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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/79

10:00 a.m., May 18, 1988

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
F. Cassell	C. Enoch
	Jiang H.
	E. L. Walker, Temporary
	J. Prader
	G. Seyler, Temporary
A. Donoso	E. V. Feldman
M. Finaish	A. M. Othman
	B. Goos
	K.-H. Kleine, Temporary
	J. Reddy
	J. Hospedales
	L. M. Piantini, Temporary
M. Massé	J. Gold, Temporary
	A. R. Ismael, Temporary
Y. A. Nimatallah	
G. Ortiz	C. Noriega, Temporary
J. Ovi	
	D. Marcel
	G. Pineau, Temporary
G. A. Posthumus	G. P. J. Hogeweg
	C.-Y. Lim
	I. Sliper, Temporary
G. Salehkhou	O. Kabbaj
	L. E. N. Fernando
	S. Yoshikuni
	T. Morita, Temporary
	S. Appetiti, Temporary

L. Van Houtven, Secretary and Counsellor
M. J. Primorac, Assistant

<u>Also Present</u>
Staff Association Committee: R. H. van Til, Chairman; H. Ayeb, S. E. Cronquist, R. Hemming, M. Stuart. Administration Department: G. F. Rea, Director; H. J. O. Struckmeyer, Deputy Director; D. A. Anderson, D. S. Cutler, A. D. Goltz, P. D. Swain, L. A. Wolfe. Exchange and Trade Relations Department: E. Brau. Legal Department: J. V. Surr. Secretary's Department: C. Brachet, Deputy Secretary. Western Hemisphere Department: S. T. Beza, Director; M. Caiola, Deputy Director; J. Ferrán, Deputy Director; M. R. Figuerola, D. N. Lachman, P. Neuhaus, A. G. Santos. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: E. Ayales, M. B. Chatah, W. N. Engert, J. E. Zeas. Assistants to Executive Directors: N. Adachi, R. Comotto, V. J. Fernández, B. Fuleihan, S. Guribye, M. Hepp, A. Iljas, S. King, M. A. Kyhlberg, C. Y. Legg, V. K. Malhotra, J. A. K. Munthali, D. V. Nhien, D. Saha, R. Wenzel, D. A. Woodward.

1. STAFF COMPENSATION - 1988 REVIEW AND ADJUSTMENT

The Executive Directors, meeting in restricted session, considered a memorandum from the Managing Director on the 1988 review and adjustment of staff compensation (EBAP/88/103, 4/25/88). They also had before them a paper on the same subject prepared by the Staff Association Committee (EBAP/88/118, 5/10/88).

The Executive Board then took the following decision:

1. Salaries will be increased by 3.6 percent for Fund staff in Grades A9-B5 and by 1.5 percent for Fund staff in Grades A1-A8 with effect from May 1, 1988. The adjustments will be applied to the minima and maxima of the salary scale in accordance with the revised interim salary structure set out in the attachment to EBAP/88/103, Supplement 1 (5/19/88).

2. The cost of the increases under paragraph 1 above is estimated to amount to $4,900,000 for FY 1989, and accordingly appropriations for the Administrative Budget for FY 1989 shall be increased as follows:

Budget Category	Approved Budget	Additional Appropriations	Revised Budget
1. Personnel expenses:			
A. Salaries	$109,790,000	$2,800,000	$112,590,000
B. Other personnel expenses	57,740,000	2,100,000	59,840,000
		$4,900,000	

Adopted May 18, 1988

2. URUGUAY - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Uruguay under the procedures for enhanced surveillance (SM/88/86, 4/20/88). They also had before them a background paper on recent economic developments in Uruguay (SM/88/97, 5/3/88).

Mr. Donoso made the following statement:

The performance of the Uruguayan economy over the past three years has been outstanding. Prudent demand policies in the context of a market economy, free of any exchange restrictions and interest rate regulations, have brought about more stable conditions and enhanced growth prospects. This has been manifested not only in an impressive reactivation of the economy but also in a revival of private sector investment and a substantial correction of the basic imbalances that hitherto had characterized the economy.

The program to correct the external imbalances of the economy has centered in a tightening of the public sector finances. The consolidated nonfinancial public sector and central bank deficit, which had reached 9 1/4 percent of GDP in 1985 was reduced to 4 1/4 percent in 1987, reflecting a serious effort on both the revenue and the expenditure sides.

The public finance adjustment throughout this period was supported by a flexible exchange rate policy. After a major devaluation in 1982, the exchange rate fluctuated around the new real value until 1985, after which exchange rate management was reoriented to fully protect the competitiveness of the economy. Surrounded by economies experiencing severe difficulties the authorities have further depreciated the national currency most recently.

The authorities have considered that wage policies need to complement exchange rate policies in fostering an appropriately competitive environment. Thus, they have provided guidelines that, although not fully complied with by the private sector, have protected the competitiveness of the economy while bringing a decline in the incidence of industrial disputes.

The progress made in reducing the inflation rate has proved more difficult than anticipated. The departure from the original objectives is explained by a stronger than expected external situation when high priority was being given to the protection of the competitiveness of the economy, and by the feedback of past inflation in the economy through wage adjustments in the private sector. Nevertheless, emphasis on prudent demand policies has brought about a steady decline in the inflation rate in the last two years and the authorities are committed to making further progress in this area.

Substantial progress has been made over the past three years in improving Uruguay's external accounts. The country benefited from the recent improvement in the terms of trade, achieved a reduction in its current account deficit to perfectly sustainable levels, accumulated the equivalent of some 5 percentage points of GDP in international reserves (or almost seven months' worth of imports), and financed a recovery of growth. Real GDP has grown an accumulated 12 percent in the past two years and it is expected that it will grow at a satisfactory rate again in 1988.

Policies for 1988 are to be oriented toward consolidating the internal and external adjustment while reducing the rate of inflation. In this respect, my authorities intend to continue along the path which they have been following since mid-1985. They plan to further reduce the deficit of the nonfinancial public sector to 1 percent of GDP in 1988, while at the same time limiting the losses of the central bank deficit to 2.6 percent of GDP. These results are to be achieved through the combined effect of: the recently enacted increase in the rate of the value-added tax; measures to reduce the lag on tax collections; new modalities of taxation to be implemented in the agricultural sector, and more general improvements in tax administration. Also, public enterprises are to increase their efficiency and are to keep tariffs at realistic levels. All this constitutes a strong reaffirmation of the central role of the tightening of the public sector finances in the Uruguayan program.

Exchange rate policy for 1988 will remain oriented in a direction that will assure the competitiveness of the economy. At the same time, in order to foster the continued reduction in inflation while preserving stability in industrial relations, my authorities are contemplating a move toward longer-term contracts that would contain clauses providing for adjustments according to past and prospective rates of inflation while at the same time avoiding full indexation or destabilizing commitments. Wage policies, enhanced control over the operation of the Mortgage Bank, and increased coordination of policy with the Bank of the Republic, as already implemented successfully, are the supporting elements of the decision to limit the growth of monetary aggregates to 50 percent in 1988 to assure the reduction of inflation.

Medium-term prospects for Uruguay are positive. Uruguay has already successfully implemented the most demanding stages of adjustment. In order to sustain appropriate rates of growth in the coming years, the authorities are concentrating on the increase of national savings to finance higher rates of investment. On the staff projections, the achievement of an adequate increase in consumption per capita appears to be compatible with a continuous reduction of indebtedness. The effort required seems perfectly feasible for a country that has succeeded in adjusting without abandoning its continued commitment to an exchange and trade system free of restrictions on current transactions and on capital transactions and to a financial system free of interest rate regulations.

The authorities find that the procedure of enhanced Article IV surveillance for Uruguay has stimulated appropriate policies. Also, it has served to convey to the country's creditors a more accurate view of the economic situation, which is reflected in the recent improvement in the financial terms of its multiyear rescheduling agreement. The authorities wish to thank management and the staff for their contributions to this process, and they trust that they can count on further support from the Fund in the period ahead.

Mr. Noriega made the following statement:

On the occasion of the 1987 Article IV consultation with Uruguay, we expressed our commendations to the authorities for having achieved substantial progress in setting the economy on a path of sustainable growth and balance of payments equilibrium. Today, we welcome further progress on the economic front, and a reaffirmation by the authorities that they will persevere with the same policy.

In the past year, real GDP increased by close to 1 percentage point above its original forecast, unemployment and inflation abated, the public sector borrowing requirement continued to fall, and foreign reserves have reached the equivalent of seven months' worth of imports. More important, the medium-term outlook indicates that if current circumstances prevail, economic growth will be sustained simultaneously with a fall in the external debt indicators.

With these figures in mind, we may look beyond the slippages with respect to the nominal targets for end-1987 set for the increase in net domestic assets of the Central Bank and for the combined deficit of the nonfinancial public sector and the Central Bank. Setting targets in nominal terms within a context of high and volatile inflation may prove counterproductive--and this problem may re-emerge this year--but in this case what should concern us is the fact that inflation reflects underlying problems facing the authorities which, unless confronted directly, may put the positive results achieved so far at risk.

Thus, while reiterating our support for the thrust of the current economic program, I will comment on some unsettled issues which, depending on the way they unfold, could affect the longer-run outcome of this program.

First, on growth prospects, although the accumulated growth of real GDP in the past two years amounts to close to 12 percent, the level in 1987 was only slightly above that of 1982; thus, we can view the developments of the past two years as a partial rebound of the economy. In the interim, however, investment fell substantially in real terms, so that further expansion of output might be constrained. In this respect, the recovery of investment expenditures, particularly by the private sector, is reassuring, but it might be necessary to further intensify this trend in order to reach the targets set in the medium-term outlook. It is therefore urgent to reverse the reduction in private savings, which as a proportion of GDP was, in 1987, less than half its value in 1983.

In relation to public finances, the adjustment effort to reduce the deficit has been borne in a large proportion by increases in revenue, so that not much more reduction can be expected in the future. However, under the current social security law, it will become even more difficult to curtail expenditures; backward-looking indexation has placed the Government in the paradoxical situation that the faster inflation falls, the larger will be the transfers to social security in real terms. It is important, therefore, for the authorities to exert the utmost restraint in current expenditures in order to be in a position to channel more resources to investment. We should, nevertheless, point out that in the span of four years the combined deficit will have been reduced by more than half.

There are some worrying considerations in the financial sector. On the one hand, the positive real interest rates during the past year have been successful in reversing the declining trend in financial intermediation. However, upon closer examination, it is revealing that the growth of the monetary aggregates is largely attributable to the increase in foreign currency denominated deposits. Although the dollarization of the system has so far not affected the adequacy of the exchange and interest rates, this process nevertheless places constraints on the management of financial policies.

The second issue refers to the debt-to-debt conversion scheme recently announced by the Government. Although we cannot predict its impact on internal liquidity, we may be confident that with higher interest rates in the domestic market than externally, potential users of this scheme will use resources held abroad to repay domestic liabilities. This process, of course, would raise questions on the validity of condoning internal liabilities when there is a presumption that these individuals maintain sufficient assets abroad to cover their internal debts. However, these same individuals could speculate on the possibility that if they borrow internally in order to purchase foreign public debt to clear their internal liabilities, in the future they may be excused once again of this new borrowing. Such speculation, by generating an increase in liquidity, poses a difficult choice for the authorities: to depreciate the exchange rate with a possible rekindling of inflation, or to dispose of their foreign reserves so as to sterilize the liquidity. The latter response would amount to using foreign reserves to cancel domestic private debt.

The medium-term balance of payments outlook seems to indicate that the current economic program will achieve a sustainable position in the medium term. Furthermore, the sensitivity analysis presented in the staff report is useful in assessing the risk associated with variations in the different assumptions. The interest rate assumptions are somewhat conservative in the light of the level prevailing at present, and the forecasts are not very responsive to oil prices. On the other hand, the results seem to be very sensitive to the assumptions about non-oil import and export values, and the fluctuations that we have seen in their values in the past prevent us from making a more optimistic assessment of the forecasts.

The points I have mentioned deal more with short- and medium-term macropolicies, although one could focus on these issues from a structural perspective. In that case, one could mention not only the burden of the foreign debt, but also the growing indexation of the economy resulting from the new social security law; the fixed periodicity of wage contracts; the dollarization of the financial system; and the decreasing, but as yet high and not uniform, trade protection. These situations pose difficult challenges to the authorities for their medium-term policies. While the current program is in the process of correcting internal imbalances and thereby reducing inflationary pressures, it does not appear to tackle directly the inertial component of inflation--though the lengthening of wage contracts should help in this respect.

The Uruguayan economy, as most highly indebted economies, faces serious and difficult problems, the more so because it remains vulnerable to developments beyond its control. However, the program in effect in Uruguay since 1985 has achieved substantial progress, and has set the economy in a stronger position to start addressing these more protracted issues.

Mr. Kleine expressed his chair's satisfaction with the progress made over the past three years in redressing the macroeconomic imbalances in Uruguay. It was reassuring to notice that Uruguay's commendable adjustment efforts had been accompanied by satisfactory growth and that the country's external creditor banks had rewarded the relatively good performance by modifying the multiyear rescheduling agreement.

Despite those positive developments, some slippages in the fiscal and monetary policy targets under the enhanced surveillance program did occur in 1987, Mr. Kleine continued. Overruns in budgetary expenditures and higher than programmed monetary growth pointed to some weaknesses in policy implementation. While those slippages had not clouded medium-term prospects, they should, nevertheless, be taken as a warning that more had to be done in those areas. Therefore, the staff's cautioning remarks with regard to fiscal and wage policy were highly appropriate. One would hope that, on the next occasion to review the performance under the Government's economic program for 1988, all quantitative targets would have been met.

With regard to the economic program for the remainder of 1988, he had little to add to the staff's assessment and recommendations, with which he fully agreed, Mr. Kleine said. His chair continued to share the staff's concern that the authorities' inflation target might not be sufficiently ambitious to keep the economy on the intended course of further adjustment and growth. He also endorsed the staff's view on exchange rate policy and, in particular, on the need to formulate a comprehensive set of structural measures aimed at the social security system and at the public sector enterprises.

His chair continued to believe that, for the time being, the enhanced surveillance procedure remained the appropriate course to assist Uruguay in normalizing its relations with commercial banks, Mr. Kleine concluded; Uruguay deserved further support from the Fund in its endeavors.

Mr. Enoch made the following statement:

> Uruguay's progress since the last Board discussion of its economy has been broadly satisfactory, with strong growth, some reduction in inflation, and a reasonable external performance. However, there is no room for complacency: there were significant slippages in fiscal and monetary policy, particularly in the fourth quarter of 1987, and these contributed to a rather smaller reduction in inflation than was previously expected. The current account deficit on the balance of payments was also slightly higher than had been projected, despite stronger terms of trade--on account of the higher wool price--and lower international interest rates. However, the increase in the deficit appears to be attributable, at least in part, to the weakness of major export markets in the region--most notably Brazil--and reduced revenues for tourism from Argentina.
>
> While the proposed policy stance for 1988 is also broadly satisfactory, I wonder whether a more ambitious target for reducing inflation might not have been preferable. At the time of the last Article IV consultation discussion, the authorities were aiming to lower inflation from 70 percent in 1986 to 50 percent in 1987, and to 35-40 percent in 1988. The first figure already represented a much higher level than had originally been intended for 1986, and the staff expressed doubts then as to whether the objectives for 1987 and 1988 were sufficiently ambitious. In fact, the rate of inflation for 1987 was over 57 percent, representing a significant slippage relative to the program, and the objective for 1988 has been raised to 45 percent. Maintenance of the original 1988 target of 35-40 percent would have been preferable.
>
> Faster progress on inflation would require a strengthening of both fiscal and monetary policies. The major problem on the fiscal side is the losses of the Central Bank, since the projected deficit of the nonfinancial public sector, at 1 percent of GDP,

seems reasonable in itself. However, reducing central bank losses is likely to be a long, slow process, and there would be a case for maintaining a tighter stance in the nonfinancial public sector than would otherwise be necessary, until this problem is resolved. While the authorities' efforts to contain expenditure and to improve tax collection are very welcome, the revenue projection for 1988 remains lower than that originally programmed for 1987. For this reason, and owing to the temporary nature of part of the fiscal improvement expected this year, it might have been appropriate to adopt further revenue-raising measures. As the staff report notes, the fiscal target for this year is the absolute minimum that the authorities should seek to achieve.

Monetary policy appears broadly consistent with the inflation target under the program, although again, some tightening to secure a larger reduction in inflation might be desirable. The authorities' intention to keep interest rates positive in real terms is very welcome, but they should be ready to raise nominal rates if necessary, rather than maintaining them constant until inflation is reduced. Higher rates in the short term could contribute significantly to a faster decline in inflation, allowing lower nominal rates in the future. Spreads between deposit and lending rates remain very high.

Wage policy could also make a significant contribution to reducing inflation, and it should help to improve business confidence as well as industrial relations. The authorities' plan to avoid full indexation of wages is welcome, and the emphasis should be placed as far as possible on prospective rather than past inflation. Undue emphasis on the latter could represent a significant obstacle to the effective reduction of inflation.

More generally, it is clear that some major structural reforms will be necessary to establish the basis for improved macroeconomic policies over the medium term. I would note, in particular, the need for reform of the social security system, improvements in the operation of public enterprises, strengthening of the Central Bank's financial position, and increased competition in the financial system. Trade liberalization can also make a substantial contribution to the efficiency of the Uruguayan economy, but will need to be offset by exchange rate adjustment and compensatory revenue measures. Against this background, the authorities' intention to negotiate a further structural adjustment loan with the World Bank is welcome. On the question of competition in financial markets, I would be interested in any indication the staff could provide as to the possible timing of the Bank of the Republic's divestment of the three commercial banks it took over following their financial difficulties.

A program of structural adjustment that effectively tackled these problems would provide a firm basis for future growth in conjunction with a sustainable external position, as outlined in the medium-term projections in the staff report. These projections are rather less optimistic than those presented in the context of the last Article IV consultation, in terms of both the current account balance and the rate of economic growth. The deterioration in the current account balance appears to arise almost entirely from a major weakening of net factor services, partly as a result of higher interest rates. However, the extent of this deterioration, particularly in the later years of the projection--more than 60 percent in 1992--is somewhat surprising in relation to the projected change in the London inter-bank offered rate, particularly in view of the recent reduction in spreads on commercial bank debt. I would welcome the staff's comments on this question, as well as their views on the likely effects of regional trade agreements with Brazil and Argentina over the medium term.

In summary, Uruguay is performing well, and should continue to do so, although there seems to be scope for stronger action to reduce inflation. In the medium term, substantial structural reform will be necessary, and the authorities' efforts in this direction should allow a continuation of strong growth with a sustainable external position.

Mr. Pineau made the following statement:

The year 1987 turned out to be a good one for Uruguay. The healthy growth rate posted last year largely reflects a sustained recovery of capital formation. Moreover, new progress was made in the restoration of external creditworthiness, as exemplified by the favorable terms granted by commercial banks to Uruguay under the amended multiyear rescheduling agreement.

Without challenging this favorable assessment, it should be stressed that the external position remains vulnerable and that domestic financial discipline needs to be further tightened.

First, on a procedural matter, one cannot but consider that, had the authorities abided by the original schedule for the midyear review, the slippages that occurred at the end of 1987 could have been contained somewhat. I will not elaborate on some of the most obvious shortcomings inherent in the enhanced surveillance procedure. Even if the weaknesses in the implementation of Uruguay's adjustment strategy appear to be relatively minor, the fact that they occurred at all reinforces my authorities' skepticism with respect to enhanced surveillance.

As for the fiscal stance, a relaxation of the expenditure restraint policy was clearly experienced last year. This is all the more regrettable because, on the revenue side, the outcome proved to be better than expected and would have allowed a strong overall performance. The pervasiveness of indexation mechanisms in Uruguay's economy lies at the root of this disappointing result. One conclusion that the authorities should draw from this experience is that a lasting stabilization of financial conditions depends largely on a decisive lowering of inflationary expectations.

In the area of price developments, wage policy plays a central role. The authorities' intention to experiment with a new indexation setting, which would include a larger forward-looking component, is most welcome. Nevertheless, it seems rather risky to try to break the link with past inflation while lengthening the adjustment period for wages, and it seems preferable to focus first on forward-looking indexation with sufficiently ambitious objectives. Once inertial inflation shows some signs of becoming more moderate, it will then become reasonable to adjust the timing of periodic wage adjustments.

A significant dampening of inflationary pressures, coupled with an improved fiscal position, would go a long way to facilitate monetary control. Nonetheless, more progress would be needed, in particular with a view to improving the structure and working of the financial system. The excessive concentration of the banking sector is mainly due to the widespread difficulties facing commercial banks in recovering loans--a serious flaw, which undermines the quality of portfolios and has a direct bearing on the Central Bank's heavy operating losses. Such a structural weakness can also be a major obstacle in mobilizing the savings needed to finance a sustained investment pickup, which remains one of the authorities' top priorities. I would be interested to learn how the authorities intend to address this structural problem and what the World Bank's role in this area could be.

On the external position, international conditions were favorable last year, as the price of some traditional exports firmed. Furthermore, Uruguay was able to renegotiate its multiyear rescheduling agreement on such favorable terms that the external debt prospects now appear to have improved significantly. These are undeniably welcome developments, but they should not tempt the authorities to relax their efforts.

Two points on the external position deserve special mention. First, export earnings are still heavily dependent on a narrow range of traditional goods and apparently the authorities have no intention of strengthening the basis of the export sector; I would welcome comments by Mr. Donoso or the staff. Second, even if the debt burden has been significantly alleviated, the medium-term scenarios made it clear that the external position remains vulnerable to any downward development in the world economy. This should reinforce the authorities' willingness to pursue the adjustment process, which is not yet completed.

Ms. Gold made the following statement:

We congratulate the authorities on the success they have had in accelerating economic growth in the past few years. At the same time, they have made significant progress in addressing both domestic and external imbalances. Particularly noteworthy is the growth in per capita real income of 7.7 and 4.5 percent in the past two years, while in Latin America as a whole, real income per capita increased only 1.7 percent in 1986 and virtually stagnated in 1987.

As I am in general agreement with the staff report, I will make a few brief statements concerning the performance of the economy under the enhanced surveillance program, and on my authorities' concerns regarding the 1988 program. These are primarily in two areas--fiscal policy and the pace of reduction of the inflation rate.

The performance of the economy under the enhanced surveillance program was somewhat mixed. Although there were some slippages in the latter part of the year, most of the program targets were broadly met. On the positive side, real growth was stronger than planned at nearly 5 percent; the current account deficit was broadly in line with the target; the investment recovery that began in 1986 was intensified; and the urban unemployment rate declined from a peak of 16 percent in 1983 to 9 1/4 percent.

However, there were some problems meeting the program objectives, which indicates that continued adjustment efforts are required. The most important drawbacks were the overrun in fiscal expenditures, a substantial increase in the government floating debt, the slower than programmed reduction in the inflation rate, and a substantial real increase in private wages of about 9 percent.

My authorities view the 1988 targets as broadly appropriate. In particular, we agree that real interest rates must be maintained at current positive levels until there is firm evidence that the inflation rate is abating. We also strongly support the continuation of the flexible exchange rate policy in order to maintain international competitiveness. However, the program could be strengthened in the areas of fiscal policy and reduction of the inflation rate.

The overall fiscal targets seem appropriate, but there is a need to strengthen expenditure controls to guard against further slippages. There has been significant strengthening of revenues in the past few years, and further measures have been enacted recently to increase the value-added tax, as well as to improve tax administration. Nevertheless, there remain significant deficiencies in the expenditure control mechanism, with little effective control on budget implementation and spending commitments.

It is clear that inflation is the Achilles' heel of Uruguay's economy. While the inflation rate has been reduced progressively since the 1985 stand-by arrangement, the inflation targets have consistently not been achieved, and Uruguay could benefit considerably from addressing this problem in a more aggressive manner. Given the rather good performance of the economy in the past two years, it is understandable that the public support required to introduce a somewhat more heterodox approach to this problem, such as the one being followed in Mexico, is not likely to exist. Nevertheless, we consider there is further scope to reduce the inflation rate at a faster pace.

The authorities should not underestimate the high cost of the persistently high inflation level, including distortions in relative prices and productivity losses. But even more important is the increasing indexation of the economy, as evidenced by the recently enacted social security legislation. This not only creates other problems in the economy, such as reducing control of fiscal expenditures, but also substantially increases the difficulties of reducing the inflation rate. The move to long-term wage contracts may also create similar problems. In theory, wage adjustments will take into account past and prospective inflation rates but, in practice, inflationary expectations are formed on the basis of past inflation rates, creating a wage-price spiral that may prove difficult to reverse.

I would like to express the satisfaction of my authorities with the enhanced surveillance arrangement with Uruguay, which so far has proved to be a productive collaboration between the Fund and the authorities. Uruguay has made significant progress since the completion of the 1985 stand-by arrangement in terms of both continued economic growth and further adjustment. We look forward to further productive discussions.

Mrs. Walker made the following statement:

The report before us today describes a country that has adopted and implemented an adjustment program which is bearing fruit. While there has been some slippage in fiscal and monetary policy since the end of the stand-by arrangement, and inflation rates remain higher than targeted, program objectives in other areas have been met. Particularly noteworthy is the continued maintenance of a flexible exchange rate system, free of restrictions, which undoubtedly is contributing to the reduction in the current account deficit. In addition, the growth in the export sector fueled a continued significant recovery in economic activity in 1987.

While Uruguay has made progress in its economic recovery over the past several years, the process of adjustment is not over. Slippages in the fiscal and monetary areas should be corrected, and prudent policies should continue to be followed in these areas. In addition, perhaps a more ambitious approach could be found to foster a further reduction in inflation. I agree with the need for additional structural measures in a number of areas, including public sector enterprises, social security and financial market reforms, and trade liberalization. In the area of fiscal policy, we welcome the authorities' recognition that careful management of public expenditures will be required. In this connection, a cautious wage policy will be critical, and we urge the authorities to avoid establishing longer-term wage contracts that might be too closely linked to indexation. We agree with the staff that tighter expenditure control, particularly in areas where there is room for maneuver, will be critical to meeting the deficit targets, and we support the need to strengthen expenditure control mechanisms to ensure that expenditures are kept in line with program targets.

In this regard, we hope that the authorities will be ready to adopt additional measures if necessary to meet the program's fiscal objectives.

Continued strengthening of the public sector enterprises' finances will also be necessary. Along with tariff adjustments and pursuit of a cautious wage policy, the authorities have stated that continued efforts will be made to improve the efficiency of these enterprises. The steps contemplated for the state railroad company, the port of Montevideo, the state airline company, and the public fishing entity appear to be in the right direction. However, I would be interested in staff comment on the possible impact of these reforms on improvements in the efficiency of the public sector.

In the area of monetary policy, because rates of monetary growth were slightly above the program's projections for 1987, it will be important that measures be taken to ensure that the 1988 program targets are met. The steps that the authorities are taking to control the operations of the Mortgage Bank and increased coordination with the Bank of the Republic should contribute to this effort. We welcome the attainment of the positive level of real interest rates and agree that the nominal levels should be held at least at current levels until the inflation rate subsides.

Regarding external policies, as I said, we welcome the maintenance of a flexible exchange rate policy. However, there does appear to be justification to the concern over the real appreciation of Uruguay's exchange rate against that of Argentina, and this development should be monitored closely. On external debt management, we welcome the authorities' concern over the buildup of short-term debt and their efforts to limit this buildup in the future. In the area of tariff reform, we agree that the effective rate of protection appears high, and would support further reductions in tariff protection.

Finally, the medium-term scenarios point to the sensitivity of positive results to the pursuit of sound fiscal and monetary policies, as well as to external developments. If these external developments or slippages in policies place the program's targets at risk, we urge the authorities to implement additional steps to meet the goals of their adjustment program, which they have been successfully pursuing thus far.

Mr. Seyler made the following statement:

In a time of slow international growth combined with a stubbornly persistent debt problem, it is comforting to note that occasionally the programs and surveillance of the Fund can be quite successful. The improvement in Uruguay over the last two years is impressive. After the recession of 1984 and 1985, the main economic indicators now appear quite favorable, an achievement that is all the more remarkable if viewed against the background of the conditions generally prevailing in Latin America.

These positive developments are well covered in the staff's report, so I will confine myself to some constructive comments that may help the authorities overcome remaining difficulties in the areas in which, so far, they have been less successful.

One of these areas seems to be inflation. In recent months, at least, the decline in the rate of inflation has almost halted. This seems to be due to the basing of most economic decisions, whether by individuals or other economic agents, on deep-seated inflationary expectations, which are proving difficult to eradicate. In this connection, it may be interesting to look at the measures recently taken by the Mexican authorities, and the success they have achieved so far. As I understand it, the Mexicans realized that the only way to break out of the inflationary circle was to link the adjustment of wages and social security benefits to future inflation targets, rather than to past inflation outcomes. Apparently, the setting of inflation targets, on which wage negotiations are then based, can be an effective method of reducing inflationary expectations. To gain the support needed to implement such a scheme, it might be necessary to agree to a clause allowing for retroactive compensation in case actual inflation turns out to be higher than the official forecast.

This method can succeed, of course, only in cases in which the inflation stems solely from expectations, the elimination of which will solve the problem. With Uruguay's public sector deficit presently hovering around 4 percent, it is reasonable to assume that the public finances are not exerting any actual inflationary pressure. The example of Belgium and other countries has shown that even higher public sector deficits do not necessarily exert inflationary pressures, as long as the economic agents have confidence in the domestic currency.

In the case of Uruguay, however, such confidence is clearly lacking, as shown by the high real interest rates on loans which exceed the inflation rate by over 30 percentage points (Chart 9 of the background paper). Of course, real interest rates of this magnitude place heavy burdens on the economy, indirectly causing steep deterioration in loan performance and weakening the whole financial system. It seems to me that the functioning of the financial system, which lies at the heart of the efficient allocation of resources in the economy, is already seriously impaired. The interest rate spreads of over 20 percentage points between loan and deposit rates, not to mention the 75 percent market share of the Bank of the Republic, indicate an urgent need for structural reforms.

It is, of course, difficult to say whether inflation lies at the root of the weaknesses of the financial system, or vice versa. In any case, it is less important to debate how a vicious circle began than it is to discover how it may be dissolved. It seems that structural improvements in the financial sector, in combination with adequate wage and price policies, must be among the ingredients of a recipe for gradually reducing inflation, strengthening the balance of payments, and achieving sustained economic growth. Such a mixture of policies would also make the domestic currency more attractive and reduce the need for the public sector to borrow in foreign currencies.

Mr. Hogeweg made the following statement:

I was struck by the relatively low reduction of the inflation rate incorporated in the 1988 economic program. The authorities' response to the staff inquiry as to whether a more aggressive approach might not be considered is intriguing, since it includes a reference to institutional constraints stemming from the recently enacted social security legislation, which effectively indexed benefits to past inflation. Appendix II of the background paper gives some information on this social security legislation. It appears that a well-intended reform package, which would have structurally lowered the cost of the system and which would have taken away some excessive privileges to some groups, was amended by Congress to the extent that the system has become more costly and less manageable than before.

One can discern the importance of this parliamentary action in various sections of the staff report. It caused overruns in public spending in 1987, resulting in a higher than targeted deficit that was financed by credit to the public sector by the Central Bank, leading to a rate of monetary growth that was also above the projections. Worse still, the link that has been established between benefit increases and past inflation rates implies that it has become much more difficult to fight inflation and, to the extent that this fight succeeds, real benefits will increase, which is an additional burden to the budget. Furthermore, while the authorities recognize the need for reform, they ruled out the possibility of reform during the current Administration. In view of this experience, it is hardly surprising that the authorities are concerned that a well-intended introduction of long-term wage contracts might lead to counterproductive complete indexation to past inflation as well.

With all this in mind, I was somewhat surprised to read that the World Bank, in 1987, disbursed a first $40 million tranche of its $80 million structural adjustment loan, mainly in support of reforms to the social security system. I would be interested to hear some views on the prospects of the World Bank operations in this area. Also, it struck me that Mr. Donoso's statement is silent on the social security system.

On monetary policy, I share the authorities' view that a 75 percent market share by one commercial bank poses dangers for the efficient operation of the financial system. It could also pose risks for monetary control, because it reduces monetary management to a bilateral affair, which is clearly no substitute for a money market. I therefore very much agree that at least the three banks that were taken over by the largest bank when they failed should be allowed to operate as separate entities.

I was disappointed by the limited success of the efforts to recover the large nonperforming private sector loan portfolio of the Central Bank. On previous occasions, this chair has expressed its concerns in this regard, and I therefore welcome the innovative approaches to solving this problem.

The structural problems that I have just mentioned should not detract from the commendable success the authorities have had in their economic management. It is gratifying that enhanced surveillance has contributed to the recent improvement in the financial terms of Uruguay's multiyear rescheduling agreement. The medium-term prospects for Uruguay are positive, and I do hope that the authorities will be able to keep the adjustment effort on course.

Mr. Piantini made the following statement:

The Uruguayan economy has continued its satisfactory performance into 1987, thereby consolidating the progress that has been made since 1985. As we are in general agreement with the positive tone of the staff appraisal, I will concentrate my comments on some areas that will need to be monitored carefully in the period ahead if a sound basis is to be laid for further economic expansion.

During the past few years, transfers to social security have represented an average of more than 30 percent of the Central Administration's total current expenditure, and this proportion is expected to increase in the light of the recent social security legislation. Moreover, the indexation mechanism that is now in place will reduce the Government's room for maneuver in reducing inflation. For this reason, we are encouraged by the authorities' decision to work closely with the World Bank in seeking basic reforms to the social security system. This seems to be a necessary precondition for putting the public finances on a sustainably sound basis, particularly in light of Uruguay's demography, which is characterized by very low growth in the labor force.

The implementation of wage policy has fallen short of the authorities' expectations and has prevented programs from reducing inflation more quickly. We welcome the authorities' plan to introduce a wage system based on longer-term wage contracts so as to reduce inflationary expectations; the competitiveness of the export sector will certainly benefit from this process.

From a longer-term perspective, continued efforts to reduce the public deficit will be needed to facilitate a reduction in lending rates from their currently high levels. This is a prerequisite for boosting private sector investment, which remains below 10 percent of GDP. Complementing this process will be the acceleration in the reduction of the private sector's financial obligations to the Central Bank.

The authorities' commitment to a flexible exchange rate policy will continue to be an important element in their efforts to strengthen the balance of payments. We note the substantial improvement in competitiveness since end-1982, which has facilitated a marked turnaround in Uruguay's external account, permitting progress in addressing Uruguay's external debt situation. However, I would voice a word of caution on the authorities' present external debt policy; increased short-term foreign borrowing can only be justified if the returns on the investment are consistent with the debt service requirements.

Despite the substantial progress made by the authorities, the medium-term outlook for the balance of payments is still fragile, basically owing to the development of external market restrictions and increased interest rates as is shown in the staff's sensitivity analysis. The burden of debt will continue to be high, with debt service accounting for 35 percent of the exports of goods and services in 1993, notwithstanding the improvement achieved in terms of commercial bank debt during the last rescheduling in March. The authorities' decision to implement the debt/equity mechanism and the debt-to-debt conversion scheme, whereby domestic debtors could use external debt to cancel internal obligations to the Central Bank, will certainly contribute to a reduction in Uruguay's debt burden.

This chair strongly supports the objectives and targets of Uruguay's economic program for 1988. The authorities' commitment to a policy stance of gradual improvement in the public sector accounts and the maintenance of a competitive exchange rate has served well to reactivate the economy, while bringing down inflation and reducing the balance of payments deficit over the past three years. The policy lines suggested for the remainder of 1988 should allow Uruguay to make further advances in these areas. Clearly, the enhanced surveillance procedure has been extremely helpful to the authorities in the attempt to reconcile domestic and international considerations.

Mr. Morita made the following statement:

Generally, I share the staff's view, especially on the fiscal area, and so I will be brief. I join previous speakers in commending the authorities on their efforts to date. As a result of these efforts, positive signs have emerged in the economy. The favorable growth rates of real GNP during the past two years are one of the examples. However, the economy still has a certain vulnerability, in that the inflation rate has declined only slightly. As the economic developments of Uruguay's neighboring countries will be somewhat uncertain, the authorities' firm stance on fiscal and monetary policies should continue.

Now, let me turn to specific policy areas. First, it is very important that the authorities achieve a targeted deceleration in the rate of growth of the monetary and credit aggregates. On the investment side, it seems that confidence in the economy has rebounded to some extent. Investment increased to 9.3 percent of GDP after falling for two successive years. Bank lending to private residents also increased in terms of GDP. On the other hand, savings declined to 7.6 percent of GDP in 1987, and the share of foreign currency deposits by residents to total banking system deposits by residents has increased steadily from 57.8 percent to 68.9 percent between 1982 and 1987. On this basis, I would say that further efforts to subdue inflation are needed. Furthermore, questions might be raised as to whether the interest rates on domestic currency deposits have been competitive, especially when the stubbornly high inflation rate and the associated economic uncertainties are taken into account. I therefore join the staff in saying that nominal interest rates should be kept at their current level at a minimum, and that positive real interest rates should be maintained.

Second, on the wage scheme, the authorities are considering establishing a system of long-term wage contracts. While I can support this idea in general, I agree with the staff's emphasis on the need for a cautious approach in establishing the inflation adjustment clauses. Such clauses may cause some rigidities in the context of the wage policy and could be harmful when the inflation rates are at an unfavorably high level.

Third, on the external sector, significant growth of the exports in the nontraditional sectors is a welcome development. To maintain this momentum, an adequate degree of competitiveness must be kept through a flexible exchange rate policy. I urge the authorities to keep the exchange rate under close review.

Mr. Nimatallah asked the Secretary whether a paper was due to be circulated on ways in which countries could control unusually high rates of inflation. Uruguay seemed to be doing well under enhanced surveillance except for the problem of inflation, and he wondered whether more direct measures to break the vicious circle of inflation could be proposed. Apparently, indexing was not contributing to the control of inflation. The latest suggestion to index according to the future rates instead of past rates appeared to have been equally ineffective.

The Secretary responded that while no particular study on the control of inflation was included in the Managing Director's work program statement, he would check with heads of departments to see whether any such study was under way and inform Mr. Nimatallah of the results.

The staff representative from the Western Hemisphere Department said that the authorities had indeed raised their inflation objective, in the spirit of realism, to 45 percent from the 35-40 percent that had been mentioned earlier. They had stressed that it was important that their targets be credible, and that the higher target would still represent a gradual deceleration, thus continuing the pattern that had existed over the past three years. The adjustment of the inflation target had been made in recognition of the pressures arising from the indexation of the social security system, as well as from problems on the wage front and the higher than expected inflation in 1987. The authorities were nevertheless still seriously committed to the reduction of the inflation rate. They considered that wage policy could play an important role in that regard, and accordingly they would attempt to have a forward-looking indexation mechanism in long-term wage contracts.

It was clear that the reduction of inflation would also have to be supported with tight fiscal policy, the staff representative added. Revenues had been increasing over the past three years, and the authorities would now be well advised to concentrate their efforts on the expenditure side.

The central bank losses were still large, the staff representative went on. Those losses essentially reflected external debt payments resulting from the contraction of external debt that had been used to acquire the bad portfolio of commercial banks some four or five years earlier; the recovery on that loan portfolio had been very disappointing. An innovative technique had recently been introduced through a debt-to-debt conversion scheme, which should aid the recovery on the Central Bank's loan portfolio, as would the handing over of the administration of the portfolio to the Bank of the Republic.

Concern had been expressed by Mr. Noriega about the possibility that the debt-to-debt conversion might be financed internally, the staff representative recalled. However, the commercial banks apparently would not be willing to extend credit to people who had been remiss in repaying existing loans, and the authorities considered that most of the debt-to-debt conversion would be financed from monies held abroad without having an adverse impact on the domestic economy. They were expecting as much as $50 million to be converted through the scheme.

On the medium-term forecasts, the staff representative said that underlying the growth forecasts was an expectation that investment would be increased substantially over the next few years. That increase would also need to be supported by efforts on the structural side. The impact of structural measures already adopted had been rather modest, but they did give an indication as to the direction in which the Government was going. So far, those reforms had concentrated mainly on the railways, but the authorities did intend to widen the scope of their efforts at structural reform.

In the last year of the administration, the authorities did not currently enjoy a majority within Congress, the staff representative from the Western Hemisphere Department pointed out. Accordingly, one should not expect very much in the way of structural reform until a new Administration took office. That was very much the case in the area of social security system where, despite the authorities' intentions, they had been overridden in Congress and did not see the prospect of accomplishing very much in the remainder of their period in office.

The staff representative from the Latin American and Caribbean Office of the World Bank said that the disbursement of $40 million under the first tranche of the structural adjustment loan had taken place around June 1987, when the Bank's Executive Board approved the loan. Several areas were covered in addition to social security: for example, under the heading of public sector management were included the reform of social security, tax reform, the restructuring of public enterprises, and periodic tariff adjustments of public enterprises. Also included were financial sector reforms, relating to the strict application of the restructuring or refinancing law; the improved regulation of the banking system; and new corporate and bankruptcy laws to be presented to Congress. A conditionality referring to the preparation of the public investment program for three years was attached to the loan, as was a conditionality referring to trade and export promotion, with the intention that maximum import tariff rates would be reduced by about 15 percentage points.

With respect to social security, some of the reforms being proposed had not been approved by the legislature, the staff representative continued. The Bank had a report under way, which would be published shortly, on the social security situation. The transfer by the Government to the social security system in part represented the government payroll contribution on account of its own employees. The remainder covered transfers, not to the main social security system, but to the army and police retirement funds, which were separate entities. Therefore, the actual transfer that took place to the social security system in 1987 was only about 2.3 percent of GDP, and the Bank expected that it would be reduced by 1990 to about 2 percentage points of GDP.

Although not all the progress intended had been achieved with the present reform, the staff representative from the Latin American and Caribbean Office of the World Bank said, the Bank expected to try to change other parameters of transfers to the social security system, which included about 1-1.5 percentage points for social security pensions. Another component was family allowances and other programs that had been traditionally unfunded since the 1979 reform. The Bank's plan was to tackle those unfunded programs also in the coming months, since not much legislative action would be necessary in that area.

Mr. Donoso said that while his authorities were aware of elements of their economy that still remained to be improved, that should not obscure the fact that Uruguay had been conducting a very successful program. There had been substantial progress in all main policy areas, as had been revealed in the statements of Executive Directors and in the staff report.

With respect to the exchange rate, it was clear that the competitive situation of the economy was very good, Mr. Donoso noted. Real wages had facilitated the adjustment of the external accounts. Market institutions were of primary significance in the Uruguayan economy, and there were no restrictions with respect to foreign transactions. Part of the overall success of the program had been because of actions in those areas.

In terms of overall expenditures and external imbalances, the current account deficit for the past two years had been 1/2 percentage point of GDP, while it had been over 2 percentage points, on average, before that, Mr. Donoso said. That was a very important evolution, particularly since it appeared perfectly sustainable and financeable. There had also been strong adjustment in the public finances, with the consolidated deficit of the Central Bank and the public sector having dropped from 9 percent to 3.6 percent between 1985 and 1988. There was also better control over the monetary aggregates, and the rate of inflation had been reduced from 100 percent to 50 percent.

Investment had risen as a component of aggregate demand by 25 percent in real terms in the past year, Mr. Donoso continued. There had been much progress in the sense of correcting imbalances and assuring the possibilities of growth for the economy.

There remained a number of areas in which the authorities were still working, Mr. Donoso indicated. The level of investment to assure growth prospects was of concern. The social security system required attention, although transfers were down to about 3 percentage points of GDP. One should not include the transfers by the Central Government, which were contributions to its own employees. Financing of the public sector could also be improved, but there had been great progress in that area. The authorities were trying to reduce the rate of inflation, and in that respect they were concerned about how to introduce the new system of wage adjustments. Directors had mentioned the importance of introducing more competition to the financial system, including further diversification of exports. Indeed, the authorities were concentrating their efforts on all the areas in which Executive Directors had expressed concern, and they were optimistic about the possible results.

The Chairman then made the following summing up:

> Executive Directors were in general agreement with the views expressed in the appraisal of the staff report for the 1988 Article IV consultation with Uruguay under the procedures for enhanced surveillance.
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> Directors commended the authorities on their continued efforts at adjustment since the last Article IV consultation discussions, which consolidated the favorable results attained since March 1985. Through the continued pursuit of cautious financial policies and the maintenance of a competitive exchange rate, further progress has been made in reactivating the economy while addressing the external imbalances and achieving a gradual reduction in inflation.

Directors considered as broadly appropriate the authorities' 1988 economic policy objectives of promoting moderate growth, maintaining external equilibrium, and seeking a further reduction in inflation, although most speakers believed that the authorities' inflation objective should be more ambitious.

Directors stressed that an improvement in the low savings and investment ratios was called for in order to enhance Uruguay's medium-term growth prospects. In that respect, they believed that the fiscal target for 1988 should not slip, particularly in light of the once-and-for-all nature of some of the revenue-raising measures. Directors observed that every effort should be made to keep expenditures strictly in line with the program's targets and that the authorities might be advised to consider the introduction of additional revenue-raising measures. From a medium-term perspective, speakers generally emphasized that structural measures had to be adopted in relation to the social security system and the public enterprises, and that the efforts to contain the operating losses of the Central Bank needed to be intensified, if further progress was to be made in raising public sector savings and in reducing the overall fiscal deficit.

Directors underlined the importance of attaining the proposed deceleration in the rates of growth of the monetary and credit aggregates. The successful implementation of monetary policy would require that the credit institutions be submitted to effective supervision by the Central Bank with a view to restoring a sound financial position of the banks. Some Directors also expressed the view that nominal interest rates should not be reduced until clear evidence was at hand that inflation was receding from its present level.

Most Directors considered that slippages in wage policy had played a part in the slower than anticipated deceleration in inflation to date. While noting that the authorities' proposal to lengthen wage contracts could contribute to more stable industrial relations, Directors cautioned that special care would need to be exercised to ensure that those contracts were forward looking and did not result in full wage indexation.

Directors noted the overall improvement since mid-1987 in Uruguay's level of international competitiveness and they welcomed the authorities' intention to continue with a flexible exchange rate policy in order to meet the program's balance of payments objectives. Directors also noted the projected decline over the medium term in Uruguay's external debt ratios, but they cautioned that the level of Uruguay's external debt would remain high and that care would need to be exercised in contracting new external indebtedness, especially at the shorter-term maturities.

Directors supported the authorities' intention to reduce further the level of effective tariff protection in the medium term.

It is expected that the midyear consultation under enhanced surveillance with Uruguay will take place within six months and that the next Article IV consultation will take place on the regular 12-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/78 (5/16/88) and EBM/88/79 (5/18/88).

3. INDONESIA - RELEASE OF INFORMATION

The Executive Board approves the proposal to release the staff report on recent economic developments in Indonesia (SM/88/89, 4/27/88) to the Inter-Governmental Group on Indonesia, as set forth in SM/88/89, Supplement 1 (5/12/88).

Adopted May 17, 1988

4. APPROVAL OF MINUTES

a. The minutes of Executive Board Meetings 87/144 and 87/145 are approved. (EBD/88/127, 5/10/88; and Sup. 1, 5/13/88)

Adopted May 16, 1988

b. The minutes of Executive Board Meetings 87/146 through 87/148 are approved. (EBD/88/129, 5/11/88)

Adopted May 17, 1988

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/120 (5/13/88) and EBAP/88/122 (5/16/88) and by an Advisor to an Executive Director as set forth in EBAP/88/120 (5/13/88) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/88/125 (5/17/88) is approved.

APPROVED: December 23, 1988

LEO VAN HOUTVEN
Secretary