugal's buff statement that they have no intention to do so.

At the last review, a number of us, including this chair, grumbled that the Staff had been somewhat too lenient both in appraising the outlook for the Brazilian economy and in setting revised targets and benchmarks. It then appeared, in the course of our discussion, that the reason why they were so relaxed was that the actual commitment of the authorities, on a number of grounds, went far beyond what was written in the report. Well, developments since the last review seem to have proven them right.

Against that background, I am confident that, notwithstanding their treating the arrangement as precautionary and regardless of the recent anti-IMF rhetoric blasts, the authorities will, once again, uphold their formal and informal commitments. Therefore, I do not object to the proposed revision of performance criteria and support the completion of the fifth review.

Mr. Taylor made the following statement:

The clouds of doubt of the previous review have been dissipated, and Brazil has performed well above most expectations. Risks remain, and the staff appraisal is correct in considering what they may be. I would be inclined to join a number of Directors in saying that there still seem to be some risks in the fiscal area, both in the short run and, particularly, in the longer run. I was not convinced by the staff representative's answer to Mr. Bernes's question, given that the PSBR remains above 3 percent, and that there are risks such as court case outcomes. Nevertheless, I strongly agree with paragraph 59 of the staff report, which mentions that should some of the risks materialize, the authorities will take timely corrective measures. The authorities have now established a sound track record.

The importance of the growth projections is no less in this program than in any other. My understanding is that other observers are somewhat less sanguine than the staff about the growth prospects for 2000 and 2001. For example, the OECD foresees growth of 3.2 percent in the current year and 4.1 percent in 2001. Does the staff consider that there are mainly downside risk to GDP forecasts? What interest rate assumptions underlie the growth forecasts, and do they take into account the most recent interest rate rise in the U.S.? Do they take into account the possibility of further fiscal and monetary tightening?

On the vexed question of the NIR floor, the concern is the possible unsettlement of capital markets if there is a gap between the actual level of reserves and the program floor. I consider that, in Brazil, the problem is generated by an unduly single-minded policy on publication, and that it makes little sense to address that problem by weakening conditionality. The authorities should rather be encouraged to publish a target, and the question should therefore be considered in the context of a discussion on publication, transparency, and the management of sensitive information.

On intervention policy and Mr. Wijnholds's comments on the absence of a clean floating exchange rate regime, interpretation in that area is important. Is there really no such thing as a clean float? New Zealand, for two or three decades, has not intervened in the exchange market. And, it has not intervened in the last three years, in spite of a more than 30 percent appreciation of its currency. Nonetheless, it is worth bearing in mind that the interest rate can be used to target the exchange rate or the inflation rate, and this points to the fact that the nature of the management of exchange rate regime deserves more attention. In that regard, I have received a comment from one of my authorities concerning the possibility of a conflict between the NIR target and the inflation target when it comes to monetary policy. The staff recommendation at paragraph 60 is that monetary policy be tightened if NIR were to begin falling toward the proposed floor in the program. That does not seem entirely consistent with the overriding goal for monetary policy, which is to pursue the inflation target.

Finally, on the SDDS, appendix V of the staff report makes it clear that there is a large gap between what should be required in the SDDS, and the current state of Brazil's relevant statistics. I hope that the gap will be entirely closed by improving the quality of Brazil's statistics, and not by lowering the quality called for in the SDDS.

Mr. Wijnholds said that, in response to Mr. Taylor's comments on intervention under floating exchange rate regimes, a clean float had never existed for an extended period of time, although New Zealand probably came closest to having achieved that objective. Intervention did not manifest itself only through the sale or the purchase of foreign exchange by the central bank. It could also take the form, for example, of a large payment to be made by the government outside of the foreign exchange market; there were various other ways to intervene. The fact remained that New Zealand was holding $4 billion in reserves, and its law indicated that, in extreme circumstances, it could intervene in the foreign exchange market. Perhaps it should, or even adopt the Australian dollar. In any case, for developing countries and emerging market economies, there could be a need, given the thinness of the foreign exchange market, to have available some resources for intervention—to be used very sparingly under normal circumstances.

Mr. Carstens said that, in response to Mr. Taylor's comments on the supposed contradiction between inflation targeting and the tightening of monetary policy, if NIR were to begin falling toward the proposed floor in the program, he considered that there was no implicit contradiction between the two targets. If NIR were falling toward the program floor, that probably meant that the exchange rate was under pressure, and a reduction in the exchange rate tended to be inflationary. Therefore, a tightening of monetary policy would be consistent with increasing NIR and reaching the inflation objective. An inflation targeting framework was based on having a strong objective, but it did not presuppose how monetary policy should be adjusted to reach the inflation target.

Mr. Pickford said that, while he agreed with Mr. Carstens that there was not necessarily an implicit contradiction between the two policies, setting up a NIR target in an inflation targeting regime might nevertheless lead to conflicting objectives. Also, it made sense to determine the nature of pressures on the exchange rate before deciding whether to intervene in the foreign exchange market.

The Deputy Director of the Western Hemisphere remarked that, with regard to the growth prospects and the downside risks for the rest of 2000, the staff report made it clear that Brazil was still vulnerable to the effects of external shocks, and should those be substantial, they would undoubtedly take a toll on GDP growth. Currently, the indications were that GDP growth stood above 4 percent, and that, in the first quarter of the year, the economy had grown at an annualized rate of more than 5 percent. One could therefore comfortably predict that GDP growth would be within a 3.5 to 4 percent range, possibly even slightly higher, depending on the extent to which the increase in U.S. interest rates affected the risk premium in Brazil and constrained monetary policy, and the extent to which the central bank might have to keep a tight, or even tighter, monetary policy stance in response to pressure stemming from high oil prices. The projections in the staff report, particularly with regard to the scenarios on public sector debt, were based on a hypothesis of a gradual decline in the SELIC rate in the course of 2000. The SELIC rate currently stood at 18.5 percent, which was in line with projections, but there was a projection of a further decline in the last two quarters of the year, which might not materialize, particularly if a further increase in U.S. interest rates were to occur.

On the pass-through of international oil prices to domestic prices, the staff and the authorities considered that an additional increase in oil prices in mid-2000 would be necessary, the Deputy Director continued. The central bank had already embedded an increase of about 12 percent in its inflation projections for the remainder of 2000. Nevertheless, the exact amount of the increase and its distribution across various products would depend not only on the outlook for international oil prices and the exchange rate at the time of the decision, but also on the overall prospects for the public sector finances, because the planned R$3.5 billion surplus in the petroleum account of the treasury was not a target in itself. The principal target was a primary surplus of the consolidated public sector equivalent to 3.25 percent of GDP, and, subsidiarily, a primary surplus of the central government amounting to 2.6 percent of GDP. That target was embedded in the budget framework law. Therefore, if other revenues were above projections, or if the authorities considered that they had sufficient margin to contain other expenditures, they might choose to increase oil prices by a lesser amount. In principle, and from an efficiency standpoint, the staff favored a positive surplus in the petroleum account. However, there was no particular reason why the surplus should amount precisely to the R$3.5 assumed in the program and in the budget.

On the question of whether monetary policy was currently characterized by an excessive anti-inflationary bias, the Deputy Director emphasized that it was highly important for the central bank to establish its credibility in the context of the inflation targeting framework, and to remain comfortably within the inflation target band. The band was rather large, owing to the fact that the inflation targeted was actual inflation, and not core inflation. The central bank had thus needed to give itself some margin for maneuver to accommodate supply shocks related to oil prices, for example. Given the current level of inflation, and under the assumption that no major external shock would occur, one could be confident that the central bank would be able to stay within the band without having to resort to a significant tightening of monetary policy.

With regard to the country's external vulnerability, the Deputy Director remarked that a fundamental shift had occurred with the adoption of the floating exchange rate regime. The exchange rate had depreciated substantially, as reflected in the strong performance of the trade balance, both in terms of export performance and in terms of import substitution. By all accounts, Brazil's exchange rate was highly competitive, which could be considered as an element of substantial increased strength. That was also borne out by the strong performance of foreign direct investment (FDI), which was broad-based—both in terms of the sectors concerned and in terms of geographical distribution—and only to a small extent related to privatization. The future prospects for FDI were encouraging, provided that the economy continued to grow and the environment remained financially stable. In that respect, it was interesting to note that in a year such as 1999, which had witnessed considerable financial turmoil, FDI had reached $30 billion. Foreign direct investment was likely to continue in areas such as petroleum exploration.

On the issue of short-term debt, the Deputy Director indicated that there had been some shift in 2000 in the composition of trade credits toward lower maturities, because the central bank had reduced the minimum maturity requirement for those credits. In a situation of relatively stable market conditions, one would not expect that to be a substantial element of added vulnerability.

The average maturity of short-term public debt in Brazil had increased substantially, moving from 8.6 months at end-1999 to 11.5 months currently, the Deputy Director continued. While it would be desirable to see the maturity of domestic public debt increase further—an objective to which the authorities attached high priority—there were trade-offs involved. If the authorities wanted to increase the share of fixed rate instruments and, at the same time, lengthen debt maturities in a period when the yield curve was turning upwards, the costs of such a strategy could be high. Given the current prospects for inflation, it would probably not be advisable to lock into two or three year maturities at rates well in excess of 20 percent. In that respect, greater use of inflation-indexed debt would be worth considering, as it was a logical corollary to a successful inflation targeting regime. However, the authorities had political economy concerns, which, essentially, had to do with the fear of reigniting demands for indexation in the economy more generally. Nonetheless, the authorities intended to resort increasingly to CPI-indexed debt, particularly for instruments with considerably longer maturities that were of interest to institutional investors. The staff had also been advising the reduction of dollar-indexed debt, and the authorities had indicated that, starting in March 2000, they would reduce the rollover rate of foreign exchange-indexed debt. They had done so, except during the previous two or three weeks, when the rollover rate had been close to 100 percent, because they did not want to add additional pressure to the market by not renewing part of the debt that, unfortunately, still represented the main hedging mechanism for importers and private sector agencies that had dollar-denominated liabilities coming due in the near future.

On the issue of the NIR floor, although it could create a tension with the fundamental objective of monetary policy, which was the control of inflation, it was necessary to have in the program a meaningful NIR floor in order to safeguard Fund resources, and, more generally, to enhance market perceptions about the ability of the country to face its obligations in the future, the Deputy Director observed. The staff proposal that the NIR floor be kept below the previous indicative target for the second half of 2000 did not represent a modification of a previous performance criterion. It had always been understood that the indicative target defined in the fourth review of the program would be subject to revision during the fifth review, when it was to be transformed into a performance criterion. Even though it had been lowered, the NIR floor still represented an adequate safeguard of resources, particularly given Brazil's recent advance repayment of substantial part of its liabilities to the Fund. The lowering of the floor also met some of the concerns of the authorities with regard to pressures in the foreign exchange market. Looking back at the experience of the latter part of 1999, the lowering of the NIR floor had contributed—although it was not the main factor—to easing pressures on the exchange rate that had not been warranted by fundamentals.

In response to Mr. Carstens's question on the manner in which the authorities intervened in the foreign exchange market, the staff representative indicated that the central bank generally carried out the servicing of the public debt through off-market transactions. It received the proceeds of external borrowing from the treasury and used them to service the debt. Purchases and sales in the market were essentially interpreted as smoothing intervention mechanisms. In that sense, Mr. Carstens was correct to point out that too much rigidity regarding the objective of increasing reserves might convey to markets the sense that intervention was being carried out for the purpose of affecting the exchange rate. Nevertheless, given that the treasury was planning, in 2000, to tap the foreign exchange market for more than the amount required to service the debt, it might be possible to meet the target of an increase in the overall level of net reserves without signaling to markets that the central bank was trying to moderate fluctuations in the exchange rate.

Mr. Carstens asked the staff to comment on the pass-through of the change in the exchange rate to inflation, especially given the current low level of inflation in the country, and whether it had been affected by a change in fundamental conditions in the labor market.

The Deputy Director of the Western Hemisphere Department said that the staff had been favorably surprised by the low pass-through in 1999, and was still trying to understand fully the reasons for that development. They probably included the low degree of openness of the economy, the depressed state of domestic demand, and the fact that profit margins before the devaluation had been high. However, there was little doubt that, as capacity constraints tightened, the pressures—both in terms of fiscal capacity and in terms of the labor market—that additional depreciations of the exchange rate could impart to prices would become stronger. Capacity utilization levels had been increasing and were close to historical peaks. Nevertheless, there was still continued slack in the labor market, in spite of the cyclical increase in the participation rate, as employment prospects had begun to improve. Real wages, although no longer falling, were not giving any indication of a sustained increase. The authorities were monitoring the situation closely. Currently, the main risk was probably an adjustment in domestic oil prices exceeding what the authorities had embedded in their scenario.

Ms. Jul clarified that the aim of her question on the tax-to-GDP ratio and public investment was to learn from the staff whether they considered the revenue base to be sufficiently strong, and if they perceived a need to contain expenditure in other areas, in light of fiscal tensions in the medium term.

The Deputy Director of the Western Hemisphere Department remarked that, at more than 30 percent, Brazil had a high tax-to-GDP ratio, especially in relation to the level of per capita income. By comparison, the ratio in Argentina stood at 20 percent, with a significantly higher per capita income. Therefore, the authorities did not have much scope for raising revenue through an increase in the overall tax burden. It was unlikely that, over the medium term, further fiscal consolidation could come primarily from the revenue side. It would instead have to come from the expenditure side and, in part, from reduced interest payments linked to the reduction in the debt-to-GDP ratio. This reduction would be made possible by the primary surplus target that had been embedded in the draft law for the 2000 budget framework, which contained a three-year plan for further fiscal consolidation. It was noteworthy that the three-year plan targeted a surplus at the federal government level equal to 2.2 percent of GDP in 2002, a presidential election year in which spending pressure was likely to be strong. If the project of law was passed by the congress, it would place a binding floor on the primary surplus for 2002. That demonstrated, in conjunction with the Fiscal Responsibility Law, a change in the country's fiscal regime, which would, in due course, be reflected in reduced interest rate spreads and reduced interest payments on the public debt. Together with important savings in terms of cost efficiency of government programs at the federal, state, and municipal levels, that should provide room for needed additional spending in social areas like health and education.

Mr. Portugal thanked the staff for their report, their advice, and their answers to Directors' questions. He also thanked Directors for their statements, for their commendation of efforts undertaken by the authorities, and for the many valuable comments and suggestions that would be conveyed to the minister of finance and the governor of the central bank.

The authorities agreed on the need to make further progress in the fiscal area to ensure the continued success of the program, Mr. Portugal continued. The apparently slow pace of reforms in the tax and social security areas owed to the complexity of the issues the authorities had to deal with, and the inherent difficulties in implementing significant changes in those areas in a democratic regime, where the parliament and the press were fully active, and extensive negotiations with all interest groups involved were required. To illustrate, the unification of the VAT had required months of negotiations with the states before reaching an agreeement on the framework, and was currently bogged down because of a disagreement with representatives of the private sector in congress. While the authorities had accepted to eliminate some cumulative, indirect taxes, those representatives wanted to introduce in the constitution the principle of noncumulativity of taxes. However, the authorities were concerned that that could lead to excessive litigation procedures that would take years to settle and lead to significant revenue loss, and had therefore refused to introduce the principle in the constitution for the sake of speed. They had proposed instead to integrate the principle in an intra-constitutional law, but that had been considered as insufficient legal security by the representatives. Although the tax reform was a highly important objective for the purpose of increasing the efficiency of the economic system, it was not aimed at increasing revenues in the short run, and would not have a direct impact on the sustainability of the fiscal effort through 2002. The gains of a more efficient economic system would materialize in the medium to long term, via an increase in revenues and higher growth.

On the concerns expressed by some Directors with regard to the inflation target—in light of the possible increase in oil prices, the 11 percent increase in the minimum wage, and the depreciation of the exchange rate—Mr. Portugal considered that inflation expectations would not be substantially increased. The increase in the minimum wage had not been perceived as a sign of lack of commitment to the inflation target, as markets had expected a considerably higher adjustment, and the increase of around 2 percent in real terms of the minimum wage had been considered by markets as an important victory for the government. The economy was substantially deindexed, unit labor costs had declined, the employment rate was high, and there were still no significant demand pressures. In spite of important external factors, such as the extreme volatility in international financial asset prices and the increase in international oil prices, the authorities would probably succeed in remaining within the inflation target band, although the annual rate would perhaps not be as low as what the markets were currently expecting, which was 6.1 percent.

On the question of external vulnerability, Mr. Portugal observed that, while it was correct to point out that Brazil remained more vulnerable to external shocks than some other countries, the important question was whether the country was currently more or less vulnerable than in the past. In his view, the country was significantly less vulnerable than in the past, especially because of the changes in fiscal policy and in the exchange rate regime.

Finally, on the issue of debt management, Mr. Portugal said that he agreed with Directors who had emphasized the importance to increase the maturity and duration of domestic debt, to shift the composition of public debt away from foreign exchange-indexed debt and toward fixed rate instruments. That had been the policy of the authorities, and the results had been positive, with an increase in the maturity and duration of domestic debt and a higher share of fixed rate paper in total debt. There had also been a reduction of foreign exchange-indexed debt, which stood at $110 billion in November 1999 and $95 billion in April 2000. As Mr. Faini had rightly pointed out, the authorities were proceeding gradually, fully respecting market conditions. As changing the composition of debt was not only a question of accepting a higher price, but also, crucially, of generating the demand for new instruments.

The Acting Chairman made the following summing up:

> Executive Directors commended the authorities for the performance of the Brazilian economy. They noted that developments in the economy since the completion of the fourth review at the end of November 1999 have been better than projected, and that Brazil has continued to make progress in macroeconomic adjustment and structural reforms. In particular, Directors noted that activity is recovering at a sustained pace, unemployment continues to decline gradually, and inflation is decelerating. They also welcomed the strong expansion in exports in recent months.
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> Directors supported the government's economic policy framework for 2000, which centers on continued fiscal consolidation, a monetary policy geared to securing a decline in consumer price inflation to around 6 percent during the year, and further progress in structural reform. They noted that this framework, if firmly and consistently implemented, should help achieve the program's macroeconomic objectives for the year(namely, real GDP growth of about 4 percent, a further decline in the external current account deficit to

around 3.5 percent of GDP, and a significant overall surplus in the balance of payments.

Directors noted, however, that the outlook for the external environment remains quite uncertain, posing nonnegligible risks for Brazil's economic performance during the rest of this year. In particular, they acknowledged that adverse developments in the U.S. economy could affect external demand, dampening the recovery of Brazilian exports; steeper than currently anticipated increases in U.S. and other international interest rates could force a tightening of monetary policy in Brazil, with adverse consequences for economic growth; and higher international oil prices could necessitate steeper adjustments in domestic oil prices and reduce the projected improvement in the external accounts. In this regard, Directors were reassured by the authorities' commitment to keep these developments under close review and to take additional fiscal measures, including cuts in discretionary federal spending and timely adjustment of domestic oil prices, as needed to ensure compliance with the program targets.

Directors noted with satisfaction that the government had endeavored, both in 1999 and in the decree of execution of the 2000 budget, to protect social spending, especially in health and education, from the brunt of expenditure restraint, and to improve the efficiency of various social programs. They welcomed the authorities' renewed commitment to reducing poverty by half by 2015. In commenting on the government's initiative to create a new anti-poverty fund, some Directors, while not questioning the desirability of strengthening efforts to reduce poverty, expressed concerns that this particular mechanism could be less effective than an approach that would better target social programs in the overall budget.

Directors expressed their satisfaction with the operation of the inflation-targeting framework during its initial year, noting in particular that inflation remained well within the target band in 1999, and that so far in 2000, it is in line with the path targeted in the program.

Noting that the flexible exchange rate regime has served Brazil well, Directors encouraged the authorities to continue to refrain from intervention in the foreign exchange market. They agreed that the authorities should seek to increase NIR from their current level, as allowed by market conditions, and stand ready to tighten monetary policies if NIR were to begin falling toward the program floor. Directors welcomed the authorities' continued efforts to extend the maturity and improve the composition of the public debt. They considered that a progressive decline in the stock of foreign exchange-indexed public debt would be important for strengthening the floating exchange rate regime, and encouraged the authorities to reduce these liabilities gradually, as market conditions allow.

Directors stressed that further progress with fiscal structural reforms will be crucial to ensure longer-term fiscal sustainability. In this regard, they welcomed the recent enactment of the Fiscal Responsibility Law (FRL), which strengthens the institutional framework for sustained fiscal discipline at all levels of government. They noted that it would be important to supplement the FRL with specific penalties for noncompliance, and expressed the hope that legislation in this area, currently under review in the senate, would be approved soon. Directors also stressed the importance, especially from the standpoint of economic efficiency and equity, of timely progress in other fiscal structural reforms, especially of the social security system for public employees, and of indirect taxation.

Directors also encouraged the authorities to press ahead with the implementation of their plans for further privatization and divestment, especially in the energy, utilities, and banking sectors, and to continue progress in removing barriers to trade.

Some Directors expressed concern about the still volatile market sentiment toward Brazil, which could be adversely affected by slow progress in the government's structural reform and privatization agenda, as well as by unfavorable court decisions on pending claims against the government.

Directors welcomed the elimination, as of February 1, 2000, of the remaining multiple currency practice that was subject to approval under Article VIII, Sections 2(a), 3, and 4 of the Articles of Agreement. Further, Directors encouraged the Brazilian authorities to subscribe to the SDDS as soon as possible. Directors noted with satisfaction that, having already repaid, partly ahead of schedule, all purchases under the Fund's SRF and the BIS and Japan loan facilities, the authorities have indicated their intention to treat the Stand-By Arrangement as precautionary henceforth.

The Executive Board took the following decision:

1. Brazil has consulted with the Fund in accordance with paragraph 3(b) of the Stand-By Arrangement for Brazil (EBS/98/189, Sup. 2) in order to review program implementation and establish new performance criteria for the period through end-September 2000.

2. The two letters dated April 20, 2000, attaching a Memorandum of Economic Policies and a Technical Memorandum of Understanding (the April 2000 TMU), respectively, all from the Minister of Finance and the President of the Central Bank of Brazil, shall be attached to the Stand-By Arrangement for Brazil, and the letters from the Minister of Finance and the President of the Central Bank of Brazil dated November 13, 1998, November 25, 1998, March 8, 1999, July 2, 1999 and November 12, 1999,

together with their respective attachments, shall be read as supplemented by the letters dated April 20, 2000 and their respective attachments.

3. Accordingly, the Stand-By Arrangement for Brazil shall be amended as follows:

(a) the ceilings and floors referred to in paragraphs 3(a)(i) to 3(a)(v) of the Stand-By Arrangement shall, for the period up through September 30, 2000, be as specified in Sections II.1.a, II.2.a, II.2.b, II.2.c and II.2.d of the April 2000 TMU, respectively;

(b) subparagraphs (vi) and (vii) of paragraph 3(c) of the Stand-By Arrangement shall be amended to read as follows:

"(vi) fails to refrain from entering into any new operations in the foreign exchange futures markets, as set out in Section II.2.e of the March 1999 TMU, Section II.2.e of the July 1999 TMU, Section II.2.e of the November 1999 TMU and Section II.2.e of the April 2000 TMU, or

(vii) fails to refrain from entering into foreign exchange forward contracts, as set out in Section II.2.f of the March 1999 TMU, Section II.2.f of the July 1999 TMU, Section II.2.f of the November 1999 TMU and Section II.2.f of the April 2000 TMU; or";

and,

(c) paragraph 3(d) of the Stand-By Arrangement shall be amended to read as follows:

"3(d) until Brazil has consulted with the Fund as provided for in Section II.3.b of the November 1999 TMU and Section II.3.b of the April 2000 TMU."

4. The Fund decides that the fifth review contemplated in 3(b) of the Stand-By Arrangement for Brazil is completed. (EBS/00/82, 5/3/00)

Decision No. 12201-(00/54), adopted
May 31, 2000

3. URUGUAY—STAND-BY ARRANGEMENT

The Executive Directors considered a staff paper on Uruguay's request for a Stand-By Arrangement in an amount equivalent to SDR 150 million (EBS/00/76, 4/15/00; and Sup. 1, 5/8/00).

Ms. Jul submitted the following statement:

The Uruguayan economy exhibited a highly satisfactory performance over the past ten years, with real GDP growth averaging 3.2 percent, inflation declining from a three-digit level to 4 percent, while maintaining one of the most equitable income distributions and best social indicators in the region. This performance results from a gradual but sustained adjustment effort, which combines cautious fiscal management and moderate incomes policies, a significant trade liberalization, deregulation of domestic markets, substantive market-based reforms in social security, education, public enterprises and public administration, and an exchange rate regime that has proved successful as a nominal anchor.

Against this background, Uruguay faced a difficult year in 1999 prompted by a combination of adverse external and domestic shocks. These included the sharp depreciation of the Brazilian real early in the year, a contraction in the other economies in Mercosur, a deterioration of the terms of trade of about 8 percent, an increase in international interest rates, uncertainties associated with several rounds of elections, and a severe drought. As a result, output contracted by more than 3 percent, the largest drop since the decline experienced at the time of the debt crisis in 1982-84 and significantly larger than at the time of the tequila crisis, pushing the rate of unemployment over 11 percent by end-1999, while inflation was cut in half to 4 percent.

At the same time, the public finances weakened considerably, with the overall deficit widening to 3.8 percent of GDP in 1999, compared with a 2.1 percent of GDP deficit targeted in the program. However, the weakening of the public finances largely reflected the countercyclical stance of fiscal policy. The larger than expected contraction in economic activity resulted in lower tax revenues, while the higher expenditure is explained by the play of the automatic stabilizers like unemployment insurance and social security benefits, expenses stemming from the increase in the petroleum price and international interest rates and from the drought, and one time expenses associated with several runs of elections. Also, public capital outlays were larger-than-programmed to offset in part the sharp decline in private investment. The private savings-investment balance shifted from a negative 1.7 percent of GDP in 1998 to a positive 1 percent of GDP in 1999 (a negative 0.2 percent of GDP was envisaged in the program). In all, the current account deficit deviated from the program objectives only by about half a percent of GDP, notwithstanding a contraction of exports of 18 percent and of tourism receipts of 7 percent.

One remarkable aspect of the crisis faced by Uruguay in 1999 was that, in sharp contrast with the experience in the tequila crisis, access to international markets was not affected significantly as evidenced by the maintenance of investment grade, continued low spreads, and sustained private capital inflows, including deposits and direct investment. Consequently, and notwithstanding the larger current account deficit, there was a small accumulation of net international reserves. About one third of the larger public sector deficit was financed by a placement of bonds in the international financial markets, and two-thirds from domestic sources without crowding out the private sector, as private demand for credit weakened considerably.

Turning to the banking system, it is to be noted that part of the increase in the nonperforming loans reflects a tightening of prudential regulations in 1999 by which the period for considering a loan as not performing was reduced from 90 to 60 days. The profitability of private banks increased in 1999 and the share of nonperforming loans in total loans extended by these banks remained at low levels (3.4 percent by end-September 1999). Public banks, which account for almost half of the market, present a larger share of nonperforming loans; however, they are better capitalized than private banks. Public banks assisted sectors of the economy that were most affected by the recession, by refinancing loans and stretching out payments.

It is important to note that the reduction in inflation was attained in 1999 without reducing the rate of crawl of the exchange rate band, so as to allow for a larger real depreciation of the peso on account of the impact on external competitiveness from external shocks. Despite these shocks and the uncertainties resulting from the elections, and notwithstanding a decline in domestic interest rates, Uruguay's exchange rate policy did not encounter significant credibility problems. Developments on interest rate differentials and in the interbank market rates, the behavior of the demand for money and in the foreign currency position of the financial institutions, indicate that economic agents did not anticipate a change in the exchange rate policy. This reflected confidence in the policy mix implemented by the authorities, with the exchange rate withstanding two major tests in 1999, namely, the devaluation of the Brazilian real and the elections. The volatility of the exchange rate increased in these instances and there was a temporary depreciation of the peso within the band, which was reversed however once these uncertainties were resolved, and the authorities were able to maintain the exchange rate band with no modifications.

The objectives of the economic program for 2000-01, for which my authorities are requesting a 22-month stand-by arrangement from the Fund that they intend to treat as precautionary, is to promote sustainable growth of output and employment in conditions of low inflation and external viability, while improving efficiency in general and in the public sector in particular, and addressing social needs. The program looks to build upon the progress achieved over the past ten years, while taking steps to improve competitiveness further through structural reforms affecting both the private and public sectors.

Real GDP growth is expected to recover to about 2 percent in 2000 as a result of the improvement envisaged for economic activity in Brazil and Argentina, with exports and private investment leading the recovery while domestic consumption is expected to experience a slower reactivation. The main obstacles to the economic recovery are the lasting effects of the drought on agricultural income, the increase in international interest rates, and the impact of the increase in the price of oil in 1999 on energy costs, as it will be fully reflected only this year. Inflation is expected to remain between 4 and 6 percent, before resuming a downward trend in 2001. Average inflation for the first quarter of 2000 held steady at about 4 percent, but the authorities are of the view that the full pass through of the higher oil prices has not yet been completed.

In the context of the objectives of restoring competitiveness and resuming high output growth, the government is implementing a two-pronged fiscal strategy, which includes consolidation of public finances and a reduction of the public debt to GDP ratio, with selective tax cuts to help reduce costs in the economy and foster competitiveness. The attainment of these objectives requires a reduction in fiscal expenditure and a furthering of structural reforms. The authorities will seek to reduce the overall public sector deficit to 1.8 percent of GDP in 2000 and 1.2 percent of GDP in 2001. This is to be accomplished mainly through wage restraint, a decline in social security costs resulting from the reform of the pension system, and lower purchases of goods and services reflecting also the non-recurrence of one time expenditures, and improved revenue prospects from VAT and excise taxes on durable consumer goods, increased import tax receipts, and revenue from petroleum tariffs.

In addition to strengthening the position of the public finances, a moderate incomes policy is a key element in improving external competitiveness. Given the current Indexation Law and the envisaged path of inflation, central government wages will be increased by only 1½ percent in 2000. It is expected that private sector wages will follow suit, in part as the high rate of unemployment will result in reduced wage demand pressures.

A sound competitive banking system is a key element to foster sustainable growth with price stability. The banking system has a solid reputation in the region, and Uruguay is considered to be a financial center or a "safe haven" for funds in the southern cone, due to the continued economic reform efforts and the steps taken to maintain financial sector competitiveness. To maintain this advantage, my authorities are making additional efforts to further improve efficiency in the banking sector through comprehensive and decisive actions in the areas of prudential norms and regulations, transparency and disclosure, legal environment and leveling the playing field and restructuring the public (and intervened) banks, in the context of the current economic program and a financial sector adjustment loan with the World Bank approved in February 2000.

In terms of the exchange rate policy, the authorities have gradually reduced the rate of crawl of the band to provide a nominal anchor by influencing inflationary expectations. The rate of crawl of the exchange rate band will be maintained at 7.5 percent a year for the third consecutive year, with the exchange rate expected to depreciate in real terms. No changes are being considered regarding the exchange rate system, as my authorities prefer to wait to ensure that inflation is reduced to the level of industrial countries before deciding on a permanent monetary framework.

My authorities are in broad agreement with the staff's appraisal. However, there are three points which they would like to underscore. As noted in the occasion of the first review of the previous stand-by arrangement approved by the Board in March 1999, Uruguay has a strong financial position, with sound solvency and liquidity positions. In this connection, my authorities are of the view that the discussion of vulnerability indicators in Box 3 and in other parts of the report is somewhat biased, because of the asymmetric treatment given to foreign currency assets and liabilities. If deposits by nonresidents are included on the liability side, then the assets held by banks abroad should also be included in the reserves. More than 90 percent of nonresident deposits are with the foreign private banks, and are adequately hedged. Moreover, the report also notes that the indicators may be interpreted not as reflecting a higher vulnerability to capital market shocks, but as reflecting the special characteristics of Uruguay in its capacity as a regional banking sector and "safe haven" for nonresident deposits. However, in order to further improve the ratio of reserves to short-term debt, all planned placement of government bonds will be long term, to maintain an average maturity of at least seven years, so that there is no short-term public sector debt. Another measurement bias occurs also regarding the ratio of international reserves with respect to broad money-M3, which includes foreign currency deposits by nonresidents. If these deposits are excluded, the ratio increases from 21 percent to 33 percent or to 43 percent if all foreign currency assets of the banking system are considered relative to M-3.

Another point worth considering in more detail refers to the analysis on gross public debt. The report notes that the public debt to GDP ratio increased by about 8 percentage points in the period 1994-1999. Although this is correct, it is to be noted that at the same time net international reserves increased by about 5 percentage points of GDP and that another 4 percentage points resulted from the reform of the pension system, by expliciting liabilities that were implicit before. Consequently, the increase in the debt to GDP ratio was the result of a deliberate policy of improving the external position to avoid having to access the international market at times of crisis, incurring large spreads. Also, because of the way the debt is measured, the social security reform, which decreases an implicit liability and gradually makes explicit the remaining liability, results initially in an increase in the debt to GDP ratio. These considerations notwithstanding, over the medium-term fiscal policy will aim to stabilize the debt-to GDP ratio by 2002 and to reduce it thereafter, by lowering the overall public sector deficit to half a percentage point of GDP by 2003 and eliminating it by 2005.

A third point refers to the recommendation to link social security entitlements to prices instead of the average public and private sector take-home wages. The staff recognizes that such a move is politically difficult. However, because the present indexation rule is contained in Uruguay's Constitution and was approved by 82 percent of the population, which in a consensus-based society not only makes it difficult but impossible to modify. Moreover, in my authorities' view, indexation of these entitlements to the average take-home wages does not generate difficulties over the cycle because contributions are adjusted in the same manner than benefits; however, they agree that in addition to being backward looking this type of indexation increases labor costs in the public sector directly through wages and indirectly, through benefits. On the other hand, the link to prices increases entitlements when prices rise on account of an increase in indirect taxes or public sector tariffs, and in general, contributions do not move in line with the CPI. Also, it would be preferable to deindex when the unemployment rate is low because that is when pressures on the real wage (above increases in productivity) are larger, rather than when the rate of unemployment exceeds 10 percent as recommended by the staff. The staff proposal on indexation of social security entitlements seeks to reduce these expenses; it is to be noted that under the new pension system this reduction is taking place already starting this year.

All the structural reforms envisaged in the program aim at improving productivity and competitiveness. My authorities are implementing measures to remove the monopoly status of the public enterprises; to improve efficiency and disclosure in the public sector banks and to strengthen further the financial system in general; to continue the reform of the social security system; and to bolster transparency and disclosure of fiscal developments. On transparency, a Report on the Observance of Standards and Codes (ROSC) is being prepared, progress is being made in improving the national income accounts and the monetary statistics, and in broadening the coverage of balance of payments statistics. Also, Uruguay is on schedule in their two-year time table to subscribe to the SDDS, a ROSC module in fiscal transparency is being prepared, and external auditing firms have been contracted to complete an analysis of the loan portfolio of the two public banks. In addition, my authorities will publish the Letter of Intent following the Board discussion.

In terms of trade policy, Uruguay used to have a "1" rating (most liberal on a scale of 1-10) according to the Fund's trade liberalization index. As a member of Mercosur, Uruguay has implemented the tariff reductions contemplated under this Trade Agreement. In the context this agreement, Uruguay has had also to impose an import surcharge of 3 percent, with a rating changed to "2" as a result, but my authorities support the removal of the surcharge as soon as possible. In this respect, my authorities would like to see reciprocity from the industrialized countries, so as to be able to access freely these markets, particularly for agricultural goods and manufactures. They consider the removal of trade barriers and free trade as a key element to attain long-term growth potential and as the best instrument to fight against poverty.

Finally, we would like to point out that the program prepared by my authorities aims at bringing the economy back on track to the path followed over the past decade and achieving sustainable growth over the medium term. The shortfalls and deviations experienced last year in the implementation of the previous arrangement were the result of unfavorable external and domestic shocks, under exceptionally adverse circumstances. The higher public expenditure contributed to contain social tensions and reduce the adverse impact of the recession on the momentum of reforms, by preventing an erosion of the people's support of the macroeconomic policies being implemented. As a result, my authorities were able to maintain approval of their policies without straying the course of adjustment. Moreover, the strengthening of the economic fundamentals that had taken place over the past years allowed Uruguay to face this crisis in such a manner that it reduced the severity and duration of the economic recession, without compromising the future in terms of the domestic and external balances.

Mr. Shaalan and Mr. Bakhache sublitted the following statement:

A commendable record of sound macro economic management and an effective gradual approach to adjustment and structural reforms in recent years have underpinned a favorable economic performance in Uruguay. This has earned the country a solid reputation in the region as attested by the maintenance of its investment grade credit rating. Indeed, even in the midst of a multitude of adverse external shocks in 1999 access to international financial markets did not seem to be significantly impacted.

The challenge for the authorities in the period ahead is to build on the economic progress achieved in the 1990's while fostering the economic recovery that is taking shape following a severe downturn in 1999. Given the well known constraints on policy making emanating from the high degree of dollarization of the economy, the focus of reform efforts should be on fiscal and incomes policies as well as on reviving the structural reform agenda which has stalled in 1999. Policies should be directed at achieving further fiscal consolidation while enhancing the competitiveness of the economy with a view to placing the economy back on the path of high growth and declining inflation. The high degree of openness of the economy underscores the importance of undertaking policies aimed at improving the economy's competitiveness.

The 2000-2001 economic program is appropriately designed to address the remaining difficulties in the economy and we can support the authorities' request for a Stand By Arrangement in support of the program. We are in general agreement with the thrust of the staff appraisal and will be selective in our comments.

The program's objective of halving the public sector's deficit is appropriately ambitious particularly following the steep increase in 1999. Given the decision to avoid relying on tax increases to achieve this objective, it is of utmost importance that the authorities exercise restraint on the expenditure side of the budget. Improvement in tax administration would also be very helpful in this regard. In light of the contractionary impulse of the fiscal objective for 2000 and the need not to jeopardize the ongoing recovery, we see some merit in allowing front loading of the targeted deficit in 2000. However, other considerations may argue for a different approach. In particular, the report clearly states, and we agree with this assessment, that the risks to the program in 2000 are mainly related to developments in economic activities in the region. According to the staff report on Brazil (EBS/00/82), there are non-negligible risks, mainly external, that could undermine economic growth in Brazil. This clearly applies to other countries in the region. Given that the recovery in Uruguay is underway, we believe that a more cautious approach to the use of the allowable deficit may be warranted in order not to be overly constrained in case these risks materialize. This strategy will provide the authorities with more flexible fiscal management over the course of the year.

On income policies, it appears that the moderate adjustments in public sector wages and social security benefits in 2000 is having a positive signaling effect of private sector wages as they are expected to remain unchanged in real terms. Regarding the indexation of social security benefits, there is always room for improvements. However, given the widespread support for the current system and the fact it is in the constitution, as Ms. Jul states in her informative preliminary statement, we do not see merit in pressing for changes in the system at this time.

Structural reforms should take a central role in improving competitiveness and productivity in the economy. We encourage the authorities to move forward with their gradual approach to the introduction of market oriented reforms. In this regard, priority should be given to improving the efficiency of public enterprises by streamlining the state corporate sector and eliminating the monopoly status of enterprises. The banking system is another priority as it requires further reforms in order to enhance Uruguay's role as regional banking center. We are encouraged by the pragmatic approach the staff has taken in dealing with the difficulties of privatizing intervened banks. Indeed, obstacles to privatization have to be tackled first and we encourage the authorities to implement the policy recommendations to level the playing field and restructure these banks, strengthen supervisory and regulatory framework and improve the legal environment.

On trade policy, we are encouraged by the authorities' support for the removal of the 3 percent surcharge on the common external tariff in the context of the Mercosur. We also share the authorities' emphasis on the need for improved access to industrial countries markets, particularly for agricultural and manufactured goods.

With these remarks we wish the Uruguay authorities success in implementing the reform program.

Mr. Mirakhor submitted the following statement:

Reading the well-written staff report and Ms. Jul's excellent statement, it appears that everything that could have gone wrong for a country in one given year did indeed in 1999 in the case of Uruguay: deep contraction in neighboring economies, sudden and sharp depreciation in the Brazilian real, substantial deterioration in terms of trade, a severe draught, a slow tourist season, soft international commodity prices, higher international interest rates, and, concomitant with these, several rounds of domestic elections with associated uncertainties. Against this background, economic policy challenge was to mitigate faster-than-expected deceleration in economic activity, while persevering with the objective of the medium-term fiscal consolidation, keeping an alert eye, especially, on the risk of further turbulence in the international market. The real GDP declined by an estimated 3.4 percent, the unemployment rate increased to 11.4 percent, overall fiscal deficit deteriorated by 2.7 percent of GDP, and the current account widened somewhat. Yet it is not unrealistic to conclude that the combination of external and domestic shocks could have had imposed a far heavier toll on the economy had it not been for the judicious counter-cyclical policy stance of the authorities and the underlying confidence of both domestic and international economic agents, fostered over a long period of policy credibility and attained through what Ms. Jul refers to as a "gradual but sustained adjustment efforts" throughout the 1990s. A remarkable indicator of appropriateness of the 1999 policy mix is that inflation was cut in half without reducing the rate of crawl of the exchange rate band.

While the adverse impact of rising international interest rates and petroleum prices, combined with soft commodity prices, continue to constrain the rate of recovery, it is highly commendable that the authorities are committed to reinvigoration of the economic policy and further deepening and accelerating structural reforms to restore competitiveness and resume high output growth. In this regard, the authorities are correct in emphasizing a vigorous return to the path of consolidating public finances to strengthen further the confidence of economic agents and to enhance efficiency in the economy to regain competitiveness. Given the expected revenue increases (paragraph 13 of the LOT), the intention to restrain noninterest expenditures (paragraph 14 of the LOT), and the anticipated moderation in wage growth (para. 15 of LOT), the authorities' objective of cutting the fiscal deficit in half to 1.8 percent of GDP seems achievable. Moreover, given the high level of dollarization, subordination of monetary policy to exchange rate policy aimed at improving competitiveness is appropriate. The exchange rate regime has served Uruguay well by providing a reasonable degree of flexibility, and should be maintained for the time being.

The staff is correct in arguing that furthering the structural reform agenda at a more rigorous pace offers Uruguay the most promising means of improving efficiency and accelerating economic growth. In this regard, improving the health of public banks, enhancing efficiency of nonfinancial public enterprises and improving their performance, strengthening the legal environment, instituting transparency and disclosure rules, and facilitating the flow of information to the public are measures that help increase productivity, lower costs, and strengthen competition. Both the LOT and Ms. Jul's statement make clear that the authorities are fully resolved to implement these measures.

I concur with the staff appraisal and have no hesitation in supporting the proposed decision. Moreover, I fully support Ms. Jul's position (paragrah 17 of her statement) on the need for reciprocity of action from industrial countries on tariff reduction. She and the staff correctly point out that according to the Fund's trade restrictive index, Uruguay had a rating of "1," which was revised to a "2" when the country had to impose a 3 percent surcharge. This raises a fundamental issue regarding Fund's position vis-a-vis regional trade agreements that force a country to make its trade more restrictive when it chooses to join the agreement. In case of Uruguay, the staff correctly advised against joining an agreement that would force the country to step back somewhat from its most liberal trade policy, and deserve to be commended for taking a position consistent with the Fund's Articles of Agreement. To maintain consistency and to preserve uniformity of treatment, should this advice not be given to other countries, in other regions, aiming to join other regional trade agreements when this would mean that they would have to make their trade policy less liberal? There are a number of transition economies that have achieved a "1" rating in the Fund's trade restrictive index and are aspiring to join the EU with a trade restrictive index of "4". Would the Fund's advice in these cases be consistent with that given to Uruguay? Would it not be more realistic instead to reinvigorate efforts, through bilateral and multilateral surveillance means, to insist, consistent with the Articles of Agreement, on the need for industrial countries to accelerate trade liberalization?

Mr. Portugal and Mr. Mori submitted the following statement:

Uruguay has achieved in the 1990s an outstanding economic performance in terms of GDP per capita growth, together with a substantial reduction in inflation and the maintenance of external accounts at a manageable level. These results should be attributed to the sound macroeconomic policies followed by the authorities. Policies in social areas have also been very commendable with notable results in terms of income distribution and improvements in welfare.

Prudent macroeconomic policies could not prevent the Uruguayan economy to be severely affected by external shocks and an unfavorable domestic climate. GDP contracted at an estimated rate of 3.4 percent in 1999, after a large expansion of 4.9 percent in 1998. But a track record of sound policies has allowed Uruguay to reduce the severity and duration of the economic recession, without compromising the future in terms of domestic and external balances, as pointed out by Ms. Jul.

The request of a stand-by arrangement with the Fund to support –in a precautionary way– the economic program for the next two years is a wise decision on the part of the authorities in view of the substantial uncertainty that remains in the external environment. We support the proposed decision as the program will provide the necessary framework and financing safeguards to bring the economy back on track to the path followed over the past decade and achieve sustainable growth over the medium term. The program correctly contemplates measures related to the fiscal area and to structural reforms, relying less on monetary policy which tends to be a limited instrument of demand management for a very dollarized economy.

Fiscal policy seeks to cut the deficit by 2 percent of GDP in 2000. We are concerned that a consolidation of such magnitude may have a negative impact on the pace of recovery. As noted by the staff, the fiscal balance is not expected to add stimulus to aggregate demand and restrained wage growth would limit the rebound in domestic consumption. As designed, the program seems to weigh more on exports and private investment for the revival of demand. A recovery fostered by exports may require domestic demand to be controlled, which would allow the exchange rate to depreciate faster than inflation and, hence, to improve competitiveness. The tax cuts in a context of reduction in non-interest expenditure would also contribute to these objectives. Such a framework seems to be in line with expectation of an external environment less favorable than the pre-crisis period. In any event, developments in domestic and external demand will need to be closely monitored to take timely actions in order not to hamper economic recovery.

The staff notes that fiscal consolidation efforts are necessary both to strengthen confidence and improve public debt indicators. This view is supported by some private sector economists who note that the confidence effects of fiscal consolidation on private sector activity and output growth tend to outweigh the negative effects on aggregate demand. But in the case of Uruguay, the need for consolidation under such a perspective seems to be less conclusive. In addition, one should consider that "the weakening of the public finances largely reflected the countercyclical stance of fiscal policy", as noted by Ms. Jul.

Given their past record of fiscal discipline, confidence seems not to be a problem for the Uruguayan authorities. Also, the public sector gross debt-GDP ratio stands at 36 percent, which seems to be comparatively low, and does not represent a major concern as long as the authorities continue to pursue the prudent macroeconomic policy followed so far. The five-year budget plan prepared by the government aiming at bringing the fiscal deficit down to below 1 percent of GDP over the medium term is an important element to reinforce the authorities' commitment to fiscal discipline. In view of a relatively old population, which overburdens public spending, the reform of the special pension regimes is another important component for the longer-term sustainability of public finances.

The path of growth and inflation achieved by Uruguay in recent years seems to be satisfactory, perhaps with a possible drawback related to a relatively high unemployment rate. In view of the changing external environment and in a longer-term perspective, we agree that structural reforms are key to improve efficiency in the economy through productivity enhancement and gains in competitiveness, and to support saving and private investment in the economy. In this context, we consider essential measures to foster efficiency of public enterprises by revoking the monopoly status of various enterprises, and by working on suitable legislation, regulation, and anti-trust provisions. We would also include in this policy the need of restructuring the banks administered or owned by the public sector to seek a more efficient financial intermediation.

The assessment that was drawn from the indicators of vulnerability is puzzling (table 9 and box 3). In box 3, the staff notes that "Uruguay's nonfinancial private and public sector register some of the strongest indicators (i.e. least vulnerability), in the region". But the basic objective of indicators of vulnerability is to prevent precisely the sharp contraction in GDP growth experienced by Uruguay. These indicators should detect ex-ante fragilities and assess the degree to which a country's assets and liabilities situation makes it vulnerable to shocks. Nonetheless, against a favorable assessment drawn from indicators of vulnerability, there was actually a severe contraction in output.

The staff also mentioned that "Uruguay's official gross international reserve position is large enough to absorb most external current account shocks" and that "Uruguay tends to receive more deposits, not less, when financial economic uncertainty hits the region". Indeed, even with a contraction in growth, the current account deficit widened in 1999, and capital inflows financed not only this deficit but also allowed international reserves to remain at the same level.

One should consider, however, that deposits received from non-residents, especially in periods of financial economic uncertainty in the region, were basically directed to dollar assets of very high liquidity –such as U.S. Treasury bills– instead of domestic assets, as banks in Uruguay were intermediating foreign resources to be invested in foreign assets. Therefore, capital inflows did not increase, or replace, credit to finance domestic activities as they might have simply increased holdings of foreign assets. In this respect, we agree with Ms. Jul that deposits by non-residents should be appropriately accounted as external liability with corresponding external assets, and in this perspective such deposits should not be included in the broad money.

Mr. Harinowo and Mr. Peh submitted the following statement:

The performance of the Uruguayan economy for the past decade has been encouraging. Real output has on average expanded by more than 3 percent per year whilst inflation has fallen markedly to 4 percent. The progress achieved by the economy could be attributed to the appropriate policy mix of the authorities as well as the implementation of necessary structural reforms. The economy, however, was exposed to a series of unfavorable shocks in 1999, resulting in a sharp contraction in output and rise in unemployment. While the economic environment is expected to turn for the better, the effects of the slowdown may not have yet run their full course. However, we are encouraged by the fact that investor confidence in the Uruguayan economy was not much affected by the crisis as reflected in the continued inflow of private capital. We support the authorities' request for the stand-by arrangement which they intend to treat as precautionary. The program will enable the new government to build upon the progress already achieved and implement the necessary reforms that will improve competitiveness with the aim to attaining sustainable and non-inflationary economic growth.

We welcome the authorities' commitment to consolidate the public finances and implement selective tax cuts that will provide the necessary cushion for businesses hardest hit by the recession. Its aim to reduce the public sector deficit by more than half through expenditure restraint in the form of cuts in central government spending and tendering of projects to the private sector is commendable. On the revenue side, the recovery of the economy is expected to provide some relief, in addition to the benefits from further improvement in tax administration and possible measures to reduce exemptions form VAT. The moderate increase in the public sector wages can also be expected to influence the pace of salary increases in the private sector, thereby strengthening the competitiveness of the economy. It is encouraging to note the growing willingness of some labor representatives to accept the moderation in wage raises in exchange for employment security.

The current crawling band exchange rate system, which appears to be well suited to Uruguay's circumstances, would best be maintained. The authorities have appropriately taken a more cautious approach in ensuring that a different monetary regime would only be replaced if inflation rate remains low on a sustained basis. While noting the prevailing high confidence in the system, it is important to maintain a certain level of flexibility in response to developments in the region. As growth accelerates and fiscal adjustment is implemented as planned, the government should be able to focus more on inflation reduction.

A main priority of the authorities moving forward will be the implementation of reforms in the banking system. Efforts should be directed at the intervened banks which form a significant part of the system, in raising their efficiency and productivity. In light of increasing regional competition and the risk of losing its "safe haven" status for funds in the region, the implementation of the reforms as listed in Ms Jul's very informative buff will be critical.

The recession in 1999 also reflects the constraints of the Uruguayan economy and underscores the importance of addressing these limitations. In particular, Uruguay's vulnerability to regional shocks would have been reduced if it has a more diversified export markets. Given that Argentina and Brazil together account for more than half of Uruguayan exports, Uruguay's economic performance will hinge in part on the state of these members of Mercosur. The loss of export competitiveness further underlines the need for Uruguay to improve its productivity and increase its focus on extra-Mercosur trade. In this regard, it is crucial for Uruguay to expedite the implementation of reforms as laid down in the program, including the demonopolisation of public enterprises and the promotion of greater transparency in the corporate sector.

We wish the authorities all the best in the carrying out the program.

Mr. Houtman made the following statement:

Last year at the end of March, I warmly supported a precautionary stand-by arrangement for Uruguay. This was mainly due to its impressive performance in terms of macroeconomic policies in the period since 1996, which has put the fundamentals of the economy in order so as to form a sound foundation for the future.

Indeed, Uruguay could be regarded as a proper example of a country where a prolonged application of the consistent policy mix of monetary, fiscal, and exchange rate policies, has shielded the country to a large extent from the emerging markets crisis.

Nevertheless, the SBA went offtrack towards the end of 1999. Partly due to external factors suggested sharp drop in the terms of trade following the Brazil crisis and the severe draws. This cost the economy to contract. These factors in combination with political factors relate to the presidential elections, led to substantial fiscal slip slippages. At the same time, however, Uruguay was able to maintain its investment credit rating. This, I believe, is no doubt a reflection of the favorable underlying position of the country, and the confidence that the sustained policies inspired in the private investor community.

In addition, monetary policy remains exemplary with inflation falling well under 10 percent, and relatively stable exchange rate regime.

While it is regrettable that the last stand-by arrangement went offtrack, I can see there was an unusual set of circumstances and adverse shocks that contributed to this. I basically concur with the staff's assessments, and I believe that a new 22 months precautionary stand-by arrangement for Uruguay is warranted. I can also support the underlying economic program which should bring the country back on an adequate growth path. I would like to make a few caveats, however.

In first place, I believe it is unfortunate that in 1999 has been a lost year in terms of structural adjustments. Last year, my remarks also focused on this area, and most of them still seem to be applicable. I understand that Uruguay has a history of gradualism and consensus, which has served it well, but this is not the same as keeping existing structural rigidities fully in place. For example, it is unclear why the plans independent audits of the state's own financial institutions were not carried out last year.

Also, it seems undesirable that the intervened state owned banks have been put in the care of the C and D, a holding company with no apparent expertise in banking, as the staff puts it mildly.

These developments do not inspire much confidence in the commitments for structural reform.

Second, I think that structural reform becomes all the more urgent when macroeconomic policies are basically sound. In order to bring the economy on a higher growth path. I float that the authorities now intend to restart structural reforms, and this is welcome, of course, you with I think that the Fund-supported program could have been more ambitious in structural area. Let me give a few examples.

The state enterprise sector is much larger issue in the private sector and this may becoming increasing impediments to development. The rising unemployment rate which is now over 11 percent is a case in point.

I do not believe that state enterprises should be used to obtain fiscal goals inventory carry out social policies for that matter. Last year, the national oil company did not pass on the rising price of crude oil on the international market to consumers until after the November elections. As a matter of principle, ill countries should strife for a fully transparent and market based pricing mechanism for domestic oil products in order to avoid distortions and huge fiscal costs. The price adjustment that has been made after the election system a step in the right direction, of course. But I feel that automatic adjustments should be constitutional used.

More in general, the markets in which the state monopolies operate should knowledge entity Lee be opened to competition in order to allow for the dynamics of mother forces to become effective. In this area, I believe clearer and more specific timetable would have been preferable.

Another problem is the labor influx I believe in the banking sector where it seems to affect both the competitiveness and the profitability, and sometimes even the health of some banks for which it's nearly impossible to rationalize their staffing. In addition, the half part of the banking sectors that state owned suffers from too much government interference, resulting in a low quality loan book, overstaffing and poor profitability. The privatization process of these banks has stalled for over three years now, putting into question the government's resolve. I would strongly encourage the authorities to follow the World Bank's recommendations or requirements under its loan. It would be desirable, for instance, that a supervisory authorities could also effectively intervene in the state owned banks, which I agree is not the case right now.

In light of these observations, I welcome the performance criteria that have been establishedded with respect to independent outside analysis of Bank's loan portfolio and its increasing financial and fiscal transparency by improving on public reporting. While this would certainly essential be a step ahead, I believe it is clearly not enough. I would have preferred the program to be a little bit bolder, to be frank. I believe there could have been a list, for instance, of public enterprises targeted for incorporation by a certain date, with the view to putting them at arm's length from the government. This could encourage these enterprises to become more market oriented, and thus form a prelude to eat up partial or full privatization.

Simultaneously, of course measures would be needed to open markets access and to introduce regulations to protect competition. I would certainly encourage the staff to include such types of measures in the discussion of the next review.

With these remarks, I support the proposed decision.

Mrs. Mateos y Lago made the following statement:

Uruguay enjoys special status among e emergencying market countries in particular within Latin America. Throughout the 1990s, instead of the raise per, drastically reduced inflation down to level typically found in industrialized countries, avoided currency crisis and built a reputation of financial heaven in the subcontinent. This good performance be summarized by the investment grade it was granted in 1997, and retained ever since in spite of the fallout and more recently despite the directly adverse impact of the Brazilian devaluation, the Argentine recession and the harsh terms of trade shock caused by high royal and low commodity prices.

True, the series of shocks Uruguay endured last year ended up causing a recession, albeit not a serious one, but the outlook for 2,000 and beyond looks quite promising, especially on the external front. In short of any unforeseeable problem and I use this term in the strong evident literal sense, it should not face any balance of payment difficulties. Let alone any financing gap.

Against this background, I found it somewhat odd to request a fourth precaution ear stand-by arrangement. Of course, given the strength of the economic program, we would not have any serious grounds to dough my the authorities access to a program, although as was just said by Mr. Houtman, the commitments could have been more specific. But threat be clear that we support the request.

Still, it does raise some questions that a member should want to have a Fund program with such a strong external outlook, especially given the rationale put forward in the staff report. Indeed, there are normally who reasons why a country might request a program, usually a precautionary one, in spite of not having clear balance of payment needs. Firstly, to have a buffer in case of unforeseen turbulence in international capital markets. Secondly, to tap more easily into these markets thanks to the seal of approval given to it its economic policies by the Fund. But this should open be acceptable for a transitory period for country which is have not yet demonstrated their ability to weather an international crisis, and/or whose credit-worthiness is not well established in the eyes of market participants. However, Uruguay is fortunate enough to satisfy neither criterion.

True, the authority rationale the authorities put forward is quite different. The claim of having a new program will help them gather political momentum for fiscal tightening and structural reforms, that strategy failed under the past programs which makes one doubt it will succeed in the future, but even if it does, I'm concerned that if we start committing resource resources for a country that doesn't really need them except for internal political purposes, a number of others might be attempted to do the same. Then, unless we have clear exit strategy from precautionary standbys could end up being shout short of resources to help those monopoly members that do need our support.

Maybe the revised CCL will be an answer. As of today T seems Uruguay would not qualify for a CCL but we would appreciate the views of the staff and of the authorities as to whether or not they see the C correct L as an option when Uruguay does meet the prerequisites.

Having raised those policy issues, let me say a few words on the substance of this program. Generally agree with the staff's appraisal and policy recommendations as well as with the design of the program, and in particular, I support the strong emphasis put on the reform of the public financial sector. However, I would have liked to see among the structural requirements of the program benchmarks related to the improvement of that provision. Indeed, it appears from the staff report that Uruguay's statistical database and reporting system are well below standards for a country as developed ass it is. I imagine that the size of the errors and emissions of the balance ever payment half of the amount of the capital account is yet another consequence of that. Even all give him all the technical assistance provided this Uruguay in this field, it would seem fair to build in the program some implementation clause.

Mrs. Zádor made the following statement:

I am in broad agreement with the Staff's appraisal and support the proposed the decision. In my comment I focus on fiscal policy and banking issues.

I note with regret that Uruguay's previous precautionary Stand by program went off track basically because of fiscal slippages (the overall deficit of the public sector has reached 3.8 percent to GDP compared to the programmed 1.9 percent). In July 1999, at the occasion of Uruguay's Article IV discussion, most of the Directors felt that a partial accommodation of the recession would be appropriate for Uruguay; moreover, some Directors thought that given the deep recession, a larger fiscal deficit could be considered. Indeed, output contraction has been deeper by 1.4 percent than estimated and the overall public deficit has increased by 0.9 percent more than planned. These fiscal developments do not explain satisfactorily the suspension of the program. I would appreciate more comments by the Staff on the reasons of interrupting the previous Stand by Arrangement.

As for the present successor program, I also have some mixed feelings relating to the planned ambitious fiscal stance. In 1999, the economy suffered from severe, multiple external and internal shocks and macro policies have not played a role in these negative developments. Although the recovery is under way, it depends basically from external factors as well. I am not convinced that a strong fiscal restrain for 2000 is the key instrument in halting the increase of the external deficit or the accumulation of the public debt, which, by the way, are not alarming.

I understand that the proposed fiscal stance has been agreed with the authorities. The argumentation of the authorities in favor of a strong fiscal withdrawal is very interesting, namely that in the case of a small open economy like Uruguay the "confidence effect" tends to outweigh the "Keynesian aggregate demand effect". The opposite was also true, when the last year's fiscal "overrun" and the subsequent interruption of the IMF program did not have any negative impact on the country's good reputation. Nonresident deposits and other capital inflows have increased, the exchange rate remained stable, the access to international capital markets with low spreads and the investment grade rating has been maintained. It seems that market participants indeed anticipated and accepted the temporary widening of the deficit.

Nevertheless, I wonder if the authorities are not concerned about the short term cost effects of this ambitious fiscal scenario, and if there is no room for more supportive fiscal policies given the nascent recovery and the output well below its potential. Uruguay has pursued a practice of small but continuous fiscal adjustments in the past, but now a 2 percent improvement in the primary balance could prove unrealistic if the recovery proves slower than expected. A realistically tight next year budget would still be in harmony with the exchange rate system and would be less exposed to unrealized revenues. Fiscal slippages stemming from overoptimistic revenue plans could also undermine market confidence. I would appreciate the Staff's comments on this issue.

Beyond the generally positive trends I can see an area where more ambitious actions seem desirable. I think that priority should be given to generally improve the efficiency of the public sector and particularly that of the public banks. The authorities should move faster to reform the large state banks, whose profitability is deteriorating. The government must deal with the deeper roots of the problems. Besides portfolio problems caused by the recession, these banks suffer from excessive operating costs caused by inflexible labor conditions, serious overstaffing and special pension schemes and benefit packages.

I have doubts that the BCU (the central bank) as the supervisory authority is an appropriate agent for managing the restructuring program of the intervened public banks, and should be in charge of preparing them for re-privatization. The present practice could create serious conflicts between monetary policy and quasi-fiscal activities expose the central bank to political pressures and interference. The possible need for recapitalization of these banks could also tempt the government to use central bank money. The difficulties experienced so far in fulfilling these conflicting tasks and other countries' experiences indicate that establishing an independent supervisory authority may serve the country better. In this respect I welcome the authorities' intention to conduct a study to identify and quantify the quasi-fiscal operations in various public sector institutions and agencies with a view to limiting such operations and incorporating them into the budget. This will enhance transparency in budgetary operations, and allow economic agents better judge the actual fiscal position.

I welcome the authorities' two-year action plan to subscribe to the SDDS. This will further strengthen Uruguay's good reputation.

Finally I would like to comment the discussion emerged between the authorities and the Staff on the interpretation of the different vulnerability indicators. Uruguay's case highlights the importance of properly analyzing each country's indicators within its specific circumstances.

The issue of the so-called "other assets" of the banking sector is an evergreen problem. With the introduction of the new Reserve Template in the SDDS, there is a fact that according to the standards, these assets are not included into the definition of the Net International Reserves. Nevertheless for countries that pursue an active debt management policy or acts as a regional financial center, the importance of these other assets is far larger than in other countries. It is important that the vulnerability analysis contains both approaches and explains the differences.

I also have difficulties with the ratio of Reserves to M3 as an indicator of "the risk of a possible capital flight". In the case of Uruguay the last year events have provided a convincing example that the system has weathered the storm well. I did not find an explanation or qualification by the Staff that whether a 20 percent coverage ratio is too low for Uruguay or whether the comparator countries also have these large nonresident deposits.

Ms. Brukoff made the following statement:

This chair supports Uruguay's request for a precautionary SBA.

We applaud the new government's determination to press ahead with reform, particularly in the structural area, and hope that critical steps to put fiscal policy on a more sustainable basis and to advance structural reforms will be taken, in contrast to last year's program.

We find particularly laudable the authorities' renewed commitment to increase the transparency of financial and non-financial public sector firms, and to make more explicit the quasi-fiscal costs of these operations. A clearer public understanding of the impact these activities are having on the budget is key to building support for their eventual privatization.

Undertaking statistical and fiscal ROSC's, and a self-evaluation on adherence to Basle criteria are also commendable. It might be worth exploring the possibility of adding Uruguay to the list of countries undertaking an FSSA given the importance of the country's financial sector domestically and regionally.

Increases in Uruguay's trade restrictiveness are regrettable and highlight the difficulty faced by Mercosur's "small" members. These costs of membership need to weighed carefully against the benefits and highlight the importance for Uruguay of promoting opportunities for extra-Mercosur trade.

On exchange rate policy, we note the authorities intention to slow the rate of crawl, but would be interested in hearing more from staff and Ms. Jul about the merits of moving to a peg or a fixed band, particularly for a small, open economy such as Uruguay's that remains vulnerable to external shocks.

Mr. Kranen made the following statement:

I welcome this opportunity to discuss on the same day the successful recovery of the Brazilian economy and of the Fund-supported program and to request of Uruguay for a new stand-by arrangement. This provides an interesting opportunity to reflect on two different economic strategies at the same time. As it has taken advantage of the exchange rate instrument, however supported by a comprehensive reform package, while Uruguay in defending its crawl impact to the U.S. dollar has to rely solely on domestic adjustment to accelerate the economic recovery.

The depreciation of the real has led Brazil to overcome its severe crisis, but at the same time it also had had impact on the competitive situation of other thousand American countries especially those countries which pegged their currency to the U.S. dollar.

Insofar as it does not come as a surprise that the competitiveness of the Uruguayan economy which exports about one-third of its merchandise trade to Brazil, has been affected. Against this background, Uruguay performed relatively well over the last year, in particular given the magnitude of several external shocks. Uruguay could take advantage of its positive track record over the past ten years. The solid reputation has led to successful cooperation with the Fund.

Due to the high degree of dollarization in Uruguay, the exchange rate instrument would not provide an easy way out of the current economic difficulties. The peg to the dollar also served the country well at least in the past. A continuation of the peg policy will limit the scope of political action to fiscal and structural policy. Since we broadly agree with staff recommendations in this regard, we support the proposed decision. I would like to confine my further comments to two points. Fiscal policy and the indexation of Social Security benefits.

Regarding fiscal policy, the steep increase in the public deficit last year which turned out to be four times as high as in the previous year, leaves no option that eventual consolidation, even if it focuses mainly on the expenditure side and affects public investments. It is regrettable there is no room for further fiscal stimulus which will help the economy to gain momentum.

Regarding the indexation of Social Security benefits, we agree with staff's negative assessment on this matter. Although we understand this regulation is difficult to address, given its inclusion in the constitution as Ms. Jul pointed out in her helpful statement, there might be now a window of opportunity to try the impossible, given the difficult situation Uruguay is facing.

Mr. Chairman, coming back to the exchange rate system, we have to respect the commitment of the authorities to adhere to the current peg to the dollar. However, given the difficult current situation and the shift in the competitiveness in South America, it is not advisable to exclude a change in the exchange rate instrument totally at least in the medium future.

Mr. Chelsky made the following statement:

In case I forget in my enthusiasm to applaud the achievements of Uruguay, I support the proposed decision.

Actually a couple of small things to start. With respect to Mrs. Mateos y Lago's comment about whether or not a CCL might have been more appropriate, in fact, I think that the use of the precautionary SBA is wholly appropriate and actually has been somewhat commendable, and I'm frankly more comfortable with a precautionary arrangement rather than a CCL because of the close and regular monitoring but also the clear access limits in terms of the concerns that were raised about possible burden on Fund resources. I think the clarity of the access limits are actually a positive thing, so just quickly on that.

And also, I look forward to staff's response to Mr. Mirakhor's comments at the end of his statement on regional trade agreements and what happens when a country is joining a trade agreement that results in a net increase in its restrictiveness. I presume the reference he makes with respect to the EU has to do with Baltics.

Looking backward, I'm a little bit confused on how we get from our last discussion to our current discussion. At our last discussion, one of the points of con section was the fiscal stance, and the authorities and staff had agreed on a mildly contract year fiscal policy. At that time we knew there was increasing likelihood there would be a slow down, and a number of us argued--well, some of us argued that there actually should be a move to fiscal to fiscal stimulus this. Chair argued at very least we should take the program ceiling for the deficit and allow some room which the for thees could use or not, depending on external developments for fiscal stimulus. I think we said that, in fact, we should have provision for at least a physically neutral budget, if not a mildly stimulated one. The argument being that the authorities established their credibility, and as such we could Trust them to use that room if it was necessary for macroeconomic management, and that by not doing that, were there to be a slow down and should may to make use of fiscal stimulus, they would have to request a waiver or not complete the program.

It's regrettable that for a country with as good a track record as Uruguay that the program can't be completed. Chance chances are had we done that, the extent of fiscal slippage would have probably gone beyond what the ceiling was, but I think there may be a lesson for us looking backward in that there probably was an argument for a country that has established such credibility and responsibility in its economic management to allow them in the scope of the program that degree of discretion.

As I said, I'm not sure if that would have kept the program on track, but I think it would have been a useful contribution.

One thing that troubled me in the explanation for the extent of slippage, I understand the arguments on external developments which clearly dominate, but the timing of the election as a key factor in fiscal slippages I find a little troubling. If it is the case that the authorities have the sort of record and reputation that we have been saying they do, one would not expect an election cycle to result in slippage to any significant degree. I'm wondering if staff could shed some light on how significant that factor was. I would hope that it wasn't because if it were, it would be somewhat inconsistent with the record that has been established.

Mr. Santos made the following statement:

Let me state at the outset that we support the request for a precautionary stand-by arrangement in view of the generally sound policy performance displayed over the last few yours. However, we perceive a dichotomy between sound macroeconomic adjustment policies that allowed a strong pace of desinflation during the last decade, and lack of decisive progress in structural reforms where the agenda in the near future is still very heavy.

As we agree with the thrust of the policy recommendations, we would suggest a couple of specific comments. First, on exchange rate policy, we would have preferred a smaller pace of the depreciation in the near future.

In addition to being against this type of competitive devaluations as a matter of principle, even if to offset partially the strong appreciation occurred in 1999, we believe that a more moderate pace could be instrumental in locking inflationary expectations at a lower level and in reducing inflation, particularly in a small open economy as Uruguay.

We believe that strong cost cutting and structure reform measures would per se achieve the necessary improvements in competitiveness and economic efficiency. This strategy would place the burden of adjustment squarely on the implementation of these measures, and we know that past track record in those areas is not perfect in Uruguay. Well, maybe this is why staff takes comfort in stronger pace of depreciation in the near future.

As a final reason, we feel that in Uruguay, the external constraint in the short term is not overwhelming and subsequently it would still provide some room for a more moderate pace of depreciation of the peso.

Second point, on the growth outlook for this year, we fear that the baseline scenario may be a bit on the optimistic side. We agree with staff that exports and private investment should be the engines of growth in the short term. However, we wonder whether the delayed effect of the strong appreciation in 1999 and the high real interest rates will not put a damper on the contributions of exports and private investments to growth in the year 2000, particularly taking into consideration the environment of higher foreign interest rates.

Mr. Alosaimi made the following statement:

Uruguay is to be commended for considerable record of consistent economic performance. The recent setbacks should therefore be taken in context. The output decline on policy slippages last year were prompted by a combination of adverse external and domestic shocks. Indeed, the authorities continued policy of credibility was evident from largely unimpaired access to markets of the commitment for strong policy action to reverse the 1999 trends is also evident.

Given the soundness of the agreed policy package, I fully support the precautionary stand-by arrangement that the authorities have requested.

While I broadly agree with the staff appraisal like Mrs. July, I'm interested in staff's explanation of the apparent upward basis on the mobility indicators included nonresidents liabilities, but not nonresident assets.

Given the satisfactory levels of the broad range of indicators, the economy is evidently in a uncomfortable position on external solvency. Nonetheless, but the up trend and the debt exposure is a concern. I'm therefore encouraged by the determination to lower the debt to GDP from 2003 through a gradual evaluation of the public sector deficit.

I also welcome the commitment to make budgetary adjustments through expenditure restraints rather than additions to the tax burden.

The authorities are to be commended for the twin goals of inflation and retaining the economy's competitiveness. For lasting gains, however, the emphasis should be on improved growth potential through further structural reforms. Here like staff, I attach a great importance to the ongoing reform, and restructuring of the public enterprises and the financial system.

On trade, I join others to urge for a speedy liberalization of access to markets and the advanced centralized countries. Here like Mr. Mirakhor, would be interested in staff's views and Fund's advice for the countries related to number one, on trade restrictions that aspiring to join the European Union, which has the more restrictive ratinging of four.

With these comments, I wish the authorities success.

Mrs. Del Cid-Bonilla made the following statement:

I would also like to recognize the extremely well performance of the Uruguayan economy in the last decade. Except for the two years in which the economy suffered the negative impact of severe external shocks 1995 and 1999, output rate averaged five percent. The fiscal results is cloning reform costs literally balanced and the current account deficit was below 2 percent. During the same period, inflation was declining gradually. The consistent and sound macroeconomic management has allowed the building up of confidence in part the domestic and foreign markets. These elements combine with strong financial system, allow a strengthening of the Uruguayan external position to the accumulation of international reserves which, in 1999, were enough to cover about seven months of imports of goods and nonfactor services, more than three times the size of external interest payments, and nearly four times the current account deficit.

The describing results showed the clear commitment of the Uruguayan authorities with macroeconomic stability and reform, whose programs had been supported by stand-by arrange wills with the Fund since the early nineties. They should be commended for the continued efforts. Last year, for instance, Uruguayan authorities were able to apply an appropriate economic policy mix which helped to mitigate the effects of exogenous shocks and domestic circumstances. Even though output dropped by 3.5 percent, inflation was contained at 4 percent and the overall balance of payments result was neutral, allowing the country to keep a strong external position.

The economic program for the years 2000, 2001, prepared by the authorities, is consistent and coherent and has ingredients needed to achieve the objectives of resuming high economic growth and restoring competitiveness. While at the same time maintaining macroeconomic stability. The positive growth prospects for the other economies in Mercosur this year will also contribute to invigorate the Uruguayan economy and precautionary stand-by arrangement with the Fund will help to maintain the confidence of the private investors. In this context, I encourage the authorities to persevere in the accomplishment of this program, especially to firmly limit wage increases and government expenditures in order to consolidate the public finances, keep inflation low, and improve the efficiency and competitiveness of the economy.

It is also very important to continue with the modernization of the public sector and the strengthening of the financial system in well but consistent way. I share in general the thrust of the staff appraisal and support the request of the Uruguayan authorities for a 22 months precautionary stand-by arrangement.

Before finishing, as other Directors emphasized in their statements, I would like to insist on the new of 94 reciprocity from the centralized countries with regard to access to their markets by developing countries. As I totally shared the view expressed by Mrs. July in her statement that the removal of free trade is key element to sustained economic growth and best instrument to combat poverty. I would like the staff comments in this regard.

Mr. Belay made the following statement:

> The difficult developments of 1999 have made reform efforts in the period ahead more challenging. In this regard, the economic program in 2000 and 2001 appears to offer much promise. I support the request for a stand-by arrangement.
>
> Given its link to Brazil and Argentina, in trade and finance, Uruguay is highly vulnerable to external shocks that emanate from these countries as witnessed in 1999. While it cannot isolate itself from these shocks, the economy can become more flexible to withstand these than in the past. Broad-based reforms aimed at improving productivity and competitiveness will thus be critical.
>
> In this regard, the structural reforms envisaged in the program, including the measures to remove the monopoly status of public enterprise and to continue the reforms of Social Security system can be beneficial. I note that the Uruguayan banking system enjoys a good reputation in the region and confidence in the banking is strong. In view of the importance of maintaining an adequate financial system, for taking the country into the next and more challenging phase of its development, I therefore welcome the government's intention to pay special attention to fostering a competitive banking system.
>
> Fiscal reform is to center on the reduction of expenditure rather than on raising taxes which are already high and which have been for some time the main source of fiscal improvement, with the expectation that it would help to also contain costs and improve competitiveness. In the process, however, because of the current high unemployment and slow growth of the economy, it would appear important to minimize or avoid at best costs of growth relating expenditures such as capital outlays.
>
> With these remarks, I wish Uruguay all the success.

Ms. Kornitch made the following statement:

> Let me just make a few comments designed for the years two thousand, 2001, and I believe that it provides the necessary framework to deal with the deficiencies in the economy and to establish strong fundamentals for sustaining economic growth in the future. We have also no difficulties in supporting the authorities' request for stand-by arrangements. Now let me briefly turn to specific policy issues just for emphasis.
>
> On the fiscal policies, I would like to be associated with a view expressed by Mr. Portugal and Mr. Mori expressed in their statement, and on the structural reforms, I would like to say that strong measures are required in this area, and first reforms in the banking sector need to be deepened.

Generally, the banking system of worldwide is good and competitive in the region. However, the deficiency of the banks need to be improved and technical problems should be addressed. I high share of public sector banks and enjoy preferences compared to private banks is a matter of concern, and it is crucial to deal with this issue, and to establish equal conditions for public sector banks and private sector banks to compete in the area of banking operations.

Further efforts also needed in other structural reform areas, including known financial public enterprises and promoting transparency in both sectors, public and private sectors.

With these remarks, I wish the authorities well and support the proposed decision.

Mr. Wong made the following statement:

I would like to thank the staff for their well-written report and Ms. Jul for her comprehensive and helpful buff statement. In the past decade, the Uruguayan economy has maintained an average 3.2 percent growth in real output with single digit inflation. Uruguay was unfortunate with the adverse internal and external shocks experienced last year. The economy contracted and the fiscal position weakened considerably, but this is understandable. Overall, the Uruguayan authorities should be commended for their skillful macroeconomic management. Since I broadly agree with the staff appraisal, I would like to make only a few comments for emphasis.

On the fiscal front, it is encouraging to see the authorities' commitment to public finance consolidation and necessary tax reforms. I welcome the authorities' target of reducing the public sector deficit by more than half to 1.8 percent of GDP this year and to 1.2 percent in 2001. I commend the civil servants and labor representatives for taking the lead to accept moderate wage increases, which are important for maintaining the country's external competitiveness.

On the exchange rate, the current crawling band exchange rate system has provided a solid anchor for Uruguay. It has served the economy well. Given the strong confidence and the high degree of dollarization of the economy, the system should be maintained.

In my view, the ability of the Uruguayan economy to maintain access to international capital markets and the strong confidence in the exchange rate system are to a large extent attributable to the country's sound banking system. I welcome the continued efforts of the authorities to further strengthen the banking system by tightening prudential regulations, increasing transparency and disclosure, and restructuring the public banks. Timely and speedy efforts are crucial in this area. Banking reform is a pressing issue given the intensifying competition in the region.

Finally, I share very much the views of the authorities regarding the vulnerability indicators. Presenting the data in this manner tends to be somewhat misleading for offshore financial centers, of which the staff is also aware. I find some of the comments relating to these indicators not balanced enough. I do not know the best way to deal with this problem. Perhaps, adjustment needs to be made to allow for certain characteristics of the economy in constructing these indicators, so that they can be applied across the board to all economies. Or, at least, for economies such as Uruguay, staff could consider to present more indicators so that the report can yield a more thorough and balanced picture of the reality, e.g., presenting the ratios of international reserves with respect to broad money M3, both including and excluding foreign currency deposits by nonresidents.

With these remarks, I support the authorities' request for the standby arrangement and wish the authorities well.

Mr. Hinata made the following statement:

At this stage of the discussion, the previous speaker mentioned what I want to point out. Therefore, I will submit my statement as a record. I just state that I support the proposed decision.

The staff representative from the Western Hemisphere Department remarked that the staff agreed fully with Mr. Houtman's sentiments on the need for structural reform. However, on the issue of labor market flexibility, it had to be kept in mind that Uruguay's market was not as inflexible as some of its neighbors. The key exception was in the banking sector, where a single financial-sector union maintained an effective monopsony. The staff had argued in favor of corporatizing Uruguay's leading public entities, and had also argued that such a move should be coupled with antitrust legislation.

The staff had recommended independent audits of the public sector banks in the previous Fund-supported program, the staff representative continued. However, the international auditors had indicated to the authorities that they would require a full fiscal year for an effective review, so the relevant contracts had only been signed in 2000. The delayed audits, therefore, had not resulted from reluctance on the part of the authorities.

Responding to a question from Mr. Houtman on why the staff's recommendations had not been more forcefully incorporated into the program, perhaps as benchmarks, the staff representative remarked that the Fund, when formulating structural reform requirements, needed to take into account the circumstances and political realities of the country involved. Uruguay had a strong tradition of gradualism, and there was strong popular resistance to the idea of privatization. It was necessary, therefore, to come to a realistic assessment of what the political system would be able to endure. The staff considered that a realistic objective for the coming year would be to identify and quantify all quasi-fiscal activities of the public sector. That goal was shared enthusiastically by private sector analysts in Uruguay, and had been agreed by the authorities. Just like any other corporation, public entities would be required to provide quarterly accounts. The next step would be to introduce greater competition by ensuring that the markets served by the enterprises were contestable. That step, however, would not necessarily involve changing the mix of private/public ownership. Increased transparency and public awareness, combined with external competition, would reduce the authorities' ability to use state-owned enterprises as indirect fiscal instruments.

The measures outlined above represented a considerable acceleration in the pace of structural reform, the staff representative remarked. It was important to keep in mind that a more ambitious list of structural reforms might be counterproductive, as a failure to implement such a list might set back the overall reform process. For example, in 1992, the authorities had been urged to privatize the telecommunications company. However, that measure had been soundly defeated in a national referendum, and since then, the plan had not resurfaced. In the staff's judgement—and in light of extensive discussions with the private sector, the government, and the opposition—the current list of reforms was feasible and represented a significant step forward.

There had been a question of whether Uruguay actually needed a Stand-By Arrangement in 2000, the staff representative said. He recalled that, during the Russian crisis in 1998, Uruguay's access to international capital had dried up quickly, and had remained thin for a number of months. In that period, the authorities had made a single drawing under their Stand-By Arrangement. Arguably, such arrangements were designed to address precisely that type of circumstance. As for the current environment, if events unfolded as planned, it was not expected that Uruguay would need support from the Fund. However, the authorities' experience suggested that market sentiments often moved quickly and without warning, and that a precautionary facility might be valuable.

There were also a number of other benefits of a Fund-supported program, the staff representative commented. The authorities had claimed that the Fund's endorsement had helped generate valuable political support for the reform process. Furthermore, Uruguay's economic administrative capacity was somewhat limited, so close contact with the Fund provided valuable expertise and a broader international perspective.

As for the authorities' subscription to the Special Data Dissemination Standard (SDDS), they did not want to place data on the Fund website before they were fully satisfied as to its quality, the staff representative noted. However, the staff considered that, with technical assistance, the authorities would be ready to subscribe within two years.

On the question about the "errors and omissions" item in Uruguay's balance of payments, Uruguay was a relatively open country with no capital account restrictions, the staff representative commented. A large number of citizens of neighboring countries owned real estate in the country, which often involved tax payments and service costs. The authorities were unable to measure those payments accurately, so the balance of payments typically had a positive component in the errors and omissions item. Over time, household surveys allowed the authorities to estimate the current account more accurately, increasing the size of the net service exports entry, and reducing the errors and omissions item.

Ms. Mateos y Lago noted that the reasons for the authorities' request for a Stand-By Arrangement would probably not change. She asked, therefore, whether the authorities would be likely to request yet another arrangement in 22 months.

The Acting Chairman pointed out that it was difficult for the staff to comment on the future policy decisions of the authorities.

The staff representative from the Western Hemisphere Department remarked that, by end-2001, the authorities would have subscribed to the SDDS, and the economic environment was likely to be more favorable. Beyond that, however, it was difficult to form a judgement on behalf of the authorities as to whether they would want a further arrangement.

On the issue of fiscal policy, Directors seemed to have different views as to whether the authorities' policy was too tight or too loose, the staff representative remarked. The staff had encountered a similar range of views during their discussion in Uruguay. The private sector, in particular, had been concerned about the size of the 1999 deficit, and had argued in favor of a steep reduction to boost investor confidence. Others had argued that much of the deficit in 1999 had been the result of one-off spending items that would not recur in the future. The staff had estimated Uruguay's structural fiscal balance, which suggested that the authorities should aim to reduce the deficit to below 1 percent of GDP. The question then arose as to whether that reduction should be achieved over the short term, medium term , or long term. The view of the authorities was that an immediate target of 1.8 percent was appropriate, and the staff considered that such a move was a suitable compromise between the need to boost confidence and the need to sustain Uruguay's recovery.

The staff were encouraging the authorities to participate in the Financial Sector Assessment Program (FSAP) and to prepare a Financial Sector Stability Assessment (FSSA), the staff representative noted. However, the timeframe for such a move was somewhat uncertain, as it would require considerable human resources from both the authorities and the

Fund. On the issue of Uruguay's medium-term exchange rate policy, during discussions with a country's authorities, the staff typically did not propose any specific exchange rate regime. Instead, they asked the authorities to first outline their medium-term intentions. The staff then commented on what regimes were consistent with the authorities' overall macroeconomic and structural policies. Uruguay had a highly dollarized economy, and many in the banking and business sectors were concerned that large swings in the exchange rate could have unfortunate implications for the health of the financial system. Therefore, it seemed that, over the medium term, the authorities would tend to a more fixed exchange rate. Their key challenge, however, was that they were placed between two large neighbors, one of which was rigidly pegged to the U.S. dollar, the other of which maintained a freely floating rate. Uruguay's current arrangement was a compromise—though significantly coordinated with the fixed regime of Argentine, it still allowed some flexibility to respond to external shocks.

The previous program had been revised in mid-year following the depreciation of the Brazilian real, the staff representative commented. The revision had allowed for the operation of the economy's automatic stabilizers, and had been intended to be cyclically neutral. However, the revision had not anticipated Uruguay's terms of trade loss, which was 8 percent in the merchandise area, nor had it anticipated the drought. Those developments had reduced income in Uruguay, impacting government revenue and contributing to the increase in Uruguay's fiscal deficit. As for the current program, although the growth assumptions were subject to some risks, Uruguay's external environment seemed promising—Brazil and Argentina were performing well. Although growth had picked up in Uruguay during the fourth quarter of 1999, activity in the first quarter of 2000 had been less buoyant. Still, the staff considered that the program was essentially on track, though much would depend on developments in the second half of the year.

On the issue of Uruguay's vulnerability indicators, it was true that nonresident deposits were included, whereas the foreign assets held by the banking system to offset those deposit liabilities were not, the staff representative observed. However, even if those assets were taken into account, the ratio of foreign assets to liabilities would still be about 90 percent. That was not an overly worrying figure, but there was still no cause for complacency. The corresponding figures in other countries were often higher. Still, it was difficult to arrive at a conclusive assessment in the case of a country with a significant offshore financial sector, and that was why the staff report had included a wide range of indicators. It also had be kept in mind that market adjustments of assets and liabilities were often non-linear, so that the banks might not be able to liquidate their assets easily to meet a change in depositor sentiment. Therefore, the staff's overall assessment was that, notwithstanding the foreign assets held by the banking system, some uncertainty still remained. Moreover, any assessment had to take into account the fact that Uruguay's banking system was becoming less and less competitive.

On the issue of trade policy, the staff was not well placed to discuss regional trade matters with the authorities, the staff representative remarked. Instead, the staff tended to look at a country individually, gauging the impact of any regional arrangements on that country's economy. Without making any judgement on Mercosur's common automobile policy, the decision to raise the common external tariff was clearly not beneficial for Uruguay, as it would raise costs and hamper competitiveness.

The staff representative from the Policy Development and Review Department noted that the Fund had no jurisdiction on trade matters, as such issues fell within the purview of the World Trade Organization (WTO). The Fund had been granted some jurisdiction in June 1974, but only over trade restrictions implemented for balance of payments purposes. That move had been the result of the first oil price shock. However, in the case of regional trade arrangements, the Fund tired to urge the countries involved to move to the most liberal system possible. In cases where participation in a regional arrangement required that an individual member adopt more restrictive policies, the Fund worked bilaterally with each participant to discuss the full implications of their actions. In the current circumstances, the issue of the automobile tariff had been taken up with the authorities of Brazil and Argentina.

It had to be noted, however, that Uruguay's transition from a liberalized trade rating of "1," to a rating of "2," was not too worrying, the staff representative continued. Moreover, the trade index gave a high weight to non-trade barriers, which was why the European Union had a rating of "4." On the question of whether industrialized countries might be urged to open their economies further to foreign exports, that was a continuing topic of discussion between the Fund and its industrial members—in the European context, trade policy would be a component of the Fund's forthcoming consultation with the European Union.

Mr. Chelsky observed that Mr. Mirakhor's point had not concerned the issue of jurisdiction. Instead, it had concerned the issue of equal treatment of the Fund's membership. The staff had been somewhat explicit in recommending that Uruguay not agree to raise the tariff on automobiles. However, they had been silent in the case of the Baltic countries, who were considering membership of the European Union, even though EU membership would entail more restrictive trade policies. That was not to say that those countries should not join the Union. Rather, given the Fund's policy of promoting trade liberalization, if it appeared that some members were moving in the opposite direction, the institution should draw attention to that fact and take the opportunity to discuss with them the broader implications of their actions.

Mr. Mirakhor reiterated the importance of maintaining uniformity of treatment across the Fund's membership—it did appear that the staff's treatment of Uruguay had been somewhat different to that of the Baltic countries. On the issue of jurisdiction, although formal jurisdiction on trade matters had been given to the WTO, the Fund's Articles of Agreement contained numerous exhortations in favor of free and liberal trade. In that light, the Fund did not require legal jurisdiction to comment on the issue, or to urge its membership to adopt more liberal policies. In the particular case of a country wanting to join a regional trade agreement, where that agreement would entail a more restrictive policy stance, the Fund's current approach seemed somewhat inconsistent. That was a policy issue that might be discussed in more detail at a future meeting.

The Acting Chairman thanked Mr. Mirakhor for his comments, and noted that the issue at hand was somewhat complex. Formal jurisdiction on trade matters lay with the

WTO, but it was also the case that the Fund's Articles of Agreement provided an implicit mandate in that area. Moreover, the recent Spring meeting of the International Monetary and Financial Committee (IMFC) had explicitly raised the issue of trade liberalization.

Mrs. Jul made the following concluding statement:

I would like to thank Directors for their support of Uruguay's request for a Stand-By Arrangement, and for their comments and suggestions. I will convey the issues raised to my authorities. I would also like to thank the staff for their report, and for their excellent responses. They covered most of the main issues that I wanted to raise, so I will just mention two or three points for further emphasis.

Regarding the authorities' commitment to structural reforms, judging Uruguay's commitment on the basis of last year's performance is not entirely appropriate. That was an election year—this is not to say that the authorities' actions were driven by political considerations, but it has to be kept in mind that the elections foreshadowed the end of a government, which creates particular problems in a consensus-based society like Uruguay. In addition. when we consider the fact that there were several rounds of elections, that creates difficulties in implementation. Furthermore, when we also take into account last year's sharp recession, we can understand that 1999 was not really the best environment to push for rapid reform. However, this year, the situation has changed significantly. There is a new government in office starting May 1st; the economy is recovering; and the authorities have expressed their firm commitment to reinvigorate the implementation of structural reforms, as stated in the staff report and the Letter of Intent. In this context, the World Bank loan in support of financial system reform is very important, and that process is moving ahead. We have already seen contracts given to external auditing firms for the two public banks.

I would also like to emphasize the staff's comments on the need to consider the particular characteristics of a country, the way it operates, and the implications for conditionality and ownership. This is probably a key example in which ownership is very important. Uruguay's implementation record over the past ten years has been admirable, and although, from a technical point of view, we might want to see more rapid progress, if that comes at the expense of losing ownership, then perhaps the tradeoff is unadvisable.

As for the question of why Uruguay might need continuing precautionary arrangements, given the fact that the two usual conditions for an arrangement have not been satisfied, I thank the staff for recalling the disbursement to Uruguay in 1998. During that period, the arrangement operated exactly as a precautionary arrangement should. The purchase had not been anticipated, but the resources were available, and they helped the authorities avoid having to access a turbulent, expensive capital market—a market which may have dried up at a crucial juncture. In that sense, the arrangement served a valuable purpose, and in the present environment we cannot rule out the possibility of such events happening again. That is why the current precautionary arrangement is important for Uruguay.

As for trade policy, my authorities want to emphasize the temporary nature of the 3 percent import surcharge, which is scheduled for removal on 31 December, 2000. The authorities have indicated firmly that the surcharge will be eliminated. Regarding Mr. Chelsky's suggestion on a mechanism that would provide space for countercyclical fiscal policy, that is an issue that deserves further attention. I would be interested in taking the matter up in the context of a discussion on conditionality. I would like to also answer his remarks on the relationship between the fiscal slippages and the elections. Obviously if those slippages were for electoral or political reasons, then we might be concerned about the authorities' commitment to the program's policies. However, I would characterize the effect of the election somewhat differently. There were more rounds of elections than had been anticipated, including a second round for the presidential election. This created greater uncertainty than had been expected, and helped deepen the recession by dampening private investment, which contracted by 23 percent in real terms last year. That not only affected revenues, relative to what had been envisaged in the program, but also probably made necessary countercyclical efforts in certain areas.

I think the staff has answered very well Directors' questions on Uruguay's exchange rate policy. That policy has served the country very well. I do not share the concerns of those who want to use exchange rate policy to put a floor on inflationary expectations—despite an inflation rate of 7.5 percent for a couple of years in a row, we have seen inflation brought down to about 4 percent last year. It is true that this was in the context of a recession, and was helped by the lowering of some import prices and the devaluation of the *real*, but at the same time the current exchange regime allows an appropriate compromise between the two regimes of Uruguay's neighbors. So, I do not think the exchange rate policy has caused problems.

My final comment concerns the indexation of Social Security benefits to wages. I think in that, in a consensus-based society, it is impossible to think of a change. That is why we have emphasized the need for moderate income policies, as it is important to avoid the potential fiscal effects, via Social Security benefits, of an inappropriate increase in wages.

The Acting Chairman made the following summing up:

Executive Directors approved the Uruguayan authorities' request for a stand-by arrangement. They noted that 1999 had been a difficult year for Uruguay, but that the economy was now emerging from the recession. In what promised still to be a challenging year, Directors generally welcomed the suitably ambitious policies envisaged in the program. In view of the limited progress in the structural area during 1999, Directors attached particular importance to strengthening the momentum of this reforms in the coming year. These will need to be implemented decisively to place Uruguay in a favorable position as the regional economic recovery gains strength.

Directors welcomed the authorities' overall cautious economic policies, and given the high degree of dollarization of the economy, they agreed that the focus of the economic management needed to be on fiscal and incomes policies. Directors said that the immediate challenge for Uruguay would be to bolster further competitiveness of the economy to assist in the recovery of output and employment.

Directors viewed the fiscal objectives for the economic program as striking an appropriate balance between the need to solidify confidence and assure a gradual turnaround in the mediaum-term debt indicators, and the need to allow the incipient economic recovery to build further strength. Directors were especially supportive of the authorities' intention to focus their efforts on expenditure restraint which, in due course, would offer opportunities for tax cuts--especially where the taxes are most distortive--to support lower output costs in the economy. Directors noted that such efforts would need to be sustained over the medium term and encouraged the authorities to formalize them in the Government's five-year budget proposal that will be sent to Congress in August of this year.

Consistent with the efforts at cost control in the economy, Directors strongly supported the restrained incomes policies envisaged in the program.

Several Directors noted that, while Uruguay's banking system enjoys a sound reputation in the Mercosur region, its competitive advantags have been gradually eroding because of the faster moving reforms and increasing monetary stability in the neighboring countries. Directors welcomed the efforts to lower costs in the public banks, to resolve the long-standing problem of intervening banks, to improve disclosure by banks, and the initiatives underway in the context of the World Bank FSAL. Nevertheless, the banking sector has experienced some weakening during the recession, the cost structure remains relatively high, and there has been little progress in improving labor relations. Directors stressed, therefore, that this is an area where the authorities would need to be more expeditious with reforms. The importance of pressing ahead with the privatization of the state-owned banks was also stressed.

Most Directors generally supported the maintenance of the crawling band exchange regime which has served Uruguay well. Noting the authorities' intention to bring the rate of crawl down further in the medium term, together with and in support of efforts to bring inflation down to industrial country levels, they stressed that such efforts would continue to need support from restrained fiscal policy, structural reform, and product and labor market flexibility.

Directors supported the structural reform efforts envisaged in the program, focused on enhancing transparency and disclosure in many areas and activities of the public sector, increasing competition in markets now reserved for the public enterprises, and strengthening the financial system. It was noted that these efforts need to be buttressed further by providing timely data on the economy and welcomed the authorities' intention to subscribe to the SDDS.

The Executive Board took the following decision:

1. Uruguay has requested a Stand-By Arrangement in an amount equivalent to SDR 150 million for a period of 22 months from May 31, 2000.

2. The Fund approves the Stand-By Arrangement set forth in EBS/00/76, Supplement 2.

Decision No. 12202-(00/54), adopted
May 31, 2000

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/00/53 (5/24/00) and EBM/00/54 (5/31/00)

4. SDR DEPARTMENT—DESIGNATION PLAN FOR JUNE–AUGUST 2000

The Executive Board approves the designation plan for the quarterly period June–August as set out in EBS/00/89.

Decision No. 12203-(00/54) S, adopted
May 24, 2000

5. FINANCIAL TRANSACTIONS PLAN FOR JUNE–AUGUST 2000

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/00/88, paragraph 7, and the financial transactions plan for the period June–August 2000 as set out in EBS/00/88.

Decision No. 12204-(00/54), adopted
May 24, 2000

6. RELEASE OF INFORMATION—FINANCIAL SECTOR ASSESSMENT PROGRAM AND BANK-FUND COLLABORATION IN STRENGTHENING FINANCIAL SYSTEMS

The Executive Board approves the release of the staff papers on the financial sector assessment program and on Bank-Fund collaboration in strengthening financial systems as set forth in EBD/00/39, Supplement 1 (5/17/00).

Adopted May 24, 2000

7. 2000 ANNUAL MEETING—EXECUTIVE BOARD—REPRESENTATION EXPENSES

The Executive Board approves the representation expenses at the time of the 2000 Annual Meetings as set out in EBAM/00/73 (5/24/00).

Adopted May 30, 2000

8. 2000 ANNUAL MEETING—EXECUTIVE BOARD—TRAVEL ARRANGEMENTS

The Executive Board approves the recommendation of the Committee on Executive Board Administrative Matters concerning travel arrangements for the 2000 Annual Meeting as set forth in EBAM/00/76 (5/25/00).

Adopted May 30, 2000

9. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director, by an Advisor to Executive Director, and by an Assistant to Executive Director as set forth in EBAM/00/75 (5/25/00) is approved.

APPROVAL: March 2, 2001

SHAILENDRA J. ANJARIA
Secretary