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INTERNATIONAL MONETARY FUND <sup>D404</sup>

Minutes of Executive Board Meeting 91/124

10:00 a.m., September 16, 1991

M. Camdessus, Chairman

Executive Directors

Che P.

J. E. Ismael  
A. Kafka  
J.-P. Landau

G. A. Posthumus

A. Torres  
A. Végh

Alternate Executive Directors

A. A. Al-Tuwaijri  
A. Raza, Temporary  
Zhang Z.  
Duan J., Temporary  
D. Powell, Temporary  
Q. M. Krosby  
S. B. Creane, Temporary  
M. E. Hansen, Temporary  
J. Prader  
Y.-H. Lee, Temporary  
A. Giustiniani, Temporary  
T. S. Allouba, Temporary  
I. Fridriksson  
M. Nakagawa, Temporary  
B. Esdar  
S. von Stenglin, Temporary

P. Bonzom, Temporary  
O. Kabbaj  
L. J. Mwananshiku  
P. Wright  
C. J. Jarvis, Temporary

Y.-M. T. Koissy  
E. Martínez-Alas, Temporary  
A. G. Zoccali

L. Van Houtven, Secretary and Counsellor  
K. S. Friedman, Assistant

1.	Executive Director . . . . .	Page 3
2.	Albania - Membership - Committee . . . . .	Page 3
3.	Uruguay - 1991 Article IV Consultation . . . . .	Page 3
4.	Belize - 1991 Article IV Consultation . . . . .	Page 30
5.	Approval of Minutes . . . . .	Page 39
6.	Executive Board Travel . . . . .	Page 39

Also Present

IBRD: P. Beckerman, H. L. Nissenbaum, and C. Scoseria, Latin America and the Caribbean Regional Office. European Department: U Dell' Anno. Exchange and Trade Relations Department: B. C. Stuart. Legal Department: J. M. Ogoola. Treasurer's Department: M. P. Blackwell. Western Hemisphere Department: M. Caiola, Deputy Director; L. M. Cardemil, L. E. DeMilner, G. García, P. Neuhaus, L. L. Perez, J. R. Rosales, M. A. Savastano, S. T. Stephens, L. M. Valdivieso, A. M. Wolfe. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: L. E. Breuer, C. D. Cuong, A. Gronn. Assistants to Executive Directors: J. R. N. Almeida, T. P. Enger, H. Golriz, G. Lindsay-Nanton, R. Meron, L. J. Morelli, S. Rouai, P. L. Rubianes, A. Schubert.

1. EXECUTIVE DIRECTOR

The Chairman welcomed Mr. Che Peiqin as Executive Director for China.

2. ALBANIA - MEMBERSHIP - COMMITTEE

The Chairman proposed the establishment of a membership committee to consider the staff paper on the calculation of a quota for the Republic of Albania and to recommend to the Board a quota for Albania and the terms and conditions for Albania's membership in the Fund.

The Executive Board took the following decision:

The Executive Board, under Rule D-1, decides to establish a committee to proceed with the formal investigation, to obtain all relevant information, and to discuss with the Government of Albania any matters relating to its application for membership in the Fund. The Committee shall consist of Mr. Végh, Chairman; Mr. Al-Jasser, Mr. Arora, Mr. Dawson, Mr. Filosa, Mr. Monyake, and Mr. Posthumus.

Adopted September 16, 1991

3. URUGUAY - 1991 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1991 Article IV consultation with Uruguay (SM/91/168, 8/20/91; and Cor. 1, 9/4/91). They also had before them a background paper on recent economic developments in Uruguay (SM/91/183, 9/5/91)

Mr. Végh made the following statement:

The staff papers provide a comprehensive analysis of the recent economic and financial evolution in Uruguay. I am basically in agreement with this analysis and with the policy recommendations. I will only make a few supplementary remarks for emphasis and provide additional information on recent trends for some of the main variables in the first half of 1991.

Conventional wisdom of most observers of the Uruguayan economy, both in the country and abroad, holds that the last few years have been a period of economic stagnation in Uruguay, and that this situation continues in 1991 or, worse, that the country is moving into a recession. Support for this view cannot be found in the relevant statistical information. Take for example the five-year period 1986-1990. Over that period the economy expanded by almost one fifth, as shown in Table 1 on page 4 of the

background paper, or by about 3 1/2 percent a year--not a bad performance considering that, because of Uruguay's low rate of population growth (about one half of one percent a year, close to European levels), per capita income grew by some 3 percent over that same five-year period.

As for the recession in 1991, it is equally difficult to justify such a view. In the first half of the year, unemployment declined, although at a slow pace. More significantly, in my opinion, is the factual evidence relating to the evolution of foreign trade, which represents a very useful indicator (at times contemporaneous and at times leading) of economic activity. Notwithstanding a substantial decline in realized export prices, export performance in the first half of 1991 has been satisfactory, and receipts from tourism increased. At the same time, imports rose by almost one fifth to \$751 million, compared with the level of the same period last year. Moreover, on closer inspection, the composition of imports also suggests some buoyancy in economic activity. Among import components, consumer goods rose by almost a third and capital goods by more than 55 percent. These trends appear to be related to the strong surge in tourism just mentioned, and to a pickup in construction activity. Substantial inflows of private capital also have been recorded. These figures are difficult to reconcile with the notion that Uruguay is experiencing a recession or that output and income are stagnant.

As regards the public finances, the overall public sector deficit declined from 7.6 percent of GDP in 1989 to 3.1 percent of GDP in 1990, and the present projection for 1991, which takes into account the fiscal outcome during the first half of the year, is of the order of 1.7 percent of GDP. Of the expected improvement in this year's overall fiscal balance, 0.3 percent corresponds to the effect of the debt reduction package that was concluded in February 1991. The remainder can be attributed to a small decline in expenditure and a significant increase in treasury revenue.

As the staff report points out, Uruguay's balance of payments situation is comfortable. In the first half of 1991, a small decline in exports and a large increase in imports shifted the trade account from a surplus to a deficit position. Within the current account, the unfavorable trade balance is largely compensated by an unusually strong performance of tourism, which, given the present regional circumstances, is expected to continue in 1991/92. This is even more apparent when looking at the result of the overall balance of payments because of exceptional private capital inflows in the first half of 1991, equivalent to around 10 percent of GDP on an annual basis. It should be pointed out that, because of the modality of calculating this item, as a

residual element of international payments, the total figure corresponds only in part to capital inflows; the rest corresponds to purchases of goods by nonresidents, which are equivalent to nonregistered exports. In any event, these elements contribute to the strength of the balance of payments position.

Under the Brady initiative, on January 31, 1991 Uruguay signed an agreement with its commercial bank creditors on a debt and debt-service reduction plan that covered all indebtedness under the previous refinancing agreement (MYRA) of March 1988 amounting to \$1.6 billion. The package included three options: a debt buy-back at pre-announced price; par debt exchanges with interest reduction; and new money.

The transactions with the banks were completed in February 1991, and the cash expenditure associated with the buy-back element of the package (\$463 million) was partially financed by the new money component of the agreement (\$89 million) and the first purchase under the stand-by arrangement with the Fund approved on December 12, 1990 (\$9 million). The rest of the cost was financed by a draw-down of liquid international reserves of the central bank and by proceeds of gold swaps. As a consequence of these transactions, the net international reserves of the Central Bank have declined by a significant proportion. It is the intention of the monetary authorities to replenish these reserves in the near future to a level that is compatible with the increased volume of imports so as to maintain the traditional ratio of reserves to imports, and a high proportion of total reserves in the form of gold holdings, which is the policy choice of the Government. A relatively high level of international reserves has been found to be very useful in times of financial crises of domestic or external origin. Moreover, their existence has facilitated the successful conclusion of financial arrangements with commercial creditors. Also, by enhancing the country's creditworthiness, the reserve position has reduced the interest cost of government debt instruments. In this context, it is worth mentioning that, at the present time, the Uruguayan Treasury is issuing short-term bills with a yield only slightly above LIBOR.

Exchange rate policy, changes in international reserves, and the level of external debt-service payments have a strong influence upon monetary conditions and, therefore, on the rate of inflation. This would be true in any case, but it is especially valid in the Uruguayan context, in which domestic currency is only a small proportion of total money in circulation. Uruguay is a typical case of a "dual-currency system" with a preferred currency, the U.S. dollar, and a residual currency, the Uruguayan peso. In these circumstances, and in the absence of a credible fixed rate of exchange between the two currencies, portfolio

decisions by the public result in what Professor Friedrich von Hayek observed many years ago, the opposite of what is expected under Gresham's law, and so the strong currency displaces the weak currency. Thus, in the present circumstances of Uruguay, 90 per cent of all bank deposits are held in U.S. dollars.

Under the conditions that have been described, the monetary base in domestic currency is exceptionally small, since it is the preferred currency, that is, the U.S. dollar, that satisfies the demand for money as a unit of account, a store of value, and even, to a large extent, the means of payment for transactions in real estate, cars, durable goods, and even more minor transactions. In the last few years, the dollar value of the monetary base in domestic currency has oscillated between \$300-350 million, which is only about 3-4 percent of GDP. With such a small monetary base, the inflationary impact of any purchase of U.S. dollars by the Central Bank (either for payment of interest on the external public debt or for a further accumulation of reserves, which is just another form of public expenditure) is quite large. Consider, for instance, that in a 12-month period net external payments of \$200 million plus a similar amount attributable to an increase in international reserves expand the supply of domestic currency by more than 100 percent of the initial stock. In the absence of a similar increase in the demand for domestic currency, a development which there is no reason to expect, this should result in a rate of inflation of at least 100 percent during the same time period.

This dilemma is also faced in cases in which real exchange rate targeting is the rule. As I have argued in the Executive Board on the occasion of a general discussion of exchange rate policy, real exchange rate targeting may be neither desirable--because of the almost impossible task of estimating at each moment what the equilibrium rate should be--nor feasible, because the policy may in actual practice be self-defeating, since with each purchase of U.S. dollars by the Central Bank, the demand for foreign currency is increased, and with it the nominal rate of exchange. But by simultaneously expanding the supply of domestic currency, the monetary authority may be increasing more than proportionately the level of domestic prices and, therefore, depressing the real exchange rate. If the change is exactly proportional, then we are left with the same initial real exchange rate and higher inflation.

The improvement in fiscal performance provides the fundamental conditions under which a severe anti-inflationary effort could be undertaken. But as I argued, this effort would require a hard currency policy of some kind and the abandonment of the present policy. My authorities are at present examining these new

options and agree with the staff that before such a decision is taken, a further strengthening of public finances would be required in an order of magnitude of 1-1.5 percent of GDP. For that purpose, the Administration has called for a joint effort with the opposition parties to agree on a major reform of the social security system, which would make it self-sustainable in the long run and also provide some relief for the treasury accounts in the short run. It is expected that significant progress will be made in this area before the end of the year.

Mr. Kafka made the following statement:

The Uruguayan authorities have made significant progress in basic areas of macroeconomic management. The combined (financial and nonfinancial) fiscal deficit was reduced from 7.6 percent of GDP in 1989 to 3.6 percent in 1990, and, according to Mr. Végh's statement, it should come down to around 1.7 percent in 1991. The balance of payments is basically sound. Current account surpluses have come about in 1988-91, and moderate deficits are expected in the coming years that can be comfortably sustained by projected capital inflows, sufficient to permit also a buildup of international reserves. In the area of monetary policy, the authorities' capacity to maintain control over credit has been enhanced by measures expected to limit the somewhat erratic behavior of the Bank of the Republic (BROU).

Nevertheless, and despite these achievements, inflation remains stubbornly high. Consumer prices rose by 37 percent in the first six months of 1991 compared with a target of 30 percent for the whole year. As the staff points out, fiscal and monetary policies have not been the underlying cause. Rather, price behavior is being fueled by wage agreements and by developments in neighboring countries.

The authorities, being fully conscious of the problems created by full wage indexation, have tried to induce wage agreements tied to expected rather than to past inflation. The fact that they have not been successful in this endeavor highlights the difficulties of changing entrenched behavioral patterns in this area. The staff is right to point out the "difficulty of reducing inflation under a policy aimed at restoring past levels of real wages through nominal wage increases." But as I just mentioned, the authorities seem well aware of this fact. What needs to be devised are ways to implement forward-looking wage adjustment mechanisms that do not reduce real wages excessively. "Social pacts," as those undertaken in recent years by Mexico, or before by Israel, seem to be a way, when the fundamentals are in place, as is the case in Uruguay. And there are perhaps other

approaches. In any event, we believe that in this area there is much to be learned regarding the mechanics, and that further research by Fund staff could go a long way in improving the applicability of Fund advice regarding wage adjustments geared towards disinflation when inflation itself is high.

Regarding external factors, particularly developments in large neighboring countries influencing domestic price behavior, Uruguay's dilemma is a difficult one. By floating their currency in a managed fashion the authorities avoid a rapid loss of competitiveness vis-à-vis non-neighbors when the currencies of large neighbors appreciate. But by doing so, they enhance domestic inflation. Exchange rate stability in these large neighboring countries would obviously help; but barring this outcome, we tend to believe that the authorities' approach has been the best possible response to the circumstances given Uruguay's characteristics of a small open economy.

Finally, we welcome Uruguay's agreement on debt and debt-service reduction with commercial creditors. The importance of this outcome is underlined by the fact that it is expected to yield savings in interest expenditures amounting to about 0.3 percent of GDP per year, and to lower the debt/GDP ratio by 4 percentage points of GDP. Given Uruguay's low savings ratio, these resources, together with those that should result from further fiscal adjustment, can go a long way in improving the possibilities of increasing the investment ratio over time, with its expected influence on long-term growth. We wish the authorities well in their future endeavors.

Mrs. Hansen made the following statement:

As we are in broad agreement with the staff's analysis, my remarks can be fairly brief. We welcome Uruguay's progress in a number of areas, notably on fiscal consolidation, improvements in the conduct of monetary policy, and the conclusion of an agreement with commercial banks. Nevertheless, we are disappointed with Uruguay's performance on inflation, though we recognize that not all of the contributing factors are within the authorities' immediate control. This being the case, however, the only effective course of action will be for the authorities to pursue all the more vigorously those avenues which are available for reducing inflationary pressures--that is to say, appropriately restrictive fiscal, credit, and incomes policies.

On fiscal policy, we note that there has been a dramatic improvement in public finances since 1989, when the overall public sector deficit climbed to 7.6 percent of GDP. Nevertheless, we



share the staff's doubts as to whether the authorities' revised 1991 fiscal objective, an overall public sector deficit of 2.4 percent of GDP, can be met without additional measures. The authorities' revised projection of March seems to count on a significant decline in the quasi-fiscal losses of the Central Bank, yet it is not clear from the staff report why the quasi-fiscal losses are expected to decline so dramatically from the levels of years past. Mr. Végh's statement, however, seems to suggest that the fiscal outturn for the year will be significantly lower than even the March projection. If so, this would be a welcome development. Can the staff confirm that the deficit is indeed heading down to this extent?

On incomes policy, we agree with the staff that the current backward-looking wage indexation system is fueling inflation. As difficult as it may be, there seems to be little alternative but to build the necessary political consensus to return to a forward-looking system based on expected inflation. Better control over public sector wage growth would not only help set a good example for private sector wage determination, but also help limit the need for public sector tariff adjustments that contribute to inflation.

The conduct of monetary policy has some obvious handicaps having to do with the fact that the Bank of the Republic is only gradually becoming subject to the same regulation as other banks and with the fact that foreign currency deposits represent such a large proportion of the money supply. As for the former, the agreement to bring the Bank under central bank control represents a tremendous break-through for monetary policy. We hope that the authorities will persevere in applying the normal reserve requirements and other regulation necessary to bring the Bank under control.

The foreign currency deposits are perhaps a more difficult matter. The basic remedy must be to pursue sounder policies that give residents the confidence to hold local currency. In the meantime, however, we agree that the authorities need to stand ready to sterilize such inflows. It would also be advisable to remove the incentive for borrowing in foreign currency by subjecting foreign currency deposits to the same reserve requirements as those in local currency.

With regard to the exchange rate policy, we agree with the staff that, in the current circumstances, the authorities' policy of managing the exchange rate so as to avoid any significant loss of competitiveness is appropriate. However, we would prefer to see Uruguay maintaining competitiveness through sound policies, and we urge the authorities to continue working in this direction.

In closing, we would like to welcome Uruguay's agreement with commercial banks, which provides for substantial reductions in the stock of debt outstanding and in interest costs. Nevertheless, to benefit fully from the relief that this agreement provides, Uruguay needs to adhere to more consistently restrictive fiscal and monetary policies, and a forward-looking incomes policy that will lessen inflationary pressures. In this connection, we hope that the ongoing discussions with the Fund will help define the policies necessary to bring about a lasting reduction in inflation.

Mr. Landau made the following statement:

Uruguay's economic situation progressed markedly over the last few years, and especially in 1990, when the current account surplus and reserves reached, respectively, 3 percent of GDP and 4.9 months of imports. The public sector deficit was reduced by half to 3.6 percent of GDP due to a rise in revenues and a decline in expenditures. In addition, most debt-related indicators showed continued improvement.

These positive results owed much to the program adopted and the measures taken by the new Administration. In this context, Uruguay was able to reach agreements with both the Fund and creditor banks. The debt package defined with the latter could result in a 9 percent reduction of total public external debt. For the future, the staff's baseline scenario clearly shows that the continuation of these trends and policies could have led to both a viable balance of payments and strengthened growth.

However, over the past few months, inflation has surged and targets under the stand-by arrangement, in particular those concerning the public deficit, have not been met. These slippages were due to external--specifically, regional--developments, to which a country like Uruguay is understandably very sensitive. But there is also a need for a return to more restrained policies in order to preserve and consolidate the gains already registered.

Some recent trends have been positive: tax collections were in line with the program in 1990; and there have been timely adjustments in the prices of public enterprises and full pass-through of increases in oil prices. However, the increases in public wages, the extension of tax exemptions, and the only partial compensation of increases in social expenditures can be a cause for some concern. This is also true of the delay imposed on the taxation reform. On this particular point, I would appreciate comments from the staff on the rationale for the recent proposals not including the introduction of a personal income tax. In this

context, and in order to further enhance the credibility of economic policy, it seems essential that the authorities stick to the new deficit objective even if this means the implementation of additional measures.

As far as monetary policy is concerned, the authorities have taken useful measures, such as increasing the control of the Central Bank over the large Bank of the Republic, or returning to positive real interest rates in 1990, for the first time since 1987. But, owing to a number of factors, inter alia, the already mentioned fiscal slippages, inflation has now reached three-digit figures. Moreover, the dollarization of the economy has increased, partly because of disincentives to deposits in local currency. In this context, it would be essential to re-establish real interest rates on deposits at a positive level.

In consideration of the strong position of the current account, and considering both the high level of inflation and the unpredictability of capital movements from neighboring countries, I wonder whether a greater dose of stability could not be introduced in the exchange rate policy as far as neighboring countries are concerned. This could probably also be of some help in the process of regional integration in which Uruguay is engaged. In this area, I simply wish to stress the mission's conclusion that the authorities should try to prevent any further progression towards a shorter average maturity of Uruguay's external debt.

Structural policies must also take into account the perspective opened by the MERCOSUR agreement and, hence, should aim at improving the competitiveness of the economy. Therefore, the retrenchment of 5 percent of the civil service work force decided in 1991 and the steps taken in favor of trade liberalization are very welcome. Current thinking about demonopolization, divestment of public firms, and reforms of the financial and social systems should, however, lead to concrete measures as soon as possible.

In conclusion, we are certainly impressed by the results previously achieved; we also think they need to be further consolidated and enhanced. I wish the authorities well in their efforts.

Mr. Wright made the following statement:

I would like to begin with a fairly general issue. The paper says that discussions for the 1991 Article IV consultation and for the midterm review of the stand-by arrangement with Uruguay have been held at various times. But the paper before us only covers the Article IV consultation. With respect to the stand-by arrangement, the paper does make it clear that certain performance criteria have not been met, but it contains little reference to the likelihood of bringing the program back on track, or indeed on the authorities' future intentions with respect to the program. I found this unhelpful.

This raises a further general issue. Uruguay's program was supposed to be reviewed by the Board before March 15, 1991. The review was not, of course, concluded, because the program went off track. But it is only with the circulation of the Article IV papers that the Board is given any formal explanation of why the review has not been concluded, and of the severity of the slippages from the program. In other countries where Fund programs have gone off track, equally long periods have elapsed before the Board has been informed about such issues. In cases in which other creditors and donors are basing their decisions on the views of the Fund on a particular economic program, this has the potential to create serious misunderstandings. I well understand that when a program is off track, the staff will often be engaged in discussions with the authorities, which make it neither desirable nor often possible to present a detailed paper to the Board setting out the circumstances. But I would suggest that it might be useful for the staff to make an oral report to the Board at the time the review was due to have been completed, if it proves impossible to do this by the due date. This might be followed up with further reports if a program remains off track. I would greatly welcome other Directors' comments on this.

Turning back to the particular case of Uruguay, while in quantitative terms the slippages from the program have been relatively modest, very serious problems have developed in the underlying economic indicators. The particular problem is, of course, inflation, as others have noted. The paper makes the point that some of the causes of the increase in inflation to over 100 percent are beyond the authorities' control, and I do not dispute this. But the fact remains that many of the causes of inflation, notably slippages in fiscal policy and indexation, are very much within the authorities' control. And the authorities have the capacity to take measures to counteract other inflationary pressures, if they choose to do so.

Let me single out two areas of policy where the authorities have contributed to an increase in inflationary pressures. The first is an obvious one, slippages in fiscal policy. The authorities were not able to hold the line on public sector wages; indeed, within three weeks of the stand-by arrangement being agreed to, an increase was granted which was twice as large as that envisaged under the program. Partly as a consequence of this, expenditure increased more rapidly than revenue. On the revenue side, Congress has failed to approve the tax reform package the authorities had in mind. If the program is to be brought back on track, this package, or measures with a similar effect, will need to be approved.

Wage policy is the key to the success or failure of Uruguay's policies. I have to say that I think the authorities' attempt to restore real wage levels to those that prevailed in the fourth quarter of the 1989 is seriously misconceived. The staff sets out very clearly the difficulties this will involve and the possible adverse effects on the fiscal position and on inflation. Moreover, the authorities seem to be combining this real wage rate targeting with real exchange rate targeting. I can only say that this could be a recipe for disaster, with nominal wages and inflation spiraling upwards, and the nominal exchange rate spiraling downwards in tandem. I was interested to read Mr. Végh's characteristically lucid comments on exchange rate targeting, and I was encouraged to see that the authorities were examining a number of hard currency options. I agree that the strengthening of public sector financing would need to precede this. Equally clearly, it will be hard to achieve much in this area without a fundamental reappraisal of wage-setting behavior.

I will not comment in detail on monetary policy. I am in broad agreement with the staff on this. However, I note that once again there are substantial, albeit reduced, quasi-fiscal losses of the Central Bank, which derive from the central government's external interest obligations. And as in other cases, transparency and good banking practice would be served by consolidating these and identifying them securely as obligations of the Central Government, and not of the Central Bank.

When Uruguay's stand-by arrangement was approved by the Board last December, this chair and a number of others expressed doubts about the balance of payments need. In the event, the current account surplus for 1990 is now estimated to have been three times as high as was estimated last December. I also note from both the staff report and Mr. Végh's statement that, despite the slippages in domestic economic policy, Uruguay's balance of payments position and prospects remain comfortable. Indeed, a balance of payments need for Fund resources seems likely to arise only if the

authorities fail to adopt the kind of policies that will be necessary to merit a Fund arrangement. The implication that I would draw from this is that there is a considerable need for a Fund program in this case, but little need for Fund resources.

Finally, when the Board approved the program, we were told Uruguay needed to draw on Fund resources because this was a condition precedent to its agreement with the commercial banks. Could the staff tell us where matters stand with respect to the commercial bank deal? Specifically, are any further disbursements of new money being delayed as a result of the program being off track? In any event, I strongly agree with Mrs. Hansen that the full benefit of the debt reduction in this, or, indeed, in any other case, will be seen only if the authorities agree to adhere to a firm and credible Fund policy.

Mr. Torres made the following statement:

Uruguay's economic program is a typical example of how political and external factors impose severe restrictions on the authorities' efforts to stabilize the economy. In spite of the attempts to maintain fiscal discipline, the lack of approval by Congress of the tax package has not allowed the development of a permanent source of revenues, making it difficult to observe program targets.

Other elements that have complicated the implementation of the program have been the wage policy and the increase in external demand. Indeed, the increases in prices and tariffs of public goods and services have fueled price adjustments, which, in turn, have transferred into wage increases. That development, in conjunction with the exchange rate system, creates a vicious circle, under which inflation is perpetuated. Therefore, it is strongly necessary to break that circle, starting with changes in wage determination. The authorities must increase efforts to reach an agreement with all of the related parties, in order to change the actual mechanism. Inflationary conditions have been accentuated with demand originated abroad, imposing significant pressure on the authorities to pursue a more restrictive monetary policy, and making fiscal discipline even more necessary. The recently signed treaty with Argentina, Brazil, and Paraguay to form a common market should help to reduce these external elements, if member countries commit themselves to coordinate policies.

We would appreciate further elaboration from the staff on the inflation dynamics and the role of the exchange rate system in that process. In the future, the inclusion of a more profound

analysis of specific economic problems will be very useful, as has been the case with other members.

The structure of the financial system, and the strong preference of economic agents for transactions in foreign currency, aggravate the conditions for monetary management, as Mr. Végh has pointed out. In order to control demand pressures, the Central Bank has issued short-term bills at very high interest rates, which, together with the low-income generating assets, has resulted in substantial quasi-fiscal losses. Although the authorities have tried to encourage demand for domestic assets, further actions need to be taken to diminish the degree of dollarization in the financial sector of the economy, which is a sine qua non for financial stability.

In this connection, we welcome the studies that are being carried out on possible reforms of the financial system. However, immediate actions have to be taken in this area. We would appreciate some comments from the staff on recent progress and prospects in this matter.

As other speakers, we welcome Uruguay's successful conclusion of the negotiations with commercial banks, which will not only reduce external debt burden but also enhance the external viability of the country. Finally, from the analysis presented by the staff, the deviations in the performance criteria have been relatively minor to explain the substantial differences between projected and actual behavior of some macroeconomic variables, inflation in particular. We wonder whether there is something intrinsic to the design of the program that makes it unable to capture the nature of the underlying sources of the problem. We would like more information from the staff about the current situation of the agreement, and about what issues are pending in order to conclude the review and to bring the program back on track.

The Deputy Director of the Western Hemisphere Department said that a general issue that had been raised was the problem of inflation in Uruguay, which was attributable to a combination of factors. The Uruguayan economy was highly indexed, and it would not be easy to reduce inflation sharply unless indexation was ended. That problem was clearly evident from the events during 1990 and 1991: the overall public sector deficit had been greatly reduced and credit expansion had been controlled, but fiscal and credit actions alone had not been sufficient to fight inflation, because they had not been accompanied by the required structural changes.

Private sector wages were indexed de facto to past inflation, as contracts included automatic adjustment linked with the inflation, the

Deputy Director continued. Under present law, the Executive could decide on the size of the wage adjustment for public employees, but not on their periodicity--every four months. In practice, wage adjustments in the public and private sectors took place at almost the same time. As a result, there was always pressure to adjust public sector wages by taking into account adjustments in the private sector. The increases in the wages were also reflected in higher payments by the social security system, because social security benefits were linked to salaries.

The main instruments at the disposal of the authorities to finance increases in public sector wages were basically--besides new taxes, which had been adopted in 1990 but not in 1991--public sector tariffs and prices, because those adjustments did not require congressional approval, the Deputy Director remarked. Moreover, those adjustments were needed to safeguard the finances of the state enterprises. However, increases in wages and tariffs were reflected in production costs and domestic prices. To protect the export sector, sooner or later the authorities must depreciate the currency. In Uruguay, because of the high rate of inflation, financial savings and domestic credit were denominated mainly in U.S. dollars. Therefore, the devaluation had a strong impact on production costs and inflation.

In effect, the Deputy Director went on, there was a self-perpetuating spiral of wage increases, tariff adjustments, and depreciation. It was not easy to say where the spiral started. During 1991, the authorities had slowed down appreciably the pace of depreciation of the peso, but that action had been offset by wage increases, which were linked to past inflation.

Perhaps the spiral could be broken with a kind of a shock approach consisting of coordinated and simultaneous action in fiscal, monetary, and incomes policies, the exchange rate, external tariffs, and structural changes, the Deputy Director said. In effect, that was the plan the authorities had prepared in 1990, when all the variables under their control were to be consistent with or determined by a certain rate of projected inflation. The authorities' fiscal and monetary targets were consistent with the overall plan. However, in practice, certain key elements of the plan had not materialized: a proposed tax reform was submitted to Congress twice and rejected; the reform of the social security system that the Government had proposed could not be implemented; wage policy, after an initial attempt to link it to projected inflation, had then been linked to past inflation; and strong capital inflows from neighboring countries continued. The authorities were aware of the situation and believed that inflation could be lowered drastically only by adopting a consistent, forceful stabilization plan aimed at breaking the spiral he had described; that effort, however, must include certain structural changes together with strengthened fiscal and credit policies.

The plan the authorities were currently preparing envisaged a further reduction in the overall public sector deficit, the Deputy Director went on.



It was even possible that a surplus might be needed in the circumstances, thus eliminating the need for the Treasury to continue to issue treasury bills and bonds that were dollar denominated. To reduce the dependence on tariffs, the authorities were considering new tax measures to replace those that were due to expire sometime in 1991. The authorities had proposed a revision of the social security benefits, which placed a heavy burden on government finances, as they were not self-financed. In the monetary policy area, they had moved to increase controls on credit expansion, and, in that context, it was important to emphasize that, for the first time, the Banco de la Republica was subject to the same requirements as all other banks. In the past, the Banco de la Republica had been the source of large credit expansion to the private sector. The authorities are also trying to enhance financial savings denominated in local currency. The desired shift away from dollar-denominated savings in favor of local currency-denominated savings would take some time, especially if the rate of inflation continued to be high. Similarly, the authorities had been trying to modify the present wage legislation. In the present circumstances, it would be difficult for the authorities to modify the present exchange rate policy. They were aiming to have a hard currency policy, but, for the time being, the basis for such a change had not yet been established.

It was the staff's understanding, the Deputy Director continued, that the authorities had concluded that, to implement the desired stabilization plan, the authorities must have a national consensus, which they were seeking at present, particularly because several pieces of legislation would have to be modified--wages and social security taxes in particular. As Mr. Végh had indicated, important decisions were expected before the end of 1991. Meanwhile, the staff would remain in close contact with the authorities; a technical assistance mission was expected to travel to Montevideo in the coming few days.

With respect to the fiscal performance thus far, the staff had received some preliminary figures for June that were not included in the staff report because they were still subject to confirmation, the Deputy Director commented. Apparently the end-June 1991 quantitative performance target was either met or missed by a very small margin. For 1991 as a whole, in nominal terms the fiscal deficit would probably be in line with the original plan, which meant that, in relation to GDP, it could be substantially smaller, because of the high rate of inflation. The composition of the deficit had changed. In preparing the program, the staff had envisaged a sharp reduction in quasi-fiscal losses of the Central Bank, on the basis of two assumptions: the debt relief from the debt renegotiation agreement with the commercial banks, which would affect exclusively the central bank's losses; and an expected decline in the rate of inflation and, therefore, central bank losses from open market operations. Central bank losses were higher than expected, but that was compensated by a stronger than expected performance of the Central Government, particularly in relation to revenues, and by an aggressive effort to adjust public sector tariffs and prices to safeguard the position of the public enterprises.

Uruguay had traditionally maintained a corporate income tax but not a personal income tax, the Deputy Director noted. The staff doubted whether a personal income tax would be introduced in the present circumstances of Uruguay.

The delay in issuing the report was unfortunate, the Deputy Director said. The Article IV consultation discussions with the authorities had taken place in February-March 1991, and there had been additional contacts April 29-May 3 and in July, which had delayed the preparation of the final report so that the latest information on the attempt to bring the adjustment efforts back on track could be included. The quantitative performance criteria had been met or missed only to a very minor extent; in that context, the adjustment effort was still on track. The main objective was to reduce the rate of inflation, and the authorities were reviewing their policies to determine how best to modify them, including certain structural adjustments concerning indexation in particular. The staff hoped that the necessary measures would be introduced in the next few months, in which event the staff would submit to the Board a paper concluding the review. The staff could not predict with any certainty when the various decisions by the authorities would actually be taken; those decisions were very complex.

The agreement involving the commercial banks had been concluded, and all the related transactions with the banks had been completed, the Deputy Director commented. However, because of the delay in concluding the current review with Uruguay, the disbursement of a World Bank loan related to the debt relief had been delayed. Uruguay had used its own foreign exchange to complete the operation with the banks, plus resources provided by the banks in the form of new money. The authorities in Uruguay had expected to be able to replenish the reserves by drawing on loans from the World Bank and the IDB. Both loans had been approved but had not yet been disbursed.

A very difficult question was whether the authorities should shift their exchange rate policy to base it on the U.S. dollar, the Deputy Director of the Western Hemisphere Department said. The staff doubted whether the authorities were considering that alternative. They were trying to encourage financial savings denominated in local currency, and to that end they had raised interest rates, which, however, remained negative in real terms. In addition, the authorities had planned to revise the legal reserve requirement. There was still much to do in that area, because all the financial instruments still favored dollar-denominated operations over peso currency-denominated operations. The authorities would probably have to be more aggressive in the areas of interest rates and the legal reserve requirement. Some time would be needed to break the entrenched foreign currency-denominated behavior.

The staff representative from the Exchange and Trade Relations Department noted that there had been a general question about whether a greater effort should be made to keep the Board more closely informed when a program went off track. Directors generally were aware fairly quickly after

problems developed in a country's arrangement with the Fund, either because scheduled purchases had not been made or reviews were not being completed on schedule. One question was whether it would be appropriate to discuss that situation in a formal Board meeting. A related question was whether the staff or the authorities would like to have various positions put on the table for a general discussion when the situation in the country was evolving as negotiations between the staff and the authorities continued. One reason for delays in the presentation of information to the Board was that the staff tried to present the most recent information and developments to the Board and the distribution of staff papers could be postponed when new information became available. As a general rule, the staff and the authorities were optimistic when efforts were under way to bring an adjustment program back on track. Sometimes that optimism proved unwarranted and it was not possible to bring revised programs to the Board for several months.

Mr. Végh commented that he had played a role in the separation of the Board discussions of the staff papers on the Article IV consultation with Uruguay and the review under the stand-by arrangement. The separation was appropriate, because the discussions with the authorities on the review had become protracted, and trying to schedule both Board topics for the same meeting would have delayed the Board's consideration of the situation in Uruguay. In his opening statement he had deliberately not mentioned the review under the stand-by arrangement because he had not wished to discuss that particular matter at the present meeting. The present occasion was not the appropriate time to discuss some of the issues concerning the review.

Mr. Wright commented that the point of principle he had made was a general one--it did not have to do with solely with the present case of Uruguay. The point was that, because of accidents of timing, there were at present a number of cases in which important issues about programs that had gone off track had not been made known in any great detail to Executive Directors. As a result, Directors could not know for certain how serious the various situations in those countries was. He fully agreed that the last thing that the staff and Directors would wish to have was a rigorous procedure for discussing such cases in the Board. But it would be very useful to have some sort of formal mechanism whereby the staff would provide a short, nondetailed verbal report to the Board when it was not possible to conclude a review because the program was off track; that practice would at least give Directors some feel for the nature and seriousness of the problems, something that was lacking at present.

In addition, Mr. Wright continued, in a case like that of Uruguay, it was unsatisfactory to discuss a staff report for an Article IV consultation without making any reference to the status of the underlying adjustment program. It was unrealistic to act as if that program simply did not exist. That unsatisfactory situation could have been avoided under the procedure that he had recommended.

Mr. Kafka noted that the Board already held informal discussions every two or three months on so-called "problem countries," at which time Directors could raise questions about the situation in any of those countries. Any Director who wished to have additional information on the situation in a country could ask for a short Board discussion--not a full-fledged Article IV discussion. Hence, the problem that Mr. Wright had described could be solved more or less by sticking to existing procedures.

Mr. Fogelholm said that he agreed with Mr. Wright. It was difficult to focus on one country during the informal discussions that Mr. Kafka had mentioned, which often dealt with more than 20 members from different regions. It would be helpful to have a procedure that would not be cumbersome but rather involved only short oral staff reports--5-10 minutes--perhaps under "other business," followed by a few minutes of questions and answers.

The Chairman said that he understood the concern that Mr. Wright and Mr. Fogelholm had expressed, and the matter should perhaps be examined further on another occasion. Discussing papers on Article IV consultations and reviews together generally was an efficient practice.

Mr. Al-Jasser said that he, too, shared the concern that had been expressed by Mr. Wright.

Mr. Wright said that he wondered whether he was correct in assuming that Uruguay's debt reduction with the banks was a onetime event. He wondered whether the debt reduction agreement itself would give the authorities any incentive to bring the adjustment program back on track. In other words, did the agreement on the further disbursements of new money and the replenishment of reserves by the World Bank and the IDB require Uruguay to reach an agreement with the Fund?

The Deputy Director of the Western Hemisphere Department responded that the agreement with the commercial banks was a onetime agreement. The operation with the banks had been fully completed. In addition, there was some incentive for Uruguay to bring the adjustment program back on track, as the loan from the World Bank would then be released. However, the authorities' decision to take measures to bring the program back on track not in terms of quantitative performance criteria but in terms of objectives had nothing to do with the agreement with the banks. The authorities were convinced that the rate of inflation should be reduced, and the stand-by arrangement--regardless of the amount of money involved--was a framework in which to make the needed changes in the economy. Uruguay did not appear to have a balance of payments need to use the Fund's resources, as had been noted when the stand-by arrangement had been approved. The authorities were interested in creating the framework in which to establish a solid basis for sustained growth.

Mr. Fogelholm made the following statement:

I am in agreement with the staff appraisal and will only make few comments.

Let me first say, particularly in light of the recent inflationary development, that it is most unfortunate that the Fund program has gone off track. It did, nonetheless, fulfill one of its main purposes--that of bringing about reductions in debt and debt service. The Fund disbursements were not needed as such in the first place, as maintained by this chair at the time of approval of the stand-by arrangement. Thus, I fully agree with Mr. Wright that Uruguay needs a Fund program, but no Fund resources.

The current account continues to be satisfactory, despite a recent slight deterioration, and if the contention that part of private capital inflows represent payments for nonregistered exports is correct, then the current account position would be even stronger, and thus even less a cause for concern.

The other parts of the capital inflows are somewhat of a mystery to me. Can they be categorized as the return of previous flight capital, or are they flight capital from neighboring countries, or perhaps merely a reflection of Montevideo's growing importance as a financial center? Would the staff or Mr. Végh care to comment?

In light of the extraordinary position of the U.S. dollar in the Uruguayan economy, which circumstance, for many reasons, can be considered a problem, I have, like Mrs. Hansen, difficulty understanding why dollar assets are given preferential regulatory treatment by the authorities.

Finally, with regard to the staff's comment on shock treatment, it would be interesting to know whether there has been any discussion of linking the peso to the dollar, for instance, at an exchange ratio 1:1. In the present circumstances, such a move would, of course, be most challenging and undoubtedly demand a complete de-indexation of the economy in addition to highly restrictive financial policies. But it could, indeed, open interesting perspectives for the region and its future common market, the MERCOSUR, particularly in light of the fact that Argentina already has made such a move and that the Argentine experience over the last 5-6 months seems to have been reasonably favorable.

Mr. von Stenglin said that he broadly endorsed the staff's analysis and policy recommendations. In view of the considerable macroeconomic imbalances and the serious structural weaknesses, there was certainly a need for a comprehensive and convincing program. Given, for example, the temporary nature of the fiscal adjustment measures adopted in 1990, the authorities should be aware that it was obviously insufficient to cure only the symptoms of serious economic imbalances. Therefore, he fully agreed with previous speakers that the main element of an economic program should be a stability-oriented incomes policy, a supportive fiscal adjustment, and tight monetary control.

Apart from a low rate of inflation, Mr. von Stenglin commented, a legal framework securing property rights was also important to create an environment conducive to investment. In that context, he had noted that the authorities planned to clarify the legal aspects of property rights. Further elaboration on that matter by the staff would be helpful.

Mr. Koissy said that it was appropriate to recognize the important policy measures implemented by the Uruguayan authorities over the past year that had led to some improvement in economic and financial performance. As a result of the economic program adopted in March 1990, the combined public sector deficit had been reduced, bank credit had been curtailed, and net international reserves of the Central Bank had increased. Moreover, an agreement had been concluded with commercial bank creditors on a restructuring of Uruguay's debt, and, as the staff report pointed out, Uruguay's balance of payments position was comfortable. However, there had been some slippages in the implementation of the program during the last quarter of 1990, and certain performance criteria for end-December 1990 had not been met.

The staff appeared to agree with the authorities on the policies to be followed, and the staff had made some recommendations on ways to strengthen the foundation for sustained economic growth, Mr. Koissy noted. In that context, the key policy objective was a substantial reduction of inflation by implementing firm financial policies and changes in how wages were determined. The authorities' adherence to an exchange system that was free of restrictions on both current and capital transactions was also welcome. In addition, the Government had agreed on the need for structural reforms that would foster a better climate for investment and remove inefficiencies and distortions in the use of resources. Despite the difficult task ahead of them, he was confident that the Uruguayan authorities would continue to take appropriate measures conducive to regaining the momentum of the adjustment effort that had been undertaken the previous year.

Mr. Al-Jasser made the following statement:

As noted in Mr. Végh's helpful statement, Uruguay has a buoyant current account balance and a moderate average rate of economic growth. Nonetheless, Uruguay needs to maintain control

of demand with tight financial policies to reduce persistent inflation while implementing structural reforms to lay the platform for raising the growth rate of the economy. In this regard, Uruguay's record in taking economic policy actions is encouraging where external factors, particularly those in neighboring countries, aggravate domestic economic problems.

Turning to fiscal policy, the declining trend in the size of the fiscal deficit is welcome. However, it is still necessary to cut the size of Uruguay's relatively large public sector, in order to contain inflation and crowd in the private sector. Fiscal policies are needed to rationalize expenditures, including the social security and welfare spending, to divest publicly owned firms, and to enhance tax revenue. In the short run, building a consensus behind fiscal consolidation is a key factor to stabilize the economy.

Regarding monetary policy, it is encouraging that the state-owned Bank of the Republic has been brought under the legal influence of the monetary authority. This change enhances the control of domestic credit growth and will strengthen monetary policy.

Although Montevideo is an emerging regional financial center because of its conducive financial climate, there are mixed benefits. First, unpredictable short-term capital inflows and maintenance of high liquidity in the banking system have an inflationary potential. Second, it has made reversal of dollarization of Uruguay's economy more difficult because foreign demand for dollars is added to the domestic demand. In this regard, the peso-denominated debt used for central bank open market operations is a good strategy to cope with the dollarization. However, a lasting reduction of inflation brought about by tight financial policies might have the greater impact in reversing dollarization of the economy.

Concerning structural adjustment, diversified and competitive exports have the best prospects to raise the economic growth rate. This is especially true if the common market with Argentina, Brazil, and Paraguay is successful. In this context, a fundamental change in the labor market wage determination can contribute to increased competitiveness and export expansion. The staff suggestion that wage indexation based upon the programmed reduction in inflation has merit, because it is likely to contribute to lowering inflationary expectations and, therefore, will facilitate the actual reduction in cost and price pressures.

More private investment is needed to increase capacity and to modernize production facilities to add impetus to the export

sector. The removal of distortions to resource allocation, particularly removing import trade barriers and deregulating export prices, will increase the incentive for investment. Moreover, privatization and tax policies that promote equity finance can add labor and capital to projects that have a comparative advantage. Another constraint on investment is low domestic saving, and prudent macroeconomic policies can help increase saving; however, external finance will be necessary in the near term.

In conclusion, the chief risks for Uruguay stem from the absence of domestic policy consensus and from external shocks. Nevertheless, Uruguay is on the right track in coping with some difficult economic problems. I wish the authorities well in their endeavors.

Continuing, Mr. Al-Jasser noted that interest rates on domestic currency assets might have to be increased if the dollarization process was to be eliminated. According to news reports, deposits in dollars in Egypt had been declining, apparently as the interest rate gap between domestic currency and dollar accounts had been widening enough to make it attractive for holders of dollars to switch to domestic currency. That experience was perhaps applicable in the context of Uruguay.

Mr. Golriz made the following statement:

The performance of Uruguay under the stand-by arrangement has been mixed thus far. The low rate of GDP growth during the past three years is of concern, wages have increased sharply, and the rate of investment in real terms has declined. For the period 1988-90, in which GDP gained only 1.4 percent, wages increased by more than twice, and inflation accelerated, reaching 101 percent in 1990. The public sector deficit was reduced from 7.6 percent of GDP in 1989 to 3.6 percent of GDP in 1990. Tax collection was in line with the program and increased by 3 percentage points of GDP from 1989 to 1990. However, wages, although adjusted frequently during 1990 by the Government, could not keep pace with inflation.

Monetary policy in Uruguay is under the heavy influence of the Bank of Republic (BROU), which is owned by the Government and is legally outside the control of the Central Bank. This raises the question of monetary policy's effectiveness as well as the supervision of the banking system by the Central Bank. In this context, Mr. Végh's interesting comments on the "dual-currency system" of Uruguay have correctly indicated that with a small monetary base of about 3-4 percent of GDP, any purchase of U.S. dollars by the Central Bank has a large inflationary impact. It



is quite apparent that, in addition to and in conjunction with external developments, interest rate policy in Uruguay has created considerable incentive for the dollarization of portfolios held by the public. Whereas the deposit rates remain negative in real terms, the lending rates were well above the inflation rate during 1986-90 period and have increased substantially in real terms since 1989. The spread between peso deposit and lending rates increased from 33 percentage points in 1986-88 to 77 percentage points in 1990.

In addition, while the interest rate differential between peso-denominated and foreign currency-denominated loans has been in favor of peso-denominated loans, the differential has been in favor of dollar-denominated deposits. This situation has not only created incentives for currency substitution in favor of dollars but has also discouraged domestic investment, which has declined in real terms in the past three years. Meanwhile, it appears that savings, too, have not benefitted from these policies, as savings declined in 1990. While mindful of trade-offs involved, it appears crucial that the authorities should take appropriate policies to reverse this trend.

In the structural areas, certain monopolistic activities that are now carried out by the state-owned enterprises should be limited, and private investment should have access to the commercial activities that are presently carried out by state monopolies.

Finally, the recent treaty signed with Argentina, Brazil, and Paraguay to form a common market should be carefully monitored, since, in the present circumstances, the so-called "Gulliver Effect" may neutralize the beneficial effects of this regional cooperation for Uruguay.

Ms. Duan made the following statement:

The authorities should be commended for the improvement in Uruguay's economic performance in 1990. The combined public sector deficit was reduced from 7.6 percent of GDP in 1989 to 3.6 percent of GDP in 1990; bank credit was curtailed; and net international reserves of the Central Bank increased. However, certain performance criteria for end-December 1990 were not met. Nonetheless, the key policy objective remains the bringing down of inflation. As I am in broad agreement with the staff's analysis and recommendations, my comments will be brief.

Upon assuming office, the authorities adopted correct policy measures to resist inflationary pressure. However, some of the

measures were only temporary in nature and are scheduled to be phased out beginning 1991. The authorities are encouraged to take timely and effective measures to strengthen the economic program and to keep relevant factors under firm control, particularly the fiscal deficit, bank credit, and the wage system.

As pointed out by Mr. Végh in his excellent statement, the improvement in fiscal performance provides the fundamental conditions under which a severe anti-inflation effort could be undertaken. Since the tax reform package was not approved by Congress, a set of new measures needs to be developed. We have also noted that the authorities have planned to tighten their control on current outlays and improve tax revenue. We welcome the Government's appointment of a multiparty commission to work out the corrective fiscal measures.

We agree with the staff's recommendation that the wage policy needs to be made forward-looking and geared to the objective of reducing inflation. However, we have noted that the present practice is to maintain real wages in relation to past periods of inflation, which would certainly have a direct bearing on costs, prices, and tariffs, as well as on exchange rates. It is encouraging to learn that the authorities' intention is to implement a forward-looking wage policy. Perhaps the staff could elaborate on the recent development in this respect.

A tight monetary stance is also crucial to the inflation objective. We welcome the steps taken by the authorities to enhance control over total credit, including applying the same legal reserve requirement to the Bank of the Republic as applied to other institutions. We find it important and encouraging that studies have been made on possible reforms of the financial system. A sound financial system is essential to improving savings, lowering inflation, and stabilizing the economy as a whole.

Mr. Noonan said that he supported the staff appraisal and wished to make one point for emphasis and to pose a question. On the point of emphasis, the slow and apparently hesitant progress in tackling Uruguay's fundamental inflation problem was disappointing. He recognized the persuasiveness of the arguments in favor of consensus building, but too much weight might be attached to the importance of consensus. Indeed, one could envisage a debate about the extent of consensus required for success, as a further prelude to action. In addition, he was skeptical about the potential contribution to effective action of further analysis, especially when the main determinants of Uruguay's inflation were so transparent. On the other hand, too little weight might be given to the important economic and, perhaps, political advantages to be gained from effectively tackling

inflation. In that context, the staff's elaboration on the authorities' reasoning for pursuing their inflation objective was reassuring. Clear and unambiguous leadership had a crucial role to play in the structural changes necessary to break the current inflation cycle. Indeed, it would be the critical ingredient for success. Finally, he wondered why there was an issue about the BROU's compliance with general legal reserve requirements.

The Deputy Director of the Western Hemisphere Department said that there were no restrictions on external capital movements. Moreover, there was considerable border trade, involving both visibles and invisibles, with Argentina and Brazil. In preparing the balance of payments, the authorities derived the current account from recorded transactions, such as exports and imports, based on customs data, which would not include all the considerable border trade. Capital movements shown in the balance of payments included private capital movements as a residual item. It was very difficult to know whether the accounts showed a return of capital flight or merely capital coming into Uruguay because the country had evolved into an important financial center. It was also sometimes very difficult to determine whether the capital inflows were investment or were due to capital flight. The staff knew that the banking system was receiving considerable dollar-denominated deposits; whether they were deposits of residents or nonresidents was almost impossible to determine. In the main touristic center of Punta del Este, most of the investment was made by Argentineans, but there were no complete records of that investment, which was mostly in the form of real estate in Punta del Este. The staff also knew that banks had received considerable capital, and that commercial banks were redepositing money abroad. Because Uruguay was an important financial center in the region, it was somewhat difficult to make all the desired adjustments in the economy. The authorities were fully aware that most of the bank deposits were dollar denominated; indeed, all the debt of the Treasury was denominated in dollars. The authorities hoped to be able to encourage a shift in favor of the peso without discouraging capital flows.

Eventually, authorities would like to establish a link of 1 peso to 1 U.S. dollar, the Deputy Director commented, but they were still far from that target. The rate of inflation in Argentina was about 1 percent a month, while the rate in Uruguay was still some 5-6 percent a month. Once the rate of inflation was reduced dramatically in Uruguay, the authorities might then be in a position to consider a different exchange rate policy. Thus far in 1991 there had been a considerable real appreciation of the peso, although the negative impact on the balance of payments had been somewhat difficult to see; there were not yet sufficient data.

As to property rights in Uruguay, at present the bankruptcy law in the country was somewhat vague, the Deputy Director said. There were certain legal impediments facing a creditor who wished to collect on debt that was in default. The Congress had recently passed a law delaying the collection of debt in default for about 90 days. The President had vetoed the law, but the veto had been overruled. As long as the bankruptcy law was not

clarified, the vagueness of the law might be an impediment to investors in Uruguay. The authorities had been trying to clarify property rights, but thus far the rights were still subject to considerable debate in Congress.

As to the difficulties facing the Bank of the Republic, under the present financial laws the Bank was outside the control of the Central Bank, the Deputy Director remarked. Until recently, there had been a kind of understanding between the Central Bank and the Bank of the Republic, which accounted for about one third of private sector deposits and about 45 percent of the banking system credit to the private sector. In addition, the Bank of the Republic acted as the agent for the collection of custom duties. The Bank of the Republic was not only the largest commercial bank in Uruguay but also had branches all over the country. A few months previously, the authorities had introduced a regulation empowering the Central Bank to establish legal reserve requirements for the Bank of the Republic's operations, including deposits of both the private and public sectors. Central government deposits with the Bank of the Republic were subject to a 100 percent legal reserve requirement; all other deposits were subject to normal legal reserve requirements, like any other commercial bank. The recently introduced regulation governing the deposits of the Bank of the Republic was a major accomplishment.

Mr. Fogelholm commented that a one-to-one relationship between the peso and the dollar could be part of a shock treatment package. In Argentina, the rate of inflation had fallen only after a similar step by the authorities. Ideally the rate of inflation should be reduced first, but in Argentina the rate had fallen as a result of the exchange rate policy action.

Mr. Végh said that the data for the first seven months of 1991 painted a much more optimistic picture than the authorities and the staff had estimated late in 1990 and in early 1991. Despite the gradual elimination of some temporary taxes and the reduction of some tax rates in 1990, revenue had been above estimates and expenditure had been under control, in line with the projections for 1991 as a whole. As the staff had noted, the nominal target for public finances in the program had been on track in June 1991, and given the higher rate of inflation, the real figure in proportion to GDP would be substantially lower.

External viability in Uruguay had not depended on the success of the Brady initiative, Mr. Végh considered. External viability had been achieved in Uruguay before that initiative. The previous and current Administrations had decided to support the Brady initiative mainly to consolidate that viability and to meet internal objectives.

The inflow of the capital was difficult to determine, Mr. Végh continued. The "errors and omissions" item in Uruguay's balance of payments--as was the case in most other countries--was a residual item, and the authorities did not have a clear idea of the actual developments in the

area of capital inflows. They estimated that besides the more or less normal inflow owing to the gradual and persistent consolidation of Montevideo as a regional financial center, there might have been a new element in the form of some flight capital from Brazil in addition to the capital inflow from Argentina. The major flow of capital out of Brazil was to Europe and the United States, and a small element of the capital outflow, including purchases of summer houses and bank accounts, was to Montevideo. Given the large difference in size of the two countries, those outflows might have a significant effect on Uruguay's financial market.

The Chairman made the following summing up:

Executive Directors expressed general agreement with the views contained in the staff appraisal. They commended the authorities for the adjustment effort pursued since early 1990, particularly the sharp reduction of the fiscal deficit and the tightening of monetary policy. They noted, however, that the rate of inflation had not declined as it was expected in the program with the Fund, and it was noted with regret that it had not been possible to complete the review of the Fund arrangement.

Directors took note of the fact that the authorities are reviewing policies in key areas with a view to taking measures to strengthen the economic program and make possible a major reduction of inflation. In this context, while recognizing that external factors had added to price pressures over the past year and a half, Directors believed that important contributing factors had been the spreading of indexation practices and slippages in fiscal policy. More determined restrictive financial policies supported by income policies based on rapid deindexation of the economy were essential. As a first step in that direction, the authorities were encouraged to return to forward-looking guidelines for wage settlements as originally planned under the economic program.

Directors welcomed the sharp reduction in the fiscal deficit since 1989. However, speakers pointed to the temporary nature of the fiscal package adopted in early 1990 and urged the early adoption of more permanent measures to improve the public finances. It appeared doubtful to several speakers whether the 1991 fiscal target could be met without additional fiscal measures. Tax revenues needed to be increased, but it also was essential to curb public spending and improve the efficiency of public sector operations. In this regard, Directors welcomed the authorities' plans to prepare legislation aimed at strengthening the finances of the social security system, and they stressed the importance of early approval of the draft bill that allows private participation in some activities now reserved to the public sector.

Directors commended the authorities for the adoption of mechanisms for market determination of interest rates. Tight credit policies would need to be continued, and Directors urged further steps to consolidate the reform of the financial system, including the removal of disincentives to financial savings in domestic currency.

Directors recognized that exchange rate policy in Uruguay has been complicated by volatile economic circumstances in the neighboring countries, and Directors supported the Central Bank's policy aimed at avoiding a significant loss of overall competitiveness. There was general agreement that restrictive financial and incomes policies geared to reducing inflation were the best means of assuring external competitiveness on a lasting basis, and the view was emphasized that within such a framework a move to exchange rate stability would reinforce this process. Directors were pleased to note Uruguay's relatively comfortable balance of payments position, and they encouraged the authorities to proceed with further reduction of tariff and nontariff trade barriers.

Directors expressed satisfaction with the conclusion of the debt agreement with Uruguay's creditor banks, which reflected Uruguay's excellent track record of compliance with its external obligations. Directors noted, however, the need for a strengthening of external debt management, particularly by lengthening the maturity of dollar-denominated treasury securities placed in the regional market.

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

## 2. BELIZE - 1991 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1991 Article IV consultation with Belize (SM/91/167, 8/19/91). They also had before them a background paper on recent economic developments in Belize (SM/91/181, 9/5/91).

Mr. Noonan made the following statement:

My Belize authorities wish me, on their behalf, to express appreciation of the work of the Fund mission and of the helpful discussions with the staff on various policy issues. My authorities have no substantial differences with the staff. Accordingly, my statement is mainly intended to update information on some of the issues referred to in the staff report.

As a small and relatively undiversified economy dependent mainly on agriculture and agro-based manufacturing, Belize is vulnerable to natural and external shocks. This vulnerability is well recognized by my authorities. Their economic policy has two major and complementary components, which are built on the significant support Belize has had from the international donor community in developing its infrastructure. One of those components is to vigorously and unambiguously encourage private sector investment, including direct foreign investment, in productive capacity. The other is to maintain a sound financial position, which will help the economy to cope with such hazards as a hurricane or a significant deterioration in market demand.

My authorities are particularly concerned about the potential loss or dilution of the preferential access at present available to Belize in the U.K. market for sugar and bananas and in the U.S. market for citrus. They trust that, in the evolution of both European economic integration and the Caribbean Basin Initiative, due weight will be given by the United Kingdom and the United States to the interests of Belize and its longstanding trade and other relations with both countries.

As regards their financial policies, my Belize authorities are committed to the maintenance of adequate external reserves and to keeping current public expenditures within available revenues. As the staff report indicates, my authorities will manage the Central Government's operations in 1991/92 so that the outturn on the 1991/92 budget will avoid any net recourse by the Government to the local banking system.

The staff has noted the concern of my authorities about the recent slowdown in revenue growth. Some of this slowdown is attributable to tax incentives aimed at attracting foreign investment and know-how, in order to diversify and strengthen the economy. My authorities believe that these incentives have played an important role in improving the capital stock, for example, by way of the recent additions to the stock of modern tourist accommodation in Belize. As regards ad hoc exemptions from import duties granted outside the Fiscal Incentive Act, consideration is being given to ways and means of rationalizing and reducing future exemptions.

Increased public expenditure on security reflects concern over growing crime, said by some to be related to greater access to imported television programs about alternative life styles, crime, and violence. It also reflects the authorities' desire to ensure that Belize continues to be, and is seen to be, a safe tourist destination. Expenditure on health and education will be expanded within prudent resource constraints, although it needs to

be recognized, as the staff report does, that there are shortages of skills. My authorities acknowledge the administrative weaknesses referred to in the staff report concerning the evaluation and control of budgetary expenditures and are having discussions with the Fund, U.S. AID, and the U.K. authorities with a view to improving their competence in this area with the aid of short-term technical assistance.

As regards monetary policy, my authorities are moving, in accordance with the recommendations of the staff, to transfer more of the deposits of the Central Government and the Social Security Fund at present held with commercial banks to the Central Bank. In order to facilitate this transfer and avoid any unnecessary credit squeeze, the liquid asset requirements of the commercial banks were reduced by 3 percentage points on September 1. Interest rate ceilings on bank loans have been abolished. Work is also continuing, with the assistance of the World Bank and the Caribbean Development Bank, on measures to restore viability to the Development Finance Corporation.

As regards the agreement to eliminate the stamp duty on foreign exchange purchases, the Central Bank is carrying out a study of the administrative and other costs involved at the request of the Finance Ministry, which is reluctant to forego the B\$5 million in annual revenue derived from this source. The issue will be further reviewed in the light of that study. The Common External Tariff Agreement of the Caribbean Community (CARICOM) has been enacted, and its implementation is expected in the near future.

Finally, but by no means least, I am pleased to inform Directors that Guatemala has formally recognized Belize. There will soon be an exchange of ambassadors, and an official visit by the President of Guatemala is scheduled from September 19-21, when Belize celebrates the tenth anniversary of its independence. This augurs well for improved political and economic relations between the two countries and for the development of the southern section of Belize.

Mr. Jarvis said that, as he agreed with the staff appraisal, he would make only a few comments. Belize continued to perform well: the authorities had been pursuing sound economic policies for some time, and they continued to enjoy the benefits of those policies.

He was somewhat concerned about the projected increase in the public sector wage bill, Mr. Jarvis remarked. He was not sure that it was entirely realistic to try to expand the civil service as rapidly as the authorities hoped, and he wondered about the potential effects on the public finances of



a very rapid expansion of the work force. In addition, he shared the staff's concern about the position of the Development Finance Corporation, and he welcomed the authorities' recognition of the need to improve its performance.

On the revenue side, he agreed with the staff that it would be useful to introduce a broad-based or value-added tax, Mr. Jarvis said. He was pleased that the authorities had agreed to eliminate the stamp duty on foreign exchange purchases. But he was somewhat puzzled by the new legislation that allowed foreign-owned companies in Belize to establish subsidiaries that would be exempt from the payment of income, estate, and stamp taxes. That law seemed on the face of it to discriminate against domestic companies and might create distortions in the tax system. He would welcome comments on that matter by the staff or Mr. Noonan.

He agreed with the staff's comments on the development of monetary policy, Mr. Jarvis commented. The authorities' intention to liberalize interest rates was welcome.

Mr. Bonzom said that he broadly agreed with the staff appraisal and would like to focus on two points that could prove crucial for the consolidation, in the early 1990s, of the strong overall performance in the second half of the 1980s through the adoption of sound macroeconomic policies. The need for improved monitoring and better prioritization of public sector activities, particularly capital spending, was mentioned during the previous Article IV consultation with Belize. The current staff report rightly pointed out some areas where further developments would be welcome. Such actions seemed particularly necessary as Belize could be confronted at the end of 1991 with somewhat increased public sector and external deficits.

The economic vulnerability of Belize had also been noted in 1989 and had improved only slightly over the past two years, Mr. Bonzom continued. It stemmed from excessive reliance on three main agricultural products that had still provided, in 1990, 84 percent of exports. The vulnerability of external trade was reflected in the tax system, which depended heavily on international trade tariffs, which were scheduled to provide more than half of the total revenue of the Central Government in 1991-92. Moreover, the forthcoming implementation of the CARICOM common external tariff could further increase the pressures on the revenue side of the budget.

Hence, there was a strong case to be made in favor of a sound and profitable diversification of exports into nontraditional activities, Mr. Bonzom said. As described in the background paper, that strategy was already in place, primarily through private initiative. Adequate support from the public sector--primarily, as Mr. Noonan had mentioned, in the form of sound fiscal and monetary policies and adequate structural reforms--would help the authorities to reach that long-term goal. Meanwhile, he welcomed the authorities' willingness to stick to such policies.

Ms. Creane made the following statement:

We have always been pleased to commend the Belize authorities for following a cogent set of financial policies. These have had the effect of producing strong growth, low inflation, healthy levels of private savings and investment, and a sustainable external account situation. Therefore, while the overall economic situation in Belize is still positive, particularly compared with that in many of its neighbors, it is still disappointing to see the sharp drop expected in growth for 1991, in addition to the declining levels of private saving, and particularly investment. As the staff and Mr. Noonan observed, the slowdown in growth is directly related to the economy's high degree of vulnerability to exogenous shocks.

However, signs that the authorities' strong grip on financial, and especially fiscal, policies is slipping is a bit worrisome. We were concerned to see that the original 1991/92 budget allowed about one quarter of the central government deficit--or 1 1/5 percent of GDP--to be financed by the domestic banking system. Therefore, we are encouraged by the authorities' explicit statement that steps will be taken to avoid this outcome through expenditure restraint. It would be interesting to know which areas have been targeted for cuts--and specifically if the statement includes the wage bill. Overall, it appears that continued reliance on foreign grants to provide a cushion in budget planning has the result of permitting some laxity in the fiscal accounts, in addition to injecting a degree of uncertainty, as the final outcome is based on the rate of project implementation.

Looking specifically at revenues, we would argue that the current level of revenues is already healthy and that, therefore, the authorities need not focus their concern on the lack of further revenue growth, particularly given the current slowdown in economic growth and imports. We would certainly support the staff's recommendations to introduce a value-added tax to replace existing miscellaneous indirect taxes, as well as tighter tax administration, and a shift in the weight of trade taxes in total revenues--or at least a removal of ad hoc exemptions from these taxes--or any other steps that would improve the efficiency of the tax system and the economy as a whole. For similar reasons, we strongly hope that the Finance Ministry can be convinced to follow through on the agreement to eliminate the stamp duty on foreign exchange purchases.

But the burden of fiscal tightening should fall on the expenditure side of the equation. Like the staff, we are concerned about the sharp increase in central government current and capital expenditures this fiscal year. Regarding the latter,

our concern is heightened by the ad hoc manner in which some projects were implemented in the last fiscal year and by the inclusion of maintenance spending under the capital classification. Particularly given the drop-off in private investment, it is critical that public sector investment projects be selected and administered with the highest productivity. The budgeted 16 1/2 percent increase in the wage bill is worrisome, coming after 11-12 percent average increases over the past five years. For all of these reasons, we would strongly support the Belize authorities' request for technical assistance in administering central government expenditures.

As to monetary policy, we are pleased that the authorities have decided to transfer public sector deposits back to the Central Bank. We are likewise pleased to note in the staff report the desire for a more market-determined interest rate system and plans to remove existing floors on interest rates. We note in Mr. Noonan's statement that interest rate ceilings have been abolished, and we would be interested in hearing the timetable for the likely elimination of the legal minimums. Their elimination would remove one of the few main monetary policy instruments in Belize, yet most of the other existing tools do not seem helpful in controlling credit developments. The staff observes that use of the central bank discount rate is largely symbolic, and the shifting of public sector deposits around appears to be a somewhat cumbersome tool, which leaves changes in bank reserve requirements as the remaining policy instrument. Therefore, we wonder whether, despite the limitations of a relatively small financial market, there would be any room for changing the statutes to increase and simultaneously liberalize the supply of treasury bills to allow more scope for open market operations as well as a more controlled method of covering potential gaps in the fiscal accounts.

The staff projections for the medium-term outlook are highly positive but totally dependent on maintenance of a number of favorable factors, not least of which is prudent monetary and fiscal policies. We would strongly hope for and welcome such an outcome.

The staff representative from the Western Hemisphere Department said that the authorities were having some second thoughts about the legislation that Mr. Jarvis had mentioned. The staff had not made an issue of the matter because the Government itself recognized that it had created an anomaly and was looking into correcting it.

The staff had emphasized that the planned reduction in the deficit should come basically on the expenditure side, the staff representative remarked. The authorities would like to feel free to use revenue or

expenditure measures, and given their past performance the staff had not pushed them too hard; in any event, there was a basic agreement that the proposed wage bill could not be implemented in 1991. It was hardly likely that the authorities could employ some 725 people in Belize in one fiscal year and that much savings would come from that effort. The emphasis on expanding the size of the civil service was the authorities' way of giving effect to a basic concern of theirs that certain areas had been neglected. They were particularly concerned about security, given some of the border problems. It was most unlikely that the budget would be implemented as planned.

With respect to liberalizing the supply of treasury bills, there was a basic reluctance to issue treasury bills for use by the Government, the staff representative from the Western Hemisphere Department remarked. There was not yet an understanding between the monetary and fiscal authorities. The staff and the authorities had engaged in a healthy debate on whether or not the authority for moving deposits should rest with the monetary authorities, including the Central Bank and the Ministry of Finance. The Ministry of Finance held that responsibility, and sometimes it had been disrupted. The question of issuing additional treasury bills had arisen, but the authorities had decided against that action. In fact, the Central Bank wanted to reduce volume of outstanding treasury bills.

Mr. Martinez-Alas made the following statement:

The steady and strong economic performance of Belize's economy over the last five years deserves our high praise as an example of beneficial results stemming from sound economic policies implemented with perseverance. The soundness of fiscal policy is reflected on the positive current account balance observed both at the central government level and at the consolidated nonfinancial public sector level. We are very pleased with the stance of the authorities on monetary policy, which has been geared toward maintaining an adequate level of official reserves consistent with the maintenance of a fixed exchange rate.

Nonetheless, the economy remains vulnerable to external shocks, and some concerns arise from the fiscal sector and the need to strengthen the authorities' control over monetary developments. I will address two points: the need to take further steps on tax policy and expenditure management, and the financial sector structural reform.

With regard to fiscal policy, our concern arises from the potentially disruptive effects stemming from a combination of a slowdown in revenue increases and an upward moving of the wage bill. After a five-year period of a 17 percent annual average increase in current revenue, a rather low increase of 2 percent is

forecast for 1991-1992. This result underscores the need for the authorities to focus on designing measures aimed at strengthening and broadening the tax revenue base, with due regard for efficiency considerations. We would like to encourage the authorities to move to a rapid implementation of a broad-based sales tax or to a comprehensive value-added tax. On the expenditure management side, it is highly worrisome that current outlays and locally funded capital projects have increased at a fast trend, and the wage bill has risen by 11-12 percent a year. The continuation of this upward trend in expenditures could undermine the soundness of fiscal policy. Also, we encourage the authorities to classify expenditure items in their proper place in order to avoid underestimations of the fiscal current account balance.

In relation to monetary policy, notwithstanding the soundness of monetary control, some aspects of the financial markets' working give way to concern. Mainly, three aspects are worth mentioning: the excess liquidity of the banking system, the management of interest rates, and the financial position of the Development Finance Corporation. With respect to the first of these, we share the authorities' and staff's view that control over credit developments would be enhanced if the deposits of the Central Government and Social Securities Board were held at the Central Bank, and we encourage the authorities to take the adequate measures toward that end.

On interest rate management, we would urge the authorities to move quickly to a more market-oriented interest rate determination system, and we welcome the authorities' commitment to eliminate the existing floors on interest rates. A source of great concern, related also to the fiscal situation, is the weak financial position of the Development Finance Corporation; lending at below-market interest rates may undermine the quality of investment and lead to misallocation of scarce resources. We would be very pleased if the authorities implemented the measures needed to restore its viability.

Finally, we join the staff in welcoming the authorities' continued commitment to an open payments system and their recent decision to cooperate with other countries in the region to reduce trade barriers. Although the medium-term outlook continues to be favorable, in view of its vulnerability to external developments we encourage the authorities to maintain their full commitment to sound economic policy in the future.

The staff representative from the Western Hemisphere Department said that the authorities had decided on a timetable for implementing the interest rate decision. Since then, they had removed the floor on lending

rates, and at present they were still considering the precise timetable that they should follow. The staff had encouraged the authorities to set the precise timetable as quickly as possible; the staff had hoped that the authorities would have done so prior to the current Board discussion.

Mr. Noonan recalled that the importance of diversification had been emphasized by previous speakers, and the authorities clearly agreed with the Directors' views on that issue. That fact explained the importance they attach to direct foreign investment, although the incentives provided had given rise to some problems concerning the equitable treatment of domestic investment.

Ms. Creane's point on wage growth was well taken, Mr. Noonan commented, and he would convey it to his authorities. As to the fall in the rate of economic growth in 1991, it should be emphasized that Belize was a very small and relatively undeveloped economy. Consequently, the starting or completion of even a single project could effect changes in macroeconomic variables and give the impression that there had been major changes in economic conditions when, in fact, that was not the case. The recent completion of several major construction projects, and the consequent sharp reduction in the rate of growth expected in 1991, could give the impression that there had been a significant deterioration in economic conditions, a conclusion that would be misleading.

The Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their sound economic management, which had helped Belize to achieve strong growth, low inflation, and a satisfactory balance of payments during the past five years. They noted that despite this good performance the economy remained vulnerable to external shocks, including the possible reduction of access to preferential markets for the country's major exports. Therefore, it was important that the authorities continue to pursue sound financial policies so as both to maintain high rates of domestic saving and to encourage private investment.

Because a solid fiscal performance was a key element in that strategy, Directors encouraged the authorities to limit the overall deficit of the Central Government in 1991-92 to an amount that could be financed with net disbursements of concessionary project-related foreign loans. Directors observed that the public revenue growth had slackened and urged the authorities to adopt measures designed to strengthen the revenue base, including the introduction of a broad-based sales or value-added tax to replace various existing indirect taxes. Also, they noted with some concern the rise in the wage bill in recent years and the sharp increase contemplated in the budget for 1991/92, and indicated

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/123 (9/13/91) and EBM/91/124 (9/16/91).

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 90/167 and 90/168 are approved.

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/91/226 (9/12/91) is approved.

APPROVED: March 4, 1992

LEO VAN HOUTVEN  
Secretary

