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EBS/86/101

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May 1, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Uruguay - Staff Report for the 1986 Article IV Consultation and Review Under Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Uruguay and a review under its stand-by arrangement. A draft decision appears on pages 27 and 28.

This subject has been tentatively scheduled for discussion on Wednesday, May 28, 1986.

Mr. Lachman (ext. 8648) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

URUGUAY

Staff Report for the 1986 Article IV Consultation and Review Under Stand-By Arrangement

Prepared by the Western Hemisphere and the Exchange and Trade Relations Departments

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

Approved by Eduardo Wiesner and Manuel Guitián

May 1, 1986

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I. Introduction

The 1986 Article IV consultation discussions with Uruguay were held in Montevideo between February 19 and March 11, 1986. 1/ At the same time, the staff also concluded the discussions on the mid-term review of Uruguay's 18-month stand-by arrangement that began in Montevideo between November 11 and 27, 1985. It had originally been contemplated that the review of policies for 1986 would have been completed by the end of January 1986, but that date proved to be too early. In the attached letter of intent and Memorandum of Understanding on Economic Policies, which are being dispatched from Montevideo, the Uruguayan authorities outline the economic policies to which they are committed for the remainder of 1986.

Shortly after assuming office on March 1, 1985, the authorities initiated discussions with the staff on an adjustment program that could be supported by use of Fund resources and that could serve as the basis for the multiyear rescheduling of Uruguay's external debt with the commercial banks. On September 27, 1985, the Executive Board approved Uruguay's request for an 18-month stand-by arrangement in the amount of SDR 122.85 million or 75 percent of quota (50 percent on an annual basis). On the same date, Uruguay's request for a purchase under the compensatory financing facility was approved in the amount of SDR 66.1 million or the equivalent of 40 percent of quota. By the end of 1985, Uruguay had purchased its full entitlement as of that date of SDR 35.1 million under the stand-by arrangement and the full SDR 66.1 million under the compensatory financing facility (Table 1). Further information on Uruguay's relations with the Fund is presented in Appendix I.

The last Article IV consultation with Uruguay was concluded by the Executive Board on April 8, 1985 (EBM/85/56). On that occasion, Executive Directors emphasized that the new Administration would need to give from the very start clear signals of its resolve to deal firmly with Uruguay's economic imbalances. In that context, Directors urged the Uruguayan authorities to make an early presentation of a credible and well-defined program of adjustment geared to bringing down inflation and strengthening the external accounts.

Uruguay has accepted the obligations of Article VIII, sections 2, 3, and 4.

1/ The Uruguayan representatives in these discussions included the Ministers of Economy and Finance, Agriculture and Fisheries, and Labor; the Director of the Office of Budget and Planning; the President of the Central Bank; and other senior officials. The staff mission consisted of Desmond Lachman (Head), Juan Carlos Di Tata, Roberto Ramaciotti (all WHD), Alejandro Santos (EP-WHD), Markus Rodlauer (ETR), and Elena Frolia (Secretary-WHD). The mission was assisted by Humberto Arbulu-Neira, the Fund resident representative in Montevideo.

Table 1. Uruguay: Transactions with the Fund During the Period of the Arrangement

	Outstanding June 30, 1985	1985 July-Sept.	1985 Oct.-Dec.	1966 Jan.-Mar.	1966 Apr.-June	1966 July-Sept.	1966 Oct.-Dec.	1987 Jan.-Mar.
	(In millions of SDRs)							
Transactions under tranche policies	182.7	--	31.2	-3.9	31.2	11.8	5.0	2.7
Purchases	182.7	--	35.2	--	35.2	17.6	17.6	17.6
Ordinary resources	93.1	--	17.6	--	17.6	8.8	8.8	8.8
Enlarged access resources	89.6	--	17.6	--	17.6	8.8	8.8	8.8
Repurchases	--	--	-3.9	-3.9	-3.9	-5.7	-12.5	-14.9
Ordinary resources	--	--	-3.9	-3.9	-3.9	-5.7	-8.4	-11.6
Enlarged access resources	--	--	--	--	--	--	-4.1	-3.2
Transactions under special facilities 1/	44.1	--	60.6	-5.5	-5.5	-5.5	-5.5	-5.5
Purchases	44.1	--	66.1	--	--	--	--	--
Repurchases	--	--	-5.5	-5.5	-5.5	-5.5	-5.5	-5.5
Total Fund credit outstanding (end of period)	226.8	226.8	318.6	309.1	334.8	341.1	340.6	337.8
Under tranche policies	182.7	182.7	213.9	209.9	241.1	252.9	257.9	260.6
Special facilities 1/	44.1	44.1	104.7	99.2	93.7	88.2	82.7	77.2
	(In percent of quota)							
Total Fund credit outstanding (end of period)	138.5	138.5	194.5	188.7	204.4	208.3	207.9	206.1
Under tranche policies	111.6	111.6	130.6	128.1	147.2	154.4	157.4	159.1
Special facilities 1/	26.9	26.9	63.9	60.6	57.2	53.9	50.5	47.1

Source: International Monetary Fund.

1/ Compensatory financing facility.

II. Recent Economic Developments and Performance Under the Stand-By Arrangement

The new Administration, which took office early last year, inherited a difficult economic situation. In reflection of an inadequate degree of adjustment, inflation rose to 66 percent during 1984 and was running at an annual rate of around 100 percent in the early months of 1985 (Table 2). At the same time, output continued to fall in 1984, bringing the cumulative decline in real GDP since 1981 to around 18 percent. Since 1982, the current account deficit of the balance of payments narrowed significantly in response to the reduced level of economic activity and to the real depreciation of around 40 percent that followed the floating of the peso at the end of 1982 (Table 3 and Charts 1 and 2). However, the overall balance of payments remained in deficit in 1984 and early 1985, as the authorities attempted to limit the depreciation of the peso against the background of a weakening in the capital account. At the end of June 1985, net official international reserves stood at minus US$215 million, excluding Uruguay's gold holdings of around US$850 million valued on the basis of current market prices.

While uncertainties associated with the political transition played a role in the weak economic performance in 1984, there were also shortcomings in demand management policies. Instead of declining as the authorities had programmed, the overall deficit of the nonfinancial public sector remained at around 4 1/2 percent of GDP in 1984. Moreover, the quasi-fiscal deficit of the Central Bank stayed at around 5 percent of GDP in 1984 owing to the continued poor rate of collection on the Central Bank's private sector loan portfolio. During the early months of 1985, the combined deficit of the nonfinancial public sector and of the Central Bank widened to around 10 percent of GDP mainly because the outgoing administration delayed public enterprise tariff adjustments.

The large public sector financing requirement in 1984 and early 1985 placed a heavy burden on monetary policy. At the beginning of 1984, the authorities had established a target rate of growth for M-1 of 3 1/4 percent a month, which they thought was consistent with their objective of reducing inflation. In pursuit of this monetary target, legal reserve requirements and obligatory treasury bill holding ratios for the commercial banks were raised substantially. However, this was not sufficient to prevent a significant acceleration in the rates of growth of the monetary aggregates (Table 4 and Chart 3).

In an effort to redress the economic situation, in June 1985 the authorities announced an adjustment program, which was subsequently supported by an 18-month stand-by arrangement from the Fund (EBS/85/210). The principal objectives of this program were a

Table 2. Uruguay: Selected Economic Indicators

	1982	1983	1984	1985 Prog.	1985 Est.	1986 Prog.
	(Annual percent change)					
Output, prices, and wages						
Real GDP	-9.4	-5.8	-2.4	1.0	0.6	3.0
Nominal GDP	5.1	43.8	56.5	76.0	76.9	68.9
GDP deflator	16.0	52.7	60.4	74.3	75.8	64.0
Consumer prices (average)	19.0	49.2	55.3	79.7	72.2	65.5
(end of period)	20.5	51.5	66.1	80.0	83.0	45.0
Public sector wages (end of period)	7.9	32.3	64.5	79.3	106.2	...
Percentage unemployment rate (second half)	12.7	14.9	13.7	...	12.8	...
	(In millions of U.S. dollars)					
External indicators						
Current account of the balance of payments	-427	-189	-124	-127	-135	-91
(as percent of GDP)	(-8.1)	(-3.6)	(-2.5)	(-2.5)	(-2.7)	(-1.7)
Overall balance of payments	-800	-20	-55	-84	-36	50
(as percent of GDP)	(-15.3)	(-0.4)	(-1.1)	(-1.7)	(-0.7)	(0.9)
Public sector external debt	2,301	2,730	2,757	2,995	2,972	3,147
(as percent of GDP)	(43.9)	(52.6)	(56.6)	(59.1)	(58.7)	(58.3)

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

Table 3 . Uruguay: Summary Balance of Payments

	1982	1983	1984	1985 Prog.	1985 Est.	1986 Prog.
(In millions of U.S. dollars)						
Current account	-426	-189	-124	-127	-135	-91
Trade balance	-64	257	166	136	130	176
Exports, f.o.b.	1,023	1,045	925	916	845	884
Imports, c.i.f.	-1,087	-788	-758	-779	-715	-708
Factor services, net	-188	-288	-362	-362	-356	-349
Other	-175	-159	71	99	92	83
Capital account	-373	169	69	42	99	140
Public sector	1,073	438	86	238	192	175
Medium- and long-term	473	805	59	123	85	183
Short-term	600	-367	28	115	108	-8
Private sector	-1,446	-269	-17	-196	-94	-35
Financial	14	-129	134	--	-219	-35
Nonfinancial 1/	-1,460	-140	-150	-196	125	--
SDR allocation	--	--	--	--	--	--
Overall balance	-800	-20	-55	-84	-36	50
Valuation adjustment	215	102	4	--	-19	--
Official reserve movement (increase -)	585	-82	51	84	55	-50
(As percent of GDP)						
Memorandum items 2/						
Current account	-8.8	-4.0	-2.5	-2.5	-2.7	-1.7
Overall balance	-16.6	-0.4	-1.1	-1.7	-0.7	0.9

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

1/ Includes errors and omissions.
2/ For purpose of these ratios, U.S. dollar GDP for Uruguay has been estimated using a shadow exchange rate series, which maintains the Uruguayan peso/U.S. dollar exchange rate constant in real terms at its average 1985 value.

Table 4. Uruguay: Selected Financial Indicators

	1982	1983	1984	1985 Prog.	1985 Est.	1986 Prog.
	(As percent of GDP)					
Fiscal indicators						
Nonfinancial public sector deficit	-10.0	-4.9	-4.4	-3.8	-3.1	-1.3
General government current revenue	21.1	21.1	18.7	20.5	20.2	22.2
General government current expenditure	-26.6	-22.7	-22.0	-21.5	-21.3	-21.9
Public enterprises current surplus	0.9	0.8	2.5	1.8	1.1	2.4
Public sector capital expenditures	-5.4	-4.0	-3.7	-4.6	-3.2	-3.9
Central bank quasi-fiscal deficit	-8.3	-11.5	-4.9	-4.4	-3.4	-3.6
Support to Mortgage Bank	-7.5	-6.8	-0.5	-0.3	-0.4	-0.2
Portfolio purchase scheme and other interest payments (net)	-0.8	-4.6	-4.4	-4.1	-3.0	-3.3
Combined deficit of the nonfinancial public sector and the Central Bank	-18.3	-16.4	-9.3	-8.2	-6.6	-4.9
	(In percent)					
Monetary indicators						
End-of-period growth in the monetary aggregates						
M-1	19.9	7.7	57.5	43.8	101.4	51.0
M-2	10.1	18.0	49.9	54.3	91.2	51.0
M-3 1/	52.3	14.6	62.3	...	98.8	...
Selected short-term interest rates (end of period)						
Foreign currency deposits (U.S. dollars)	10.2	9.8	10.5	...	8.1	...
Foreign currency loans	18.2	17.2	17.3	...	15.8	...
Domestic currency deposits	66.2	67.8	75.2	...	74.4	...
Domestic currency loans	76.3	85.0	86.6	...	95.0	...
Selected financial ratios						
Monetary base 2/ to GDP	7.2	7.8	7.7	7.4	7.7	7.8
Resident foreign currency deposits to total banking system deposits	57.2	54.6	58.4	...	60.1	...

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

1/ Foreign currency deposits in M-3 are converted at end-of-period exchange rates and include foreign currency deposits of residents only.

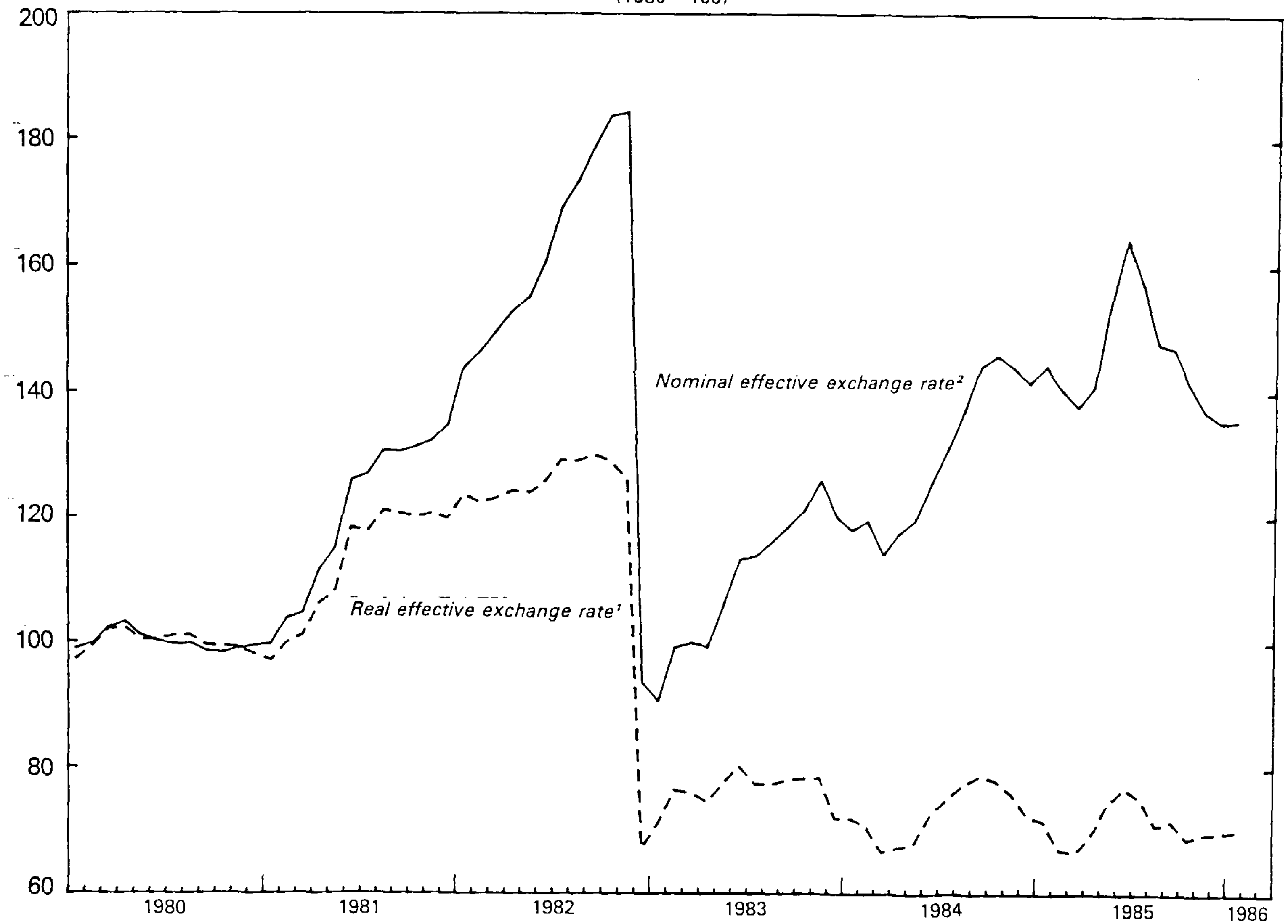
2/ Average monetary base including deposits of the Banco de la República frozen at the Central Bank since 1983.

CHART 1

URUGUAY

EFFECTIVE EXCHANGE RATE

(1980=100)



[1]Trade-weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices; increase means real appreciation.

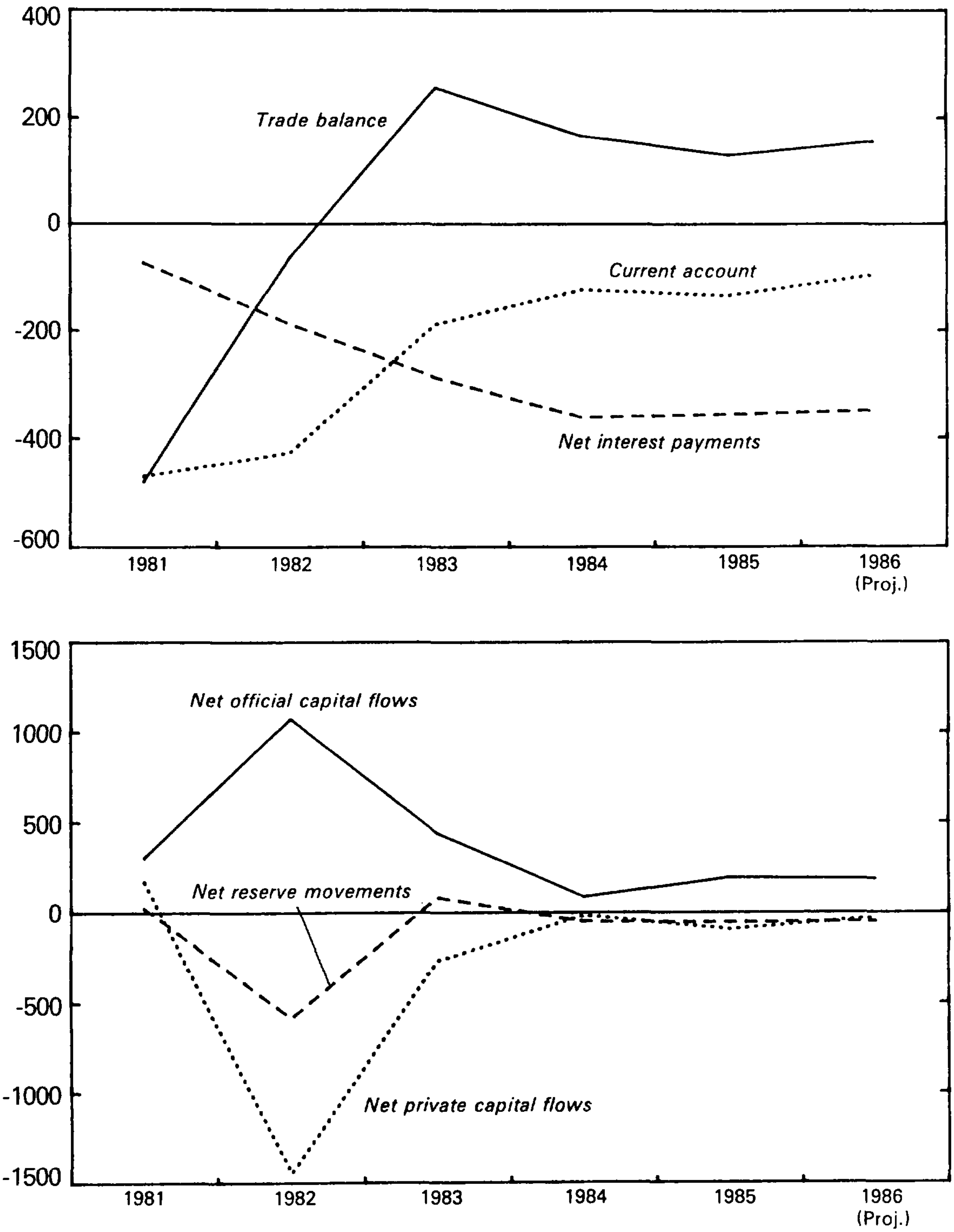
[2]Trade-weighted index of nominal exchange rates.

CHART 2

URUGUAY

SELECTED BALANCE OF PAYMENTS FLOWS

(In millions of U.S. dollars)

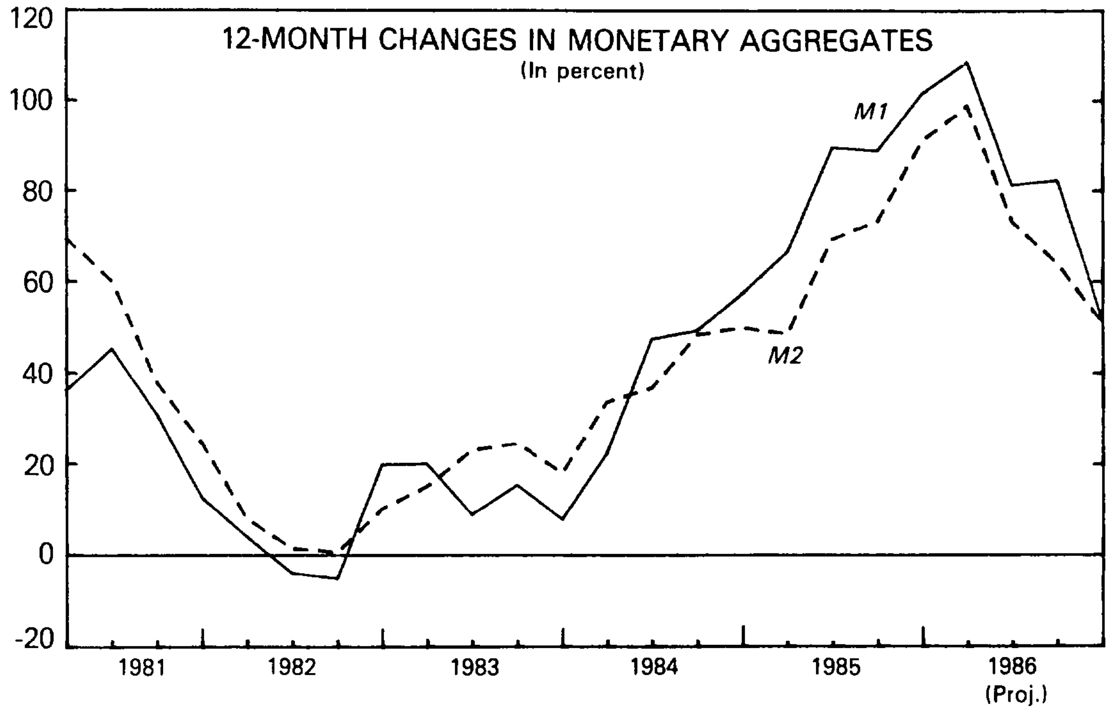


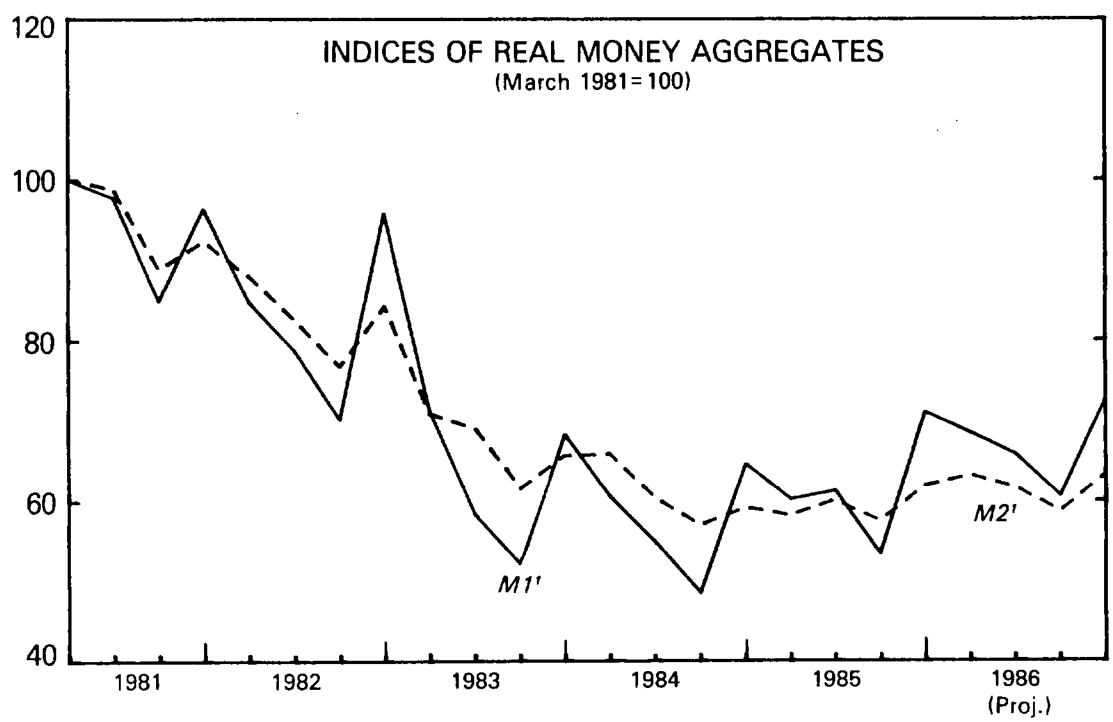
Sources: Central Bank of Uruguay and Fund staff estimates.
[1] The overall balance showed surpluses of U.S. $181 million in 1980, U.S. $12 million in 1981, and deficits of U.S. $ 800 million in 1982, U.S. $20 million in 1983, U.S. $55million in 1984, and U.S. $36 million in 1985; projections for 1986 show a surplus of U.S. $50 million.

CHART 3

URUGUAY

MONETARY INDICATORS





Sources: Central Bank of Uruguay and Fund staff estimates.

[1] Deflated by the cost-of living index.

progressive reduction in inflation and a strengthening of the external accounts. To this end, the program targeted a reduction in the 12-month rate of consumer price inflation to no more than 60 percent by June 1986 and to below 45 percent by end-1986. In addition, the overall balance of payments position was to be strengthened from a deficit of around US$80 million in the year ended June 1985 to approximate balance in the program period.

The main element of the adjustment effort was a substantial improvement in the public finances. Specifically, the combined deficit of the nonfinancial public sector and of the Central Bank was to be reduced to no more than 6 percent of GDP for the year ending June 1986 and to below 5 percent of GDP for calendar 1986. This adjustment was to be attained through a reversal of the recent decline in central administration revenue collections in relation to GDP, a restrained public sector wage policy, a substantial improvement in the finances of the public enterprises, and some reduction in the quasi-fiscal losses of the Central Bank. The programmed reduction in the overall public sector deficit was to facilitate a deceleration in the growth of the monetary aggregates without unduly restricting credit to the private sector. At the same time, the authorities' policy of demand restraint was to be accompanied by an incomes policy that would permit the reduction of inflation without an undue cost in terms of employment.

In the external area, the program envisaged a continuation of the floating exchange rate policy that had been in effect since November 1982. Accordingly, the authorities undertook to limit foreign exchange intervention to smoothing operations of a seasonal nature. Moreover, the authorities committed themselves to keeping both external current and capital transactions completely free of restrictions.

During the second half of 1985, the authorities adopted on schedule practically all the measures envisaged in the stand-by program. These included the approval of a major tax package by Congress at the end of June 1985; 1/ the raising of public enterprise tariffs by an average 20 percent in July and by 18 percent in November; the stretching out of the interval between wage settlements from a quarterly to a four-monthly basis; and the elimination at the end of the year of the interest rate ceiling hitherto in effect on domestic currency loan operations. In addition, the lag on the collection of the value added tax was shortened and the cost to the Treasury of the recently introduced export pre-financing scheme was reduced to below that originally contemplated.

Uruguay met all the quantitative performance criteria in effect for September and December 1985 by comfortable margins (Table 5). As regards the public finances, mainly in reflection of the series of revenue measures adopted since last June, there was an appreciable

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1/ A detailed description of this package is presented in EBS/85/210, page 12.

Table 5. Uruguay: Performance Under the Stand-by Arrangement

	1985	
	September 30	December 31
(In millions of new Uruguayan pesos)		
Cumulative deficit of the nonfinancial public sector since June 30, 1985		
Ceiling	3,050	8,020
Actual	1,669	4,469
Margin or excess (-)	1,381	3,551
Net domestic assets of the Central Bank		
Ceiling	4,735	11,899
Actual	-3,273	9,516
Margin or excess (-)	8,008	2,383
(In millions of U.S. dollars)		
Target for net international reserves of the Central Bank of Uruguay		
Ceiling	-164	-179
Actual	-92	-120
Margin or excess (-)	72	59
Ceiling on public and publicly guaranteed external debt with maturities up to 12 years		
Ceiling	2,922	3,002
Actual	2,900	2,932
Margin or excess (-)	22	70
Ceiling on short-term public and publicly guaranteed external debt outstanding with maturity of less than one year		
Ceiling	300	310
Actual	291	301
Margin or excess (-)	9	9
Ceiling on increase in external debt with maturities of between one and five years		
Ceiling	35	35
Actual	23	23
Margin or excess (-)	12	12

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

improvement in the Central Administration's finances in 1985 (Table 6). There also was some narrowing in the overall deficit of the public enterprises, which reflected the timely increases in the public enterprises' tariffs mentioned above, better control of capital expenditures, and a running down of petroleum inventories toward the end of the year. In addition, notwithstanding the continued low rate of collection on the Central Bank's private sector loan portfolio, the quasi-fiscal deficit of the Central Bank narrowed considerably because of the decline in interest rates abroad. As a result, despite the widening in the public sector deficit during the first half of the year, for 1985 as a whole the combined deficit of the nonfinancial public sector and of the Central Bank was reduced by around 2 3/4 percentage points of GDP to 6 1/2 percent of GDP (Chart 4).

In keeping with the program, the interval between wage settlements was extended from a quarterly to a four-monthly basis and nominal wage increases for the Central Administration were made broadly as programmed. However, in the third quarter of 1985, sizable overruns occurred in wage settlements for the public enterprises and for the private sector. These overruns mainly took the form of sharply increased benefits being paid over and above the basic wage for factors such as seniority, head of household, family size, and travel allowances. As a result, during 1985 the average overall wage is estimated to have increased by around 12 percent in real terms. As discussed more fully below, in February 1986 there was a change in wage policy aimed at minimizing wage drift.

During 1985, there was an appreciable pickup in the rate of growth of the monetary aggregates (see Table 4 and Chart 3). The major factors in this regard were the stronger than anticipated balance of payments outturn and the considerable easing in the credit operations of the Banco de la Republica, the state-owned commercial bank, immediately prior to the start of the program. In addition, there was a significant reduction in legal reserve requirements in August as part of an effort to simplify the monetary policy instruments. In an effort to reverse these trends, during the first quarter of 1986 the ratio of treasury bills to local currency deposits that the banks are required to hold was raised by 4 percentage points to 9 1/2 percent. Moreover, as described more fully below, in recent months there was an improvement in policy coordination between the Central Bank and the Banco de la Republica.

In relation to the attainment of the program's basic objective of strengthening the external accounts, performance under the stand-by arrangement has been satisfactory. At the end of 1985, Uruguay's net international reserves were approximately US$60 million above the program's targets, while in the first two months of 1986 net international reserves increased by a further US$100 million. Export performance in 1985 was significantly weaker than expected due to a further deterioration in external markets for Uruguay's exports and to unsettled domestic labor market conditions. However, the outturn for the current account deficit in 1985 was approximately as projected because of a sizable

Table 6. Uruguay: Summary Operations of the Combined Nonfinancial Public Sector and the Quasi-Fiscal Deficit of the Central Bank

(In percent of GDP)

	1982	1983	1984	1985 Prog.	1985 Est.	1986 Prog.
Current account surplus of the nonfinancial public sector	-4.6	-0.9	-0.7	0.8	0.1	2.6
General government revenue	21.1	21.1	18.7	20.5	20.2	22.2
General government current expenditure	-26.6	-22.7	-22.0	-21.5	-21.3	-21.9
Public enterprises current account surplus	0.9	0.8	2.5	1.8	1.1	2.4
Capital expenditures of the nonfinancial public sector	-5.4	-4.0	-3.7	-4.6	-3.2	-3.9
Public enterprise capital expenditure	-2.4	-1.5	-1.9	-2.5	-1.6	-2.1
Other	-2.9	-2.6	-1.8	-2.1	-1.7	-1.8
Overall surplus or deficit (-) of the nonfinancial public sector	-10.0	-4.9	-4.4	-3.8	-3.1	-1.3
Central Administration	-9.1	-4.5	-5.1	-3.3	-2.9	-1.5
Autonomous agencies	--	--	--	--	--	--
Social security	0.4	0.2	--	0.1	0.2	--
Local governments	0.1	0.1	--	--	-0.2	-0.1
Public enterprises	-1.5	-0.7	0.7	-0.6	-0.3	0.4
Central bank deficit	-8.3	-11.5	-4.9	-4.4	-3.4	-3.6
Portfolio purchase scheme and other interest payments (net)	-0.8	-4.6	-4.4	-4.1	-3.0	-3.3
Support to the Mortgage Bank	-7.5	-6.8	-0.5	-0.3	-0.4	-0.2
Combined deficit of the non-financial public sector and Central Bank	-18.3	-16.4	-9.3	-8.2	-6.6	-4.9
Financing of the combined deficit	18.3	16.4	9.3	8.2	6.6	4.9
External financing	6.5	6.0	2.3	4.9	3.7	3.1
Dollar-denominated bonds and bills	0.8	0.8	0.4	2.4	4.4	0.7
Other external financing	5.7	5.2	1.9	2.5	-0.7	2.4
Domestic financing	11.8	10.4	7.0	3.3	2.9	1.8
Memorandum item						
Total public sector expenditure	32.0	26.7	25.7	26.1	24.5	25.8

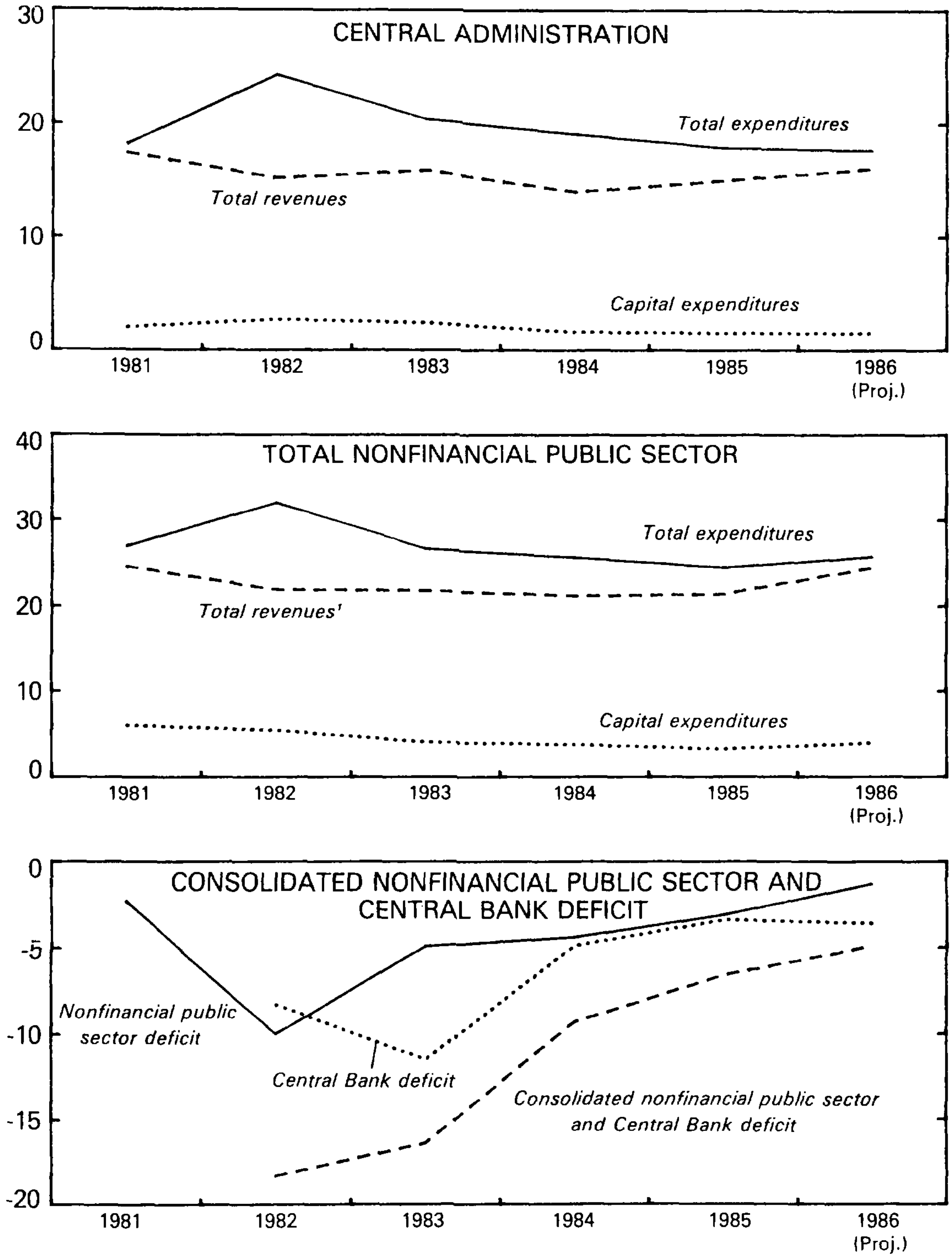
Sources: Ministry of Economy and Finance; Central Bank of Uruguay; and Fund staff estimates.

CHART 4

URUGUAY

PUBLIC SECTOR OPERATIONS

(In percent of GDP)



Sources: Budget and Planning Office; National Accounting Office; Central Bank of Uruguay; and Fund staff estimates.

[1] Includes current account surplus of public enterprises.

decline in the volume of petroleum imports, lower than programmed interest payments, and a better than anticipated tourist season. At the same time, the overall balance of payments was bolstered by an apparent recovery in confidence, which manifested itself in the increased ease with which the Government could place U.S. dollar denominated treasury bills and bonds in the market.

As regards inflation, since June 1985 there has been a significant decline in the rate of price increase, although not to the extent that had been sought. Thus, during the eight months ended February 1986, consumer prices increased by 54 percent rather than by the 44 percent that had been projected. While unfavorable climatic conditions and a better than expected tourist season played a role in these developments, part of the responsibility must also be borne by the wage and monetary policy developments referred to above.

An encouraging development in the program to date has been the apparent bottoming out of the economic recession. Preliminary data would suggest that there was a healthy rebound in agricultural and industrial production in the last quarter of 1985. On this basis, it is estimated that for 1985 as a whole economic growth was marginally positive following four years of economic decline (see Table 2). The apparent pickup in economic activity in the second half of the year manifested itself in a drop of around 1 percentage point in the rate of urban unemployment with respect to the level that prevailed in 1984.

III. Principal Policy Issues and the Economic Program for 1986

The policy discussions with the authorities centered on the design of an economic program for 1986. In this regard, the authorities emphasized that it was their intention to continue along the path of adjustment on which they had embarked last June. Accordingly, they indicated that the primary economic policy objectives for 1986 would continue to be the reduction of inflation and the strengthening of the external accounts. More specifically, policies would be geared toward reducing consumer price inflation to around 45 percent during 1986, as had been originally targeted, and at narrowing the current account deficit of the balance of payments to around 1 1/2 percent of GDP in 1986 (Table 7 and Chart 5).

The authorities observed that the main thrust of their adjustment effort for 1986 would continue to be that of reducing the fiscal deficit. In this connection, they renewed their commitment to the target originally set last June of scaling back the combined deficit of the nonfinancial public sector and of the Central Bank to below 5 percent of GDP in 1986. A major part of this reduction would derive from a further increase in the Central Administration's revenue collections by over 1 percentage point of GDP. However, an important role would also be played by continued expenditure restraint and by a further strengthening in the finances of the public enterprises.

Table 7. Uruguay: Selected Program Targets

	1983	1984	Prog. 1985	Est. 1985	Prog. 1986
		(Percentage change)			
Real GDP	-5.8	-2.4	1.0	0.6	3.0
Consumer price inflation (end of period)	51.5	66.1	80.0	83.0	45.0
		(In percent of GDP)			
Fiscal indicators					
Combined deficit of the nonfinancial public sector and Central Bank	-16.4	-9.3	-8.2	-6.6	-4.9
Nonfinancial public sector deficit	-4.9	-4.4	-3.8	-3.1	-1.3
Central bank deficit	-11.5	-4.9	-4.4	-3.4	-3.6
		(Percentage change)			
Monetary target					
M-2 growth (end of period)	18.0	49.9	54.3	91.2	51.0
		(In millions of U.S. dollars)			
External indicators					
Current account deficit on the balance of payments (-)	-189	-124	-127	-135	-91
Overall balance of payments surplus or deficit (-)	-20	-55	-84	-36	50
Total stock of public and publicly guaranteed external debt (end of period)	2,730	2,757	2,995	2,972	3,147

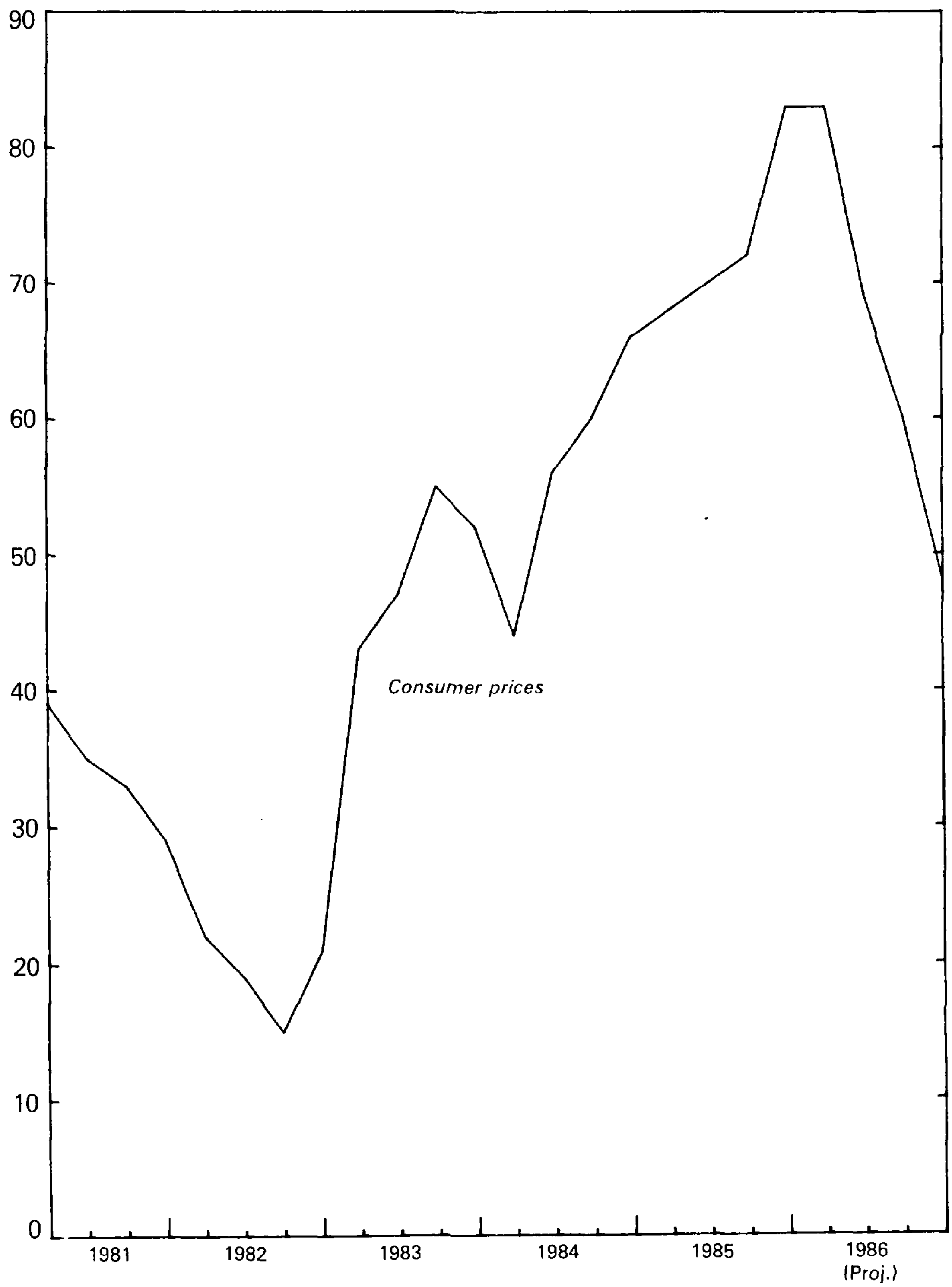
Sources: Ministry of Economy and Finance; Central Bank of Uruguay; and Fund staff estimates.

CHART 5

URUGUAY

12-MONTH INFLATION RATE

(In percent)



Source: Central Bank of Uruguay and Fund staff estimates.

The authorities recognized that their efforts in the fiscal area would need to be supported by a tightening in the stance of monetary and wage policies. They indicated that, consistent with the balance of payments objective, credit policy would aim at bringing down the 12-month rate of growth of M-2 from around 90 percent at end-1985 to 50 percent by end-1986. Over the same period, in an effort to place nominal wage increases on a decelerating path, the authorities intended to link the four-monthly wage settlements to the programmed rather than to the past rate of inflation.

In the external area, the authorities reiterated their commitment to an exchange rate policy that would maintain an adequate level of international competitiveness. At the same time, they intended to keep the exchange and trade system completely free of restrictions on both capital and current transactions.

1. Fiscal policy

The authorities expressed satisfaction with fiscal developments to date, which they believed had placed them well on the path of adjustment envisaged in the program. Moreover, they were confident that by end-1986 the fiscal deficit would be reduced to a level that could be fully financed from borrowing from multilateral organizations and from available domestic sources of finance without unduly squeezing the private sector. However, they recognized that the attainment of their fiscal objective would require the successful implementation of the new revenue measures included in the 1986 budget, continued vigilance over public sector expenditures, and a further strengthening of the public enterprises' finances.

The authorities indicated that for 1986, it was their intention to increase the revenue collections of the Central Administration to around 16 percent of GDP, which would restore Uruguay's tax effort to the level that had prevailed in the early 1980s (Table 8). In part, this improved revenue performance was to derive from the full year effect of measures introduced in the second half of 1985 and from the efforts already underway to improve tax administration and inspection. In addition, revenues would be boosted by around 1/2 a percentage point of GDP through a number of new tax measures introduced in the 1986 budget. These measures included the introduction of a tax of between a 1/4 percent and 1 1/2 percent on the assets of the financial system, the raising of the corporate income tax on public enterprises, the elimination of certain deductions previously in effect for the agricultural income tax and for the corporate income tax, the repeal of the option to choose a presumptive income tax in lieu of the regular agricultural income tax, and the shortening of the lags in the collection of the personal wealth tax.

The authorities indicated that the recent sharp decline in international petroleum prices offered a further opportunity to strengthen the public sector's finances. Accordingly, they intended to generate

Table 8. Uruguay: Summary Operations of the Central Administration

(In percent of GDP)

	1982	1983	1984	1985 Prog.	1985 Est.	1986 Prog.
Current revenues	15.2	15.9	14.0	15.3	15.0	16.1
General sales and value added tax	6.2	5.3	5.5	5.6	5.9	5.9
Selected excises on goods	3.7	3.7	3.5	4.0	3.9	3.6
Import duties	2.2	1.5	1.8	2.2	1.9	2.0
Corporate income tax	1.5	1.6	0.9	0.9	0.8	1.5
Corporate and personal wealth tax	1.0	0.9	0.6	0.9	0.9	1.0
Other revenue	0.6	3.0	1.6	1.7	1.7	2.2
Total expenditures	24.2	20.5	19.1	18.5	17.9	17.7
Current expenditures	21.5	18.1	17.5	16.7	16.3	16.1
Wages and salaries	7.4	6.0	5.1	5.2	5.3	5.7
Social security transfers	9.4	7.3	5.8	5.3	5.2	5.0
Interest payments	0.9	1.5	1.8	2.2	2.1	1.8
Transfers and subsidies	1.2	1.2	2.4	2.1	1.6	1.6
Other	2.6	2.1	2.5	1.9	2.2	2.1
Capital expenditure	2.7	2.4	1.6	1.8	1.5	1.5
Overall surplus or deficit (-)	-9.1	-4.5	-5.1	-3.2	-2.9	-1.5
Financing	9.1	4.5	5.1	3.2	2.9	1.5
External financing	1.1	0.9	1.3	2.0	4.3	0.9
Dollar denominated bonds and bills	0.8	0.8	0.5	2.4	4.4	0.7
Other external financing	0.3	0.1	0.9	-0.4	-0.1	0.2
Domestic financing	8.0	3.5	3.8	1.2	-1.4	0.6
Memorandum item						
Current account surplus or deficit (-)	-6.3	-2.1	-3.6	-1.4	-1.3	--

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

net additional revenues to the Treasury in an amount equivalent to 1/2 percent of GDP during 1986 from the imposition of an extraordinary tax on the windfall gains of ANCAP, the state petroleum enterprise, resulting from the reduced cost of petroleum imports. This revenue objective, together with developments in the international oil market over the remainder of 1986, would guide the setting of domestic petroleum prices in the second half of 1986.

In the area of expenditure policy, the authorities' basic objective was to hold the Central Administration's overall expenditures to below 18 percent of GDP in 1986, as had originally been programmed last June. An important role would be played by the pursuit of a restrained public sector wage policy as well as by a further reduction in transfers to the Mortgage Bank and to the public enterprises. At the same time, transfers from the Central Administration's budget to the social security system would be contained. To this end, at the beginning of April the Government announced an average increase in social security benefits of 32 percent, which brought their total increase for the past 12 months to 83 percent. This in effect broke with the former practice of indexing these benefits to wage increases during the preceding calendar year, which would have required a 50 percent increase in these benefits in April. The authorities indicated that a further reason for expecting lower budget transfers to the social security system in 1986 were the increased efforts currently being undertaken to reduce evasion on the payment of social security contributions.

A significant part of the adjustment effort in 1986 was to derive from a further strengthening of the operations of the public enterprises. Notwithstanding the higher tax assessments on these enterprises referred to above, the authorities were targeting a turnaround in the public enterprises' overall operations from a small deficit in 1985 to a surplus equivalent to 1/2 percent of GDP in 1986. In March 1986, the tariffs of public enterprises other than ANCAP were raised by an average 19 percent, while in April ANCAP's tariffs were increased by 6 percent. Two further adjustments in these enterprises' tariffs are scheduled for July and November, which will at least be equal to the increase in the enterprises' costs since the previous tariff adjustment. At the same time, the authorities are committed to keeping under close scrutiny the expenditure programs of the enterprises during the remainder of the year.

2. Monetary policy

The authorities noted that during the second half of 1985 there had been an appreciable recovery in the demand for real money balances denominated in domestic currency and that there had been an apparent slowing in the process of foreign currency substitution. 1/ Nevertheless, the authorities were concerned that the recent increase in money demand might prove to be of a transitory nature. Accordingly, the authorities indicated that for 1986 the main objective of monetary policy would be to scale down the 12-month rate of growth of M-2 to around 50 percent by year-end. Consistent with this objective and the balance of payments' target, quarterly ceilings had been established for the net domestic assets of the Central Bank for 1986 (Table 9).

The authorities noted that the primary reason for the change in the system of legal reserve requirements announced in August 1985 had been to simplify the system and in particular to eliminate legal reserves denominated in local currency on foreign currency deposits. Moreover, they indicated that the monetary impact of this measure had been more than offset by the recent increases in the ratio of the commercial banks' obligatory treasury bill holdings to deposits. The authorities believed that the attainment of the monetary policy objective for the rest of the year would require the pursuit of a restrained credit policy to the private sector and for this reason they ruled out any reduction in legal reserve requirements in the months ahead.

The authorities observed that over the past several months Uruguay had been confronted with a situation of larger than anticipated capital inflows. In view of the possible temporary nature of these inflows, they had opted to accumulate international reserves rather than to allow the currency to appreciate in real terms. This had added substantially to the monetary base and to the expansion of credit by the banking system. In order to obviate the recurrence of such a situation, the authorities were now committed to actively using the monetary policy instruments to sterilize, at least partially, the monetary impact of any future capital inflows. More specifically, the authorities indicated that they intended to reduce the net domestic assets of the Central Bank by at least 65 percent of any increase in international reserves above the amounts envisaged in the monetary program.

The authorities recognized that the attainment of their monetary policy objective for 1986 would require the careful coordination of policy between the Central Bank and the Banco de la Republica, the state-owned commercial bank. Since the Banco de la Republica is not subject to legal reserve requirements, it was of particular importance to establish clear guidelines with respect to the Banco de la Republica's large holdings of vault cash and of unfrozen deposits at the Central Bank. The authorities indicated that recently they had reached an informal understanding with the management of the Banco de la Republica in terms of which the Banco de la Republica was to maintain its combined holdings of vault cash and of unfrozen deposits at the Central Bank at no less than NUr$7.0 billion during the program period.

1/ For a more detailed account of currency substitution in Uruguay see Appendix II of the 1985 report on recent economic developments in Uruguay, SM/85/89.

Table 9. Uruguay: Quantitative Performance Criteria for the Stand-By Arrangement

	1986			
	March	June	September	December
	(In millions of new Uruguayan pesos)			
Ceiling on cumulative deficit of the nonfinancial public sector	8,050 1/	11,470 1/	6,500 2/	11,000 2/
Ceiling on cumulative increase from December 31, 1985 in the net domestic assets of the Central Bank of Uruguay	-7,800	-5,200	-1,100	11,000
	(In millions of U.S. dollars)			
Ceiling on public and publicly guaranteed external debt outstanding maturities up to 12 years	3,042 3/	3,087 3/	3,100	3,122
Ceiling on short-term public and publicly guaranteed external debt outstanding	320 3/	325 3/	325	330
Ceiling on public and publicly guaranteed external debt of maturities of between one and five years	161 4/	161 4/	176	176
Targets for the net international reserves of the Central Bank of Uruguay	-114.2	-129.2	-129.2	-129.2

1/ Measured from June 30, 1985.
2/ Measured from December 31, 1985.
3/ The difference in these ceilings from those earlier reported in EBS/85/210 are entirely due to the revision in the estimates of the initial stocks of external debt outstanding as of June 30, 1985.
4/ These stocks correspond to an increase of US$35 million since June 30, 1985 in the stock of external debt outstanding with a maturity of between one and five years.

In December 1985, Congress approved a domestic debt refinancing law aimed primarily at improving the financial position of overindebted agricultural and industrial enterprises by providing a framework for the orderly rescheduling of these enterprises' debts with the commercial banks. 1/ The authorities' initiatives in this regard were to be complemented by the establishment of a National Development Corporation to provide assistance to financially troubled large scale enterprises, although it was not expected that this corporation would begin operations prior to 1987. The authorities believed that the new legislation would clarify the domestic debt situation and would create the conditions for a resumption of bank lending for investment purposes. Moreover, they expected that this legislation would improve the financial position of the commercial banks, which up until now had been unable to collect on a large part of their loan portfolio. In response to the concerns raised by the staff, the authorities indicated that there would be no cost to either the budget or to the Central Bank beyond the capital contribution that the Government would make to the Development Corporation when it will start operations next year.

The authorities had been disappointed in 1985 by the virtual lack of collection on the Central Bank's private sector loan portfolio of approximately US$600 million. They attributed this to the postponement of payments by debtors in anticipation of the domestic debt refinancing legislation. The authorities now expected that the passage of the domestic debt law would enable the Central Bank to resume collecting payments on its loan portfolio. However, they emphasized that policy was not being premised on the assumption of any substantial increase in such collections prior to 1987.

In the area of interest rate policy, the authorities noted that, as had been envisaged in the program, in December 1985 they had eliminated the loan rate ceiling on the domestic currency operations of the banking system. As a result, all interest rates, in both domestic and foreign currency, were now entirely free of administrative controls. The authorities believed that such an interest rate policy would not only improve domestic resource allocation but would also help to arrest the process of currency substitution experienced by Uruguay in recent years.

3. Incomes policy

The authorities indicated that they continued to view incomes policy as an important complement to demand management policy. In this connection, they stressed that they had no particular target for a real wage increase in 1986 following the large real wage increases of the preceding year. Rather, the main objective of incomes policy in 1986 would be to promote the conditions for a further improvement in the level of employment within an environment of decelerating price inflation.

1/ This legislation is described in some detail in an appendix to the 1986 Article IV report on recent economic developments in Uruguay.

The authorities observed that in early 1986 they had made a basic change in wage policy with a view to limiting the rate of nominal wage increase and in particular to preventing the re-emergence of wage drift. Thus, rather than setting wage guidelines for individual settlements by the tripartite wage councils as had previously been the case, in February 1986 the authorities decreed a uniform 18 percent wage increase for all private sector workers. This latter limit was now to apply to all the components of the wage bill and not only to the basic wage as had earlier been the practice. In March 1986, the authorities announced a similar limit of 18 1/2 percent for the overall wage increase for public sector employees.

For the remainder of the year, the authorities indicated that they intended to adhere to their policy of setting wages at intervals of no less than four months. While the precise details of the next wage settlement were still to be finalized, the authorities emphasized that it would be linked to the programmed rather than to the past rate of inflation. The authorities also indicated that, where possible, efforts would be made to lengthen the duration of wage contracts in an effort to create a more certain work environment.

4. External policies

Following the floating of the currency in November 1982, Uruguay fully recovered the loss in international competitiveness that had been experienced between 1978 and 1982 when a policy of a preannounced schedule of depreciation was in effect (see Chart 1). The authorities indicated that they regarded the maintenance of an adequate competitive position as an essential prerequisite for their medium-term strategy of export-led growth. For this reason, they had responded to the recent strengthening in the capital account by accumulating international reserves rather than by allowing the currency to appreciate in real terms.

The authorities indicated that for the remainder of the program period they would allow the currency to depreciate in the event of pressure in the foreign exchange market. To guide policy in this respect, quarterly balance of payments targets were established (see Table 9). In the event that the capital account continued to be stronger than anticipated, the authorities indicated that they would be more inclined to accumulate international reserves rather than to allow a real appreciation of the currency, unless they were satisfied that these capital inflows were of a permanent nature. The authorities recognized the complications that this stance of policy might cause for monetary policy management, but they were of the view that the instruments of monetary policy were adequate to cope with the possible inflationary impact of further capital inflows.

While the authorities regarded exchange rate policy as the key element in their strategy of export promotion, they also attached importance to their efforts to open new markets and to provide Uruguayan exporters with export prefinancing similar to that received by their foreign competitors. Recently, a scheme of tax credit certificates ranging between 3 and 11 percent had been introduced for fish exports, but the authorities emphasized that this scheme was temporary and was being limited to the financially troubled fishing industry. In the exchange and trade area, the authorities remained committed to maintaining both current and capital transactions completely free of restrictions. As regards import tariffs, the authorities noted that in reflection of the trade liberalization program initiated in the late 1970s, the structure of Uruguay's import tariffs had been substantially simplified and the highest rate had been lowered to 55 percent. The authorities indicated that while over the medium term they intended to continue along the path of trade liberalization, in 1985 budget considerations had necessitated a uniform 5 percentage increase in import tariffs.

The authorities indicated that since last August, substantial progress had been made in the negotiation of a multiyear rescheduling arrangement for Uruguay's external debt with the commercial banks. Toward the end of last year, Uruguay's commercial bank creditors agreed in principle to the multiyear rescheduling of around US$1.7 billion or almost the entirety of maturities falling due between 1985 and 1989. The documentation for this rescheduling exercise was currently being circulated to participating banks and the authorities expected that the exercise would soon be finalized.

The authorities observed that Uruguay was not seeking new funds from the commercial banks on a concerted basis. Rather, Uruguay's projected external financing needs were to be met through a variety of sources including the increased placement of U.S. dollar denominated treasury bills and bonds, the receipt of official credits, greater use of revolving funds from the multilateral lending organizations, and a US$45 million advance by a select group of banks as part of a cofinancing arrangement with the World Bank in the energy sector. Since the initial design of the external financing package for 1986, Uruguay's projected financing needs have declined due to lower oil prices and reduced interest rates in world markets. In addition, during the early months of 1986, Uruguay took advantage of favorable market conditions to place around US$50 million more of long-term treasury bonds and bills than had been projected. As a result, the authorities were not anticipating any difficulty in financing Uruguay's program during 1986, despite the delays now expected in disbursements under the World Bank cofinancing arrangement until the second half of the year and the uncertainties regarding the timing of the support that earlier had been anticipated from U.S. AID.

In recent years, Uruguay has received a relatively low level of financial support from the World Bank and this support has mainly been concentrated on developing Uruguay's infrastructure (see Appendix III). The authorities indicated that they were now expecting to step up borrowing from the World Bank from an estimated US$35 million in 1986 to an annual rate of around US$100 million in the period beyond 1986. The major part of this borrowing was likely to take the form of structural adjustment or sectoral loans. Agreement in principle with the World Bank and with the commercial banks had already been reached on a US$95 million cofinancing arrangement for the energy sector. Under this arrangement, the commercial banks would provide an advance of US$45 million to the Central Bank of Uruguay in 1986, while the World Bank would start disbursing in 1987 on its US$50 million share of the arrangement. At the same time, the Bank would guarantee up to 50 percent of the amortization payments due to the commercial banks on their share of the cofinancing arrangement. In addition, discussions were currently underway for a structural adjustment loan in support of policy reforms in the areas of taxes, the social security system, and the foreign trade regime.

5. Performance criteria

In the letter of intent of last August, quarterly performance criteria for the net domestic assets of the Central Bank were set only through the end of 1985, while the other quantitative performance criteria (the limit on the deficit of the nonfinancial public sector, the ceilings and subceilings on the public and publicly guaranteed external debt, and the target for the net international reserves of the Central Bank) were set only through June 1986. In the attached letter of intent and Memorandum on Economic Policies for 1986, quantitative objectives have now been established for the whole of 1986 for all the variables subject to performance criteria (see Table 9). While the variables subject to quantitative performance criteria in 1986 are the same as those in 1985, a downward adjustment is now to be made to the net domestic asset ceiling of the Central Bank equivalent to 65 percent of the amount by which the net international reserves of the Central Bank exceed the levels targeted for each quarter. Moreover, the net domestic asset ceiling is also to be adjusted to take account of any changes in the system of legal reserve requirements relative to the system in effect at the end of February 1986.

IV. Medium-Term Balance of Payments and External Debt Scenario

The staff has revised the medium-term balance of payments and external debt projections presented last September in SM/85/210 (Tables 10 and 11). These revisions mainly reflect the actual balance of payments outturn for 1985 and the changed medium-term outlook for the external economic environment. In addition, the new staff projections incorporate more precise information on the terms of Uruguay's multiyear rescheduling arrangement with its commercial bank creditors. 1/ In

1/ These terms are described in an appendix of the accompanying report on recent economic developments in Uruguay.

Table 10. Uruguay: Medium-Term Balance of Payments Outlook

	Prel. 1985	Projected 1986	1987	1988	1989	1990	1991
	(In millions of U.S. dollars)						
Current account balance	-135	-90	-39	-13	30	68	107
Exports	845	884	959	1,054	1,169	1,285	1,413
Imports	715	708	744	825	914	1,013	1,123
Nonfactor services (net)	81	71	74	78	82	85	89
Factor services (net)	-356	-349	-340	-333	-321	-303	-287
Transfers	11	12	12	13	13	14	15
Capital account	99	140	63	34	12	-56	-94
Public sector 1/	193	175	63	34	12	-56	-94
Medium and long term	85	183	63	34	12	-56	-94
Short term	108	-8	--	--	--	--	--
Private sector	-94	-35	--	--	--	--	--
Overall balance	-36	50	25	21	42	13	13
Official reserve movement (increase-) 2/	55	-50	-25	-21	-42	-13	-13
Net use of Fund credit	92	17	-72	-51	-80	-76	-31
Purchases	101	70	18	--	--	--	--
Repurchases	-9	-53	-89	-51	-80	-76	-31
Other	-37	-67	47	30	38	63	18
	(Percentage changes)						
Memorandum items							
Principal assumptions							
Real GDP growth	0.5	3.0	3.0	4.0	4.0	4.0	4.0
Export volume growth							
Traditional exports	-4.6	-3.2	2.0	4.0	4.0	4.0	4.0
Nontraditional exports	-4.6	3.4	4.0	5.0	5.0	5.0	5.0
Import volume growth							
Oil imports	-15.9	8.7	3.0	4.0	4.0	4.0	4.0
Non-oil imports	6.0	7.2	5.0	6.0	6.0	6.0	6.0
Terms of trade	-8.6	12.3	4.5	0.1	0.1	0.1	0.1
LIBOR interest rate	8.5	7.5	7.5	8.0	8.0	8.0	8.0
U.S. GDP deflator	3.5	3.3	3.0	3.7	3.7	3.7	3.7
	(As percent of GDP)						
Current account balance as percent of GDP	-2.7	-1.7	-0.7	-0.2	0.4	0.9	1.3

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

1/ Reflects the rescheduling of commercial bank debt maturities falling due between 1985 and 1989 and assumes no additional commercial bank lending after 1986.

2/ In 1985, includes valuation adjustment.

Table 11. Uruguay: Medium-Term External Debt Projections

	Prel. 1985	Projected 1986	1987	1988	1989	1990	1991
I. Debt Service Payments							
(In millions of U.S. dollars)							
Total public sector 1/	411	427	421	418	454	592	627
Principal	89	122	124	122	161	302	340
Interest	323	305	297	296	293	289	287
Public sector medium and long term	357	381	382	377	411	547	581
Principal	89	122	124	122	161	302	340
Interest	268	259	257	255	250	245	241
Public sector interest payments on short-term debt	54	46	39	41	43	44	46
IMF	24	80	118	76	99	87	36
Repurchases	9	53	89	51	80	76	31
Charges	14	27	28	24	19	12	5
Private service debt service	123	115	114	118	123	128	133
Principal	31	32	33	35	36	38	39
Interest	92	83	81	84	87	91	94
II. Debt Service Ratios							
(As percent of exports of goods and services)							
(a) Before 1985/89 refinancing							
Public debt service ratio 2/ 3/	51.9	64.6	71.8	68.3	63.6	50.8	43.4
Principal	26.5	40.0	49.6	48.2	45.7	35.1	29.7
Interest	25.4	24.6	22.2	20.2	18.0	15.7	13.7
(b) After 1985/89 refinancing							
Public debt service ratio 3/	33.1	37.5	36.8	30.7	31.0	34.6	30.7
Principal	7.5	12.9	14.6	10.8	13.5	19.3	17.2
Interest	25.6	24.6	22.2	19.9	17.5	15.3	13.5
Total public and private sector debt service ratio 3/	42.6	46.0	41.8	37.3	36.8	40.4	33.5
Principal	10.6	14.6	13.7	12.1	13.7	19.4	14.9
Interest	32.0	31.5	28.1	25.2	23.1	21.0	18.6
(In percent of GDP)							
Total public and private sector debt outstanding 4/	74.9	72.8	69.1	64.4	59.7	54.5	49.2
Of which: public sector	58.7	58.3	55.5	51.9	48.1	43.7	39.3
Fund credit	6.3	6.2	4.6	3.4	2.0	0.8	0.3

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

1/ Excluding IMF and rollover of short-term debt.
2/ Includes debt service payments on borrowing required to close financing gaps that would have emerged in the absence of rescheduling.
3/ Including IMF; after 1983/84 debt relief.
4/ Excluding reserve liabilities of Central Bank and deposits of nonresidents.

regard to the stance of policies, the staff assumed that over the medium term the authorities would continue along the path of adjustment envisaged in the current stand-by arrangement and in particular that further reductions would be made in the fiscal deficit.

The staff's medium-term scenario now assumes that lower international oil prices and interest rates will allow real GDP to grow at an annual rate of 4 percent a year by 1988. On that basis, the volume of non-oil imports are assumed to grow by 6 percent a year from 1988 onward, while oil import volumes would increase by 4 percent a year. In reflection of the exchange rate policy being pursued and the upturn expected in the beef cycle, export volume growth is projected to pick up to around 5 percent a year from 1988 onward. In line with the current World Economic Outlook exercise, it was further assumed that international interest rates (Libor) would average 7 1/2 percent in 1986 and 1987, while the price paid by Uruguay for its oil imports would decline to US$15 a barrel in 1987, after which it would increase at the same rate as world inflation.

The above assumptions are consistent with a medium-term balance of payments and external debt scenario not very different from that presented in SM/85/210 (see Tables 10 and 11). In particular, under the revised set of assumptions there would continue to be a significant reduction in Uruguay's external debt service ratio by the end of the decade. Thus, in relation to exports of goods and services, the overall debt service ratio (after rescheduling) would decline from a peak level of 46 percent in 1986 to 33 1/2 percent by 1991. Similarly, the public debt service ratio would decline from 37 1/2 percent in 1986 to 30 3/4 percent by 1991.

V. Staff Appraisal

Last June, the Uruguayan Government introduced an adjustment program aimed at strengthening the external accounts and at reducing inflation with a view to laying the basis for sustained economic growth. The main element of the adjustment effort was a sizable reduction in the public sector deficit. In support of this program, on September 27, 1985 the Executive Board approved Uruguay's request for an 18-month stand-by arrangement.

Performance under the stand-by arrangement to date has been satisfactory. As of end-December 1985, Uruguay was in full observance of all the quantitative performance criteria of the program. Of particular note was the larger than programmed reduction in the fiscal deficit. Inflation came down during the second half of 1985, albeit not to the extent that had been programmed, and there was a significantly larger than programmed strengthening in the external accounts owing to a marked turnaround in the capital account. A further encouraging development was the apparent bottoming out of the domestic recession.

For 1986, the authorities are proposing to continue along the path of adjustment on which they had embarked last June. In this regard, the principal objectives of policy are a reduction in the 12-month rate of inflation to 45 percent by year-end and the containment of the current account deficit of the balance of payments to around 1 1/2 percent of GDP. The staff shares the authorities' view that the attainment of these objectives would constitute the necessary conditions for the sustained reactivation of the economy.

The main thrust of the authorities' adjustment program for 1986 is a further reduction in the combined deficit of the nonfinancial public sector and of the Central Bank to no more than 5 percent of GDP. An important role in this reduction is to be played by the revenue measures contained in the authorities' 1986 budget and by the extraordinary profit tax on the windfall gain of the state petroleum enterprise. The staff would underline, however, that realization of the fiscal objective will also require continued vigilance over public expenditures, renewed efforts at improving tax administration, and both timely and adequate adjustments in public enterprise tariffs.

A disappointing aspect of policy during 1985 was the virtual lack of recovery on the Central Bank's large private sector loan portfolio. Now that Congress has enacted a domestic debt refinancing law, the staff would urge the authorities to make every effort to increase collections on the Central Bank's portfolio in order to reduce the quasi-fiscal deficit of the Central Bank. The staff also would caution the authorities to implement the domestic debt refinancing legislation in a manner that would avoid any additional cost to the budget.

During the past year, the monetary aggregates were boosted by capital inflows from abroad, by the relatively easy credit policy of the Banco de la Republica, and by a reduction in legal reserve requirements. For 1986, the authorities' principal monetary policy objective is to scale down the 12-month rate of growth of M-2 to 50 percent by end-1986. The staff fully supports the view that a significant deceleration in the rate of growth of the monetary aggregates is necessary for the sustained reduction of inflation. The staff welcomes the recent elimination of the loan rate ceilings on the domestic currency operations of the commercial banks. Following this action, all interest rates in Uruguay are now free of administrative control.

The targeted improvement in the public sector finances should contribute importantly to the authorities' monetary policy objective. However, in addition, active use will need to be made of the monetary policy instruments and firm control will need to be exercised over the credit operations of the Banco de la Republica. The staff would caution that this is all the more so the case in Uruguay's current circumstances where further capital inflows from abroad might need to be sterilized.

In the area of wages, the Government has announced that it will continue with its policy of wage settlements at intervals no shorter than four months and that these settlements will be guided by the programmed rather than by the past rate of inflation. The authorities also are committed to avoiding a repetition of the wage drift that occurred in the latter part of 1985. The staff would stress the importance of the successful implementation of wage policy if the authorities' stabilization objectives are to be attained without jeopardizing the prospects for employment.

In the external area, the authorities are committed to maintaining both current and capital transactions completely free of restrictions. Moreover, they are committed to maintaining an adequate degree of international competitiveness. The staff supports the authorities' view that in Uruguay's present circumstances it is more prudent to respond to capital inflows by accumulating international reserves than by allowing an undue appreciation of the currency. However, the staff would draw attention to the implications that such an exchange rate policy would have for monetary policy management.

The staff believes that the understandings reached in the discussions for the mid-term review provide the basis for expecting that the overall objectives of the stand-by program will be realized. Moreover, the staff is of the view that the external financing of the program for 1986 is adequate. Accordingly, the staff recommends the completion of the mid-term review.

It is proposed that the next Article IV consultation with Uruguay take place on the regular 12-month cycle.

VI. Proposed Decision

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

1. Uruguay has consulted with the Fund in accordance with paragraph 4(d) of the stand-by arrangement for Uruguay (EBS/85/210) and paragraph 19 of the Memorandum of Understanding on Economic Policy dated August 28, 1985 attached to the stand-by arrangement, in order to review progress made in the implementation of the program and to reach understandings as specified in paragraph 4(d) of the stand-by arrangement.

2. The letter and the attached Memorandum of Understanding on Economic Policies for 1986 dated April 30, 1986 from the Minister of Economy and Finance and the President of the Central Bank of Uruguay shall be annexed to the stand-by arrangement for Uruguay, and the letter and Memorandum of August 28, 1985 attached to the stand-by arrangement shall be read as supplemented and modified by the letter and the Memorandum of Understanding of April 30, 1986.

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

(a) During any period in which:

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

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

are not observed; or

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

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

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

are not observed.

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

Uruguay - Fund Relations
(As of February 28,1986)

I. Membership Status

(a) Date of membership: March 1946
(b) Status: Article VIII

(A) Financial Relations

II. General Department

(a) Quota: SDR 163.8 million
(b) Total Fund holdings of New Uruguayan pesos: 472.9 million SDRS, equivalent to 288.7 percent of quota.

(c) Fund credit:

	Millions of SDRs	Percent of Quota
Under:		
CFF	99.2	60.6
Credit tranches	102.7	62.7
Enlarged access	107.2	65.4
Total	309.1	188.7

III. Arrangements form the Fund

(a) Stand-by arrangements since 1974.

Uruguay has had seven stand-by arrangements since 1974. The first one, for SDR 17.3 million, was fully utilized; no purchase was made under the subsequent four arrangements; and the arrangement in the amount of SDR 31.5 million or 25 percent of quota, which expired on July 14, 1982, was fully utilized. On April 22, 1983, the Executive Board approved a two-year stand-by arrangement in an amount equivalent to SDR 378 million or 300 percent of the quota then in effect. During 1983, Uruguay purchased SDR 151 million before further purchases were prevented by failure to observe the program's targets. On September 27, 1985, the Executive Board approved an 18-month stand-by arrangement in an amount equivalent to SDR 122.85 million or 75 percent of quota. To date, Uruguay has purchased SDR 35.1 million under the arrangement.

(b) Special facilities.

A purchase of SDR 55.3 million under the compensatory financing facility was made in August 1982. A repurchase of SDR 11.2 million was made in February 1983 because of overcompensation under the August 1982 CFF purchase. A new purchase of SDR 66.1 million under the compensatory financing facility was made on October 2, 1985.

IV. SDR Department

(a) Net cummulative allocation: SDR 49.98 million

(b) Holdings: SDR 0.12 million equivalent to 0.25 percent of net cummulative allocation.

(B) Nonfinancial Relations

V. Exchange Rate Arrangement: The currency of Uruguay is the new peso. From December 26, 1978 to November 26, 1982, the peso was depreciated daily in accordance with a peso-U.S. dollar exchange rate schedule announced several months in advance. This exchange rate system was then replaced by a floating exchange rate system. On March 31, 1986, buying and selling interbank rates for the U.S. dollar, the intervention currency, were NUr$ 137.25 and NUr$ 137.50.

VI. Last Consultation: The 1985 Article IV consultation was completed by the Executive Board on April 8, 1985 (SM/85/83 and EBM/85/86). The consultation is on the standard 12-month cycle.

VII. Technical Assistance: Mr. Lopez Murphy, an expert selected by the Central Banking Department has been providing technical assistance to the Central Bank of Uruguay since July 1984. Mr. Murphy's appointment has been extended through July 1986.

VIII. Resident Representative: In May 1986, Mr. Di Tata will replace Mr. Arbulu-Neira as resident representative in Uruguay.

IX. Currentness of Data: Generally adequate. Conceptual and methodological problems with financial statistics were discussed with the Central Bank of Uruguay during a Bureau of Statistics' expert's visit to Montevideo in March 1984.

Uruguay: Main Economic and Financial Indicators

	1983	1984	1985 Proj.	1985 Est.	1986
(Annual percentage changes, unless otherwise specified)					
National income and prices					
GDP at constant prices	-5.8	-2.4	1.0	0.6	3.0
GDP deflator	52.7	60.4	74.3	75.8	64.0
Consumer prices (end of period)	51.5	66.1	80.0	83.0	45.0
External sector (on the basis of U.S. dollars)					
Exports, f.o.b.	2.1	-11.5	-1.0	-8.6	4.6
Imports, c.i.f.	-27.5	-3.8	2.8	-5.7	-1.0
Non-oil imports, c.i.f.	-25.4	-6.5	5.4	2.1	11.5
Export volume	8.9	-11.1	0.9	0.9	1.1
Import volume	-23.8	-3.9	1.2	-5.0	7.7
Terms of trade (deterioration -)	0.7	2.3	-3.4	-8.6	12.3
Nominal effective exchange rate (depreciation -) 1/	28.3	17.8	...	-3.8	...
Real effective exchange rate (depreciation -) 1/	7.2	0.3	...	-3.7	...
Central government operations					
Revenue	50.8	37.3	89.6	89.6	81.8
Total expenditure	21.1	46.5	74.0	65.1	67.0
Monetary aggregates (end of period)					
Money (M-1)	7.7	57.5	43.8	101.4	51.0
Money and domestic currency quasi-money (M-2)	18.0	49.9	54.3	91.2	51.0
Money and domestic and foreign currency quasi-money (M-3) 2/	14.6	62.3	...	98.8	...
Real M-2 (end of period)	-22.1	-9.9	-16.5	4.5	4.2
(In percent of GDP)					
Public sector savings	-0.9	-0.7	0.8	0.1	2.6
Nonfinancial public sector surplus or deficit (-)	-4.9	-4.4	-3.8	-3.1	-1.3
Central bank quasi-fiscal deficit (-)	-11.5	-4.9	-4.4	-3.4	-3.6
Consolidated nonfinancial public sector and central bank deficit	-16.4	-9.3	-8.2	-6.6	-4.9
Financing of the overall public sector deficit	16.4	9.3	8.2	6.6	4.9
External	6.0	2.3	4.9	3.7	3.1
Domestic	10.4	7.0	3.3	2.9	1.8
Gross domestic investment	10.0	8.8	9.3	8.2	9.5
Gross national savings	6.4	6.5	7.0	5.5	7.9
Current account of the balance of payments	-4.0	-2.5	-2.5	-2.7	-1.7
Total external debt (end of period)	72.9	76.9	73.1	74.9	72.8
Debt service ratio (in percent of current receipts) 3/	28.2	32.4	32.7	33.1	37.5
Interest payments (in percent of current receipts) 3/	18.8	25.6	24.3	25.6	24.6
(In millions of U.S. dollars, unless otherwise specified)					
Overall balance of payments	-20	-55	-84	-36	50
Gross official reserves (months of imports of the following year) 4/	4.8	3.8	3.3	4.7	5.5

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

1/ End of period.
2/ Includes foreign currency deposits of residents only. Foreign currency deposits valued at the end-of-period exchange rate.
3/ On public and publicly guaranteed debt nonresident deposits with official banks and central bank reserve liabilities; excluding short-term amortization and after rescheduling of external debt maturities falling due to commercial banks in 1985 and 1986. The debt service ratio before rescheduling would be equivalent to 52 percent of exports of goods and services in 1985 and 65 percent in 1986.
4/ Gold valued at SDR 35 per fine troy ounce.

Uruguay: Financial Relations with the World Bank Group

(In millions of U.S. dollars)

	Commitments (Net of Cancellations)	Disbursements	Undisbursed Amount
I. IBRD Operations (as of December 31, 1985)			
Sectors			
Agricultural and rural development	155.7	111.7	44.0
Industrial Credit	50.6	35.9	14.7
Power	155.2	102.7	52.5
Transport and telecommunications	170.0	73.4	96.6
Education	9.7	3.1	6.6
Total		326.7	
Repayments		184.7	
Total outstanding		142.0	
II. IFC Operations (as of December 31, 1985)			
	Loans	Equity	Total
Commitments	27.1	5.3	32.4
Total held by IFC	20.5	5.3	25.8
Total undisbursed	5.8	2.4	8.2
III. IBRD Loan Transactions (calendar year)			
	1983	1984	1985
Disbursements	20.6	58.6	57.4
Repayments	13.8	18.8	21.4
Net lending	6.8	39.8	36.0

Source: World Bank.

Uruguay - Statistical Issues

1. General status of the statistics

Uruguay's macroeconomic statistics are much better than those of countries at a similar stage of development in terms of their comprehensiveness, quality, and timeliness. With respect to data on the public sector there are, however, a number of public entities and municipalities for which above the line data are not available. There are also some additional difficulties in reconciling above-the-line and below-the-line estimates of the public sector deficit owing to the unavailability of disaggregated data on the domestic financing of individual public entities. Similarly, while the monetary data is basically reliable and comprehensive, there are certain gaps with regard to the Mortgage Bank. Finally, the external statistics are generally adequate and the data covering the external debt is believed to accurately reflect Uruguay's external debt position.

2. Coverage, currentness, and reporting of data in IFS

		Latest Data in March 1986 IFS
Real sector	- National accounts	1984
	- Prices: consumer	October 1985
	wholesale	November 1985
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government finance	- Deficit/surplus	Q4 1985
	- Financing	Q4 1985
	- Debt	1984
Monetary accounts	- Monetary authorities	November 1985
	- Deposit money banks	September 1985
	- Other financial institutions	n.a.
External sector	- Merchandise trade:	
	value (exports)	November 1985
	(imports)	September 1985
	unit value of exports	November 1985
	- Balance of payments	1985
	- International reserves	November 1985
	- Exchange rates	January 1986

During the past year, the reporting of data for inclusion in the IFS, has been on a timely basis.

Uruguay - Basic Data

Area and population	
Area	187,000 sq. kilometers
Population (mid-1985)	3.0 million
Annual rate of population increase (1975-84)	0.7 percent
Unemployment rate (end-1985)	12.0 percent
GDP (1985)	SDR 4,987 million
GDP per capita (1985)	SDR 1,662

Ratios to GDP	1982	1983	1984	Est. 1985	Proj. 1986
			(percent)		
Exports of goods and nonfactor services 1/	27.4	27.2	26.5	24.5	23.8
Imports of goods and nonfactor services 1/	32.6	25.4	21.8	20.3	19.3
Current account of the balance of payments	-8.8	-4.0	-2.7	-2.7	-1.7
Central administration revenues	15.2	15.9	14.0	15.0	16.1
Central administration expenditures	24.3	20.4	19.1	17.9	17.7
Public sector savings	-4.6	-0.9	-0.7	0.1	2.6
Public sector overall surplus or deficit (-)	-10.0	-4.9	-4.4	-3.1	-1.3
External public debt (end of year)1/2/	47.7	57.1	56.6	58.7	58.3
Savings	9.8	6.4	6.5	5.5	7.9
Investment	14.4	10.0	8.8	8.2	9.5
Money and quasi-money in domestic currency (end of year)	23.6	19.4	18.5	20.0	17.9
Annual changes in selected economic indicators					
Real GDP per capita	9.9	-6.4	-3.0	--	2.4
Real GDP	-9.4	-5.8	-2.4	0.6	3.0
GDP at current prices	5.1	43.8	56.5	76.9	68.9
Domestic expenditures (at current prices)	4.3	36.8	52.7	76.9	68.0
Investment	-1.3	-0.7	39.0	63.7	76.0
Consumption	5.2	42.9	54.3	78.2	67.6
GDP deflator	16.0	52.7	60.4	75.8	64.0
Wholesale prices (annual averages)	12.9	73.5	77.4	76.6	...
Consumer prices (annual averages)	19.0	49.2	55.3	72.2	65.5
Central administration revenues	-8.0	50.8	37.3	89.6	81.8
Central administration expenditures	39.9	21.1	46.5	65.1	67.0
Money and quasi-money in domestic currency (M2)	10.1	18.0	49.9	91.2	51.0
Money (M1)	19.9	7.7	57.5	101.4	51.0
Quasi-money	4.7	24.5	45.5	85.1	51.0
Money and quasi-money in domestic and foreign currency 3/ (M3)	52.3	14.6	62.3	98.8	...
Merchandise exports (f.o.b., in U.S. dollars)	-15.9	2.1	-11.5	-8.6	4.6
Merchandise imports (c.i.f., in U.S. dollars)	-35.9	-27.5	-3.8	-5.7	-1.0

Balance of payments	1982	1983	1984	Est. 1985	Proj. 1986
	(millions of U.S. dollars)				
Merchandise exports (f.o.b.)	1,023	1,045	925	845	884
Merchandise imports (c.i.f.)	1,087	-788	-758	-715	-708
Investment income (net)	-188	-288	-362	-356	-349
Other services and transfers (net)	-175	-159	71	92	83
Balance on current and transfer accounts	-426	-189	-124	-135	-91
Public sector capital (net)	1,073	438	86	192	175
Private sector capital (net), including errors and omissions	-1,446	-269	-17	-94	-35
Allocation of SDRs	--	--	--	--	--
Overall balance (deficit -)	-800	-20	-55	-36	50
Valuation adjustment 4/	215	102	4	-19	--
Change in official net reserves (increase -)	585	-82	51	55	-50

International reserve position (end of period)	1982	1983	1984	1985	1986
	(millions of SDRs)				
Central Bank (gross) 5/	206.4	291.6	229.9	251.4	316.9
Central Bank (net) 5/	-119.2	-46.3	-102.3	-140.7	-95.1

1/ For the purpose of these ratios, a U.S. dollar GDP was estimated using an exchange rate for the Uruguayan peso that would keep the Uruguayan peso per U.S. dollar exchange rate constant in real terms at its average 1984 level.

2/ Excluding reserve liabilities of the Central Bank and foreign currency deposits by nonresidents.

3/ Includes foreign currency deposits of residents only; foreign currency deposits converted at the end-of-period exchange rate.

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

5/ Gold valued at SDR 35 per fine troy ounce.

Table 12. Uruguay: Net Financing of the Consolidated Public Sector

(In millions of new Uruguayan pesos)

	I 1986	II 1986	III 1986	IV 1986	1986
Financing requirement of nonfinancial public sector	-326.6	312.4	6,514.2	4,500.0	11,000.0
External financing of nonfinancial public sector	8,655.8	1,202.1	1,702.4	1,291.8	12,852.1
Treasury bonds	5,507.6	590.0	607.4	770.0	7,475.0
Treasury bills	1,223.2	-862.9	-935.1	-1,000.9	-1,575.8
Suppliers credit	668.4	737.5	799.3	855.5	3,060.7
Medium and long-term loans	1,256.6	737.5	1,230.8	667.3	3,892.2
Central Government	481.2	516.3	271.7	290.9	1,560.1
Local governments	227.3	250.8	159.9	273.8	911.6
Public enterprises	548.1	-29.5	799.3	102.7	1,420.5
Domestic financing of nonfinancial public sector	-8,982.4	-889.7	4,811.8	3,208.2	-1,852.1
Financing requirement of Central Bank	6,908.0	8,433.0	7,012.0	8,873.0	31,226.0
External financing of Central Bank	0.0	4,882.3	495.5	8,418.1	13,795.9
External financing of official bank	-40.1	-118.0	79.9	-119.8	-197.9
Total financing requirement of non-financial sector and Central Bank	6,581.4	8,745.4	13,526.2	13,373.0	42,226.0
Dollar-denominated bonds and bill	6,730.8	-272.9	-327.7	-231.0	5,899.2
Foreign loans (net)	1,925.0	6,357.3	2,525.6	9,940.9	20,748.8
Cther (net)	-2,074.4	2,661.0	11,328.3	3,663.1	15,578.0

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

Table 13. Uruguay: Projection of Central Bank's Quarterly Accounts

(Flows in millions of new Uruguayan pesos)

	1986				
	QI	QII	QIII	QIV	Total
Net international reserves	14,705	-2,581	-5,147	-1,779	5,197
In millions of U.S. dollars	110	-18	-32	-10	50
Net domestic assets	-8,443	3,199	4,128	12,097	10,982
Credit to nonfinancial public sector	-10,604	1,214	-1,136	13,141	2,614
Credit to Mortgage Bank	440	487	528	565	2,020
Net unclassified assets	5,025	9,565	8,762	10,713	34,065
Central bank loss	6,011	7,703	6,555	8,679	28,948
Bills for monetary regulation	-3,178	-585	-523	-1.013	-5,300
Frozen interest payments	2,192	2,447	2,731	3,047	10,417
Credit to banking system	-317	--	--	--	-317
Credit to private sector	--	--	--	--	--
Medium- and long-term external borrowing (in millions of U.S. dollars)	--	-4,882	-496	-8,418	-13,796
Deposits of commercial banks in foreign currency	-325	--	--	--	-325
Deposits of BROU in foreign currency	199	--	--	--	199
Frozen interest payments	-2,192	-2,447	-2,731	-3,047	-10,417
BROU's unfrozen deposits	--	--	--	--	--
BROU's vault cash	--	--	--	--	--
Export financing	-668	-738	-799	-856	-3,061
Money base	6,262	618	-1,019	10,318	16,179
Currency in circulation	4,454	-91	-1,654	9,088	11,797
Reserve liabilities of commercial banks	1,808	709	635	1,229	4,382
Vault cash	122	319	286	553	1,279
Deposits	1,686	390	349	677	3,103
Memorandum item					
Exchange rate	133.68	147.50	159.85	171.10	

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

Table 14. Uruguay: Outstanding Public Sector External Debt 1/

(In millions of U.S. dollars)

	1982	1983	1984	1985	1986 Mar. 31	1986 June 30	1986 Sept. 30	1986 Dec. 31
Total	2,301.4	2,729.5	2,757.0	2,971.9	3,036.3	3,076.8	3,091.2	3,147.2
Medium- and long-term debt 2/	1,733.3	2,526.2	2,553.4	2,670.5	2,725.8	2,772.1	2,792.3	2,854.1
Central Government 3/	296.2	294.9	317.9	325.1	328.7	332.2	333.9	335.6
Local government	0.5	0.6	2.0	5.4	7.1	8.8	9.8	11.4
Public enterprises	681.7	822.5	805.1	823.5	827.6	827.4	832.5	833.0
Central Bank	313.8	823.1	858.6	861.4	861.4	894.5	897.6	946.8
Official banks	21.9	196.5	182.9	193.1	192.8	192.0	192.5	191.8
Supplier's credit	210.4	195.1	174.4	153.2	158.2	163.2	168.2	173.2
Treasury bonds	208.8	193.8	212.3	308.8	350.0	354.0	357.8	362.3
Short-term debt 4/	568.1	203.0	203.6	301.4	310.5	304.7	298.9	293.1
Treasury notes	84.4	128.3	170.8	301.4	310.5	304.7	298.9	293.1
BROU	114.5	74.7	32.8	--	--	--	--	--
Other 5/	369.2	--	--	--	--	--	--	--

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

1/ Public or publicly guaranteed private debt stocks outstanding at end of period. Excludes reserve liabilities of the Central Bank and foreign currency deposits by nonresidents. Debt rescheduled in 1983-85 is shown as owed by the original debtor.
2/ At maturities of one year or more.
3/ Excludes IBRD sectoral loan which is treated as medium- and long-term liability of the Central Bank.
4/ At maturities of less than one year.
5/ Banco Hipotecario, COMPIPAL, Salto Grande.

Montevideo, Uruguay
April 30, 1986

Mr. Jacques de Larosière
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Larosière:

1. In our letter to you of August 28, 1985, we indicated that we would review with the Fund in early 1986 the progress made in the implementation of the economic program announced last June. The purpose of this letter is to summarize recent developments under the program and to outline the policies that we intend to pursue during 1986.

2. Performance under the stand-by arrangement to date has been most favorable. Over the past several months, our policies have succeeded in reducing inflation while at the same time they have strengthened our external accounts. These developments have occurred amidst clear signs of a significant rebound in economic growth over the past two quarters as well as of an appreciable decline in the level of unemployment.

3. For 1986, the Government intends to continue along the path initiated last June. The primary objective of economic policy will remain that of securing a sustainable reactivation of the economy. To this end, policies have been put in place aimed at further reducing inflation, at cutting back the public sector's deficit, and at strengthening the external accounts. As was anticipated last August, quantitative quarterly ceilings have now been set for the program's main policy variables, as reflected in the attached tables.

4. The Government believes that the policies upon which it has embarked for 1986 are adequate to achieve the objectives of the program, but it stands ready to take any further measures that may become appropriate for this purpose. Accordingly, the Government of Uruguay requests the completion of the review that was envisaged in paragraph 19 of the Memorandum of Understanding attached to our letter of August 28, 1985.

Sincerely yours,

/s/	/s/
Ricardo Zerbino	Ricardo Pascale
Minister of Economy and Finance	President
	Central Bank of Uruguay

Attachment

Memorandum of Understanding on Economic Policy for 1986

1. Performance under the stand-by arrangement to date has been favorable. During the second half of 1985, consumer prices increased by 34 percent or only somewhat above the 31 percent that had been targeted for this period consistent with the objective of reducing inflation to 60 percent for the year ending June 1986. At the same time, despite unanticipated delays in external loan disbursements, at the end of 1985 the net international reserves of the Central Bank of Uruguay were almost US$60 million above the program's target. This strengthening in the external accounts was achieved amidst clear signs that the domestic recession was bottoming out and that the level of unemployment had begun to decline.

2. During the second half of 1985, the Uruguayan Government adopted a series of measures aimed at strengthening the domestic financial situation. These measures included the approval of a major tax package in Congress, the periodic raising of public enterprise tariffs, the stretching out of the interval between wage settlements, and the elimination at the end of last year of the ceiling on domestic currency loan rates. In November, Uruguay was able to make its first purchase subject to performance criteria under the stand-by arrangement. Moreover, as of the end of December 1985, Uruguay was in full observance of all of the performance criteria of the arrangement.

3. During 1985, there was a marked improvement in the public finances resulting from the implementation of our economic program. Thus, notwithstanding the widening of the deficit in the early part of the year, for 1985 as a whole the combined deficit of the nonfinancial public sector and the Central Bank was reduced by around 2 3/4 percentage points to 6 1/2 percent of GDP. A major element in our economic program for 1986 is to further reduce this combined deficit to below 5 percent of GDP for the year. In order to achieve this objective a concerted effort will continue to be made on the side of both expenditures and revenues of the Central Government. Moreover, every effort will be made to further strengthen the finances of the public enterprises and to increase the collections by the Central Bank on its private sector loan portfolio.

4. In reflection of the revenue measures introduced since last June, the Central Administration's revenue collections increased by 1 percentage point of GDP to 15 percent of GDP in 1985. During the present year, the Government intends to further increase revenue collections to over 16 percent, which would restore Uruguay's tax effort to the level that prevailed in the early 1980s. In part, the improved revenue performance anticipated for 1986 will derive from the full year effect of the revenue measures introduced in the second half of 1985. However, in the main it will be the result of a number of tax measures recently introduced by the Government. These measures have included the introduction of a tax of between 0.25 and 1.5 percent on the assets of the financial system, the raising of the corporate income tax on public

enterprises, the elimination of important deductions previously in effect for the agricultural income tax, and the shortening of the lags in the collection of the net wealth tax. In addition, in keeping with its primary objective of securing a sustainable reactivation of the economy, the Government intends to capture part of the gain to Uruguay stemming from the recent decline in international oil prices through measures that would (a) compensate the Treasury for the loss in petroleum revenues resulting from lower petroleum prices and (b) generate additional revenues to the Treasury in the amount of at least NUr$4,000 million. In line with this objective, in April 1986 a tax of NUr$1,700 million was decreed on the profits of the state petroleum enterprise. The Government also intends to increase tax revenues by intensifying the efforts already under way aimed at improving tax administration.

5. The strengthening of the Central Government's revenue effort will be accompanied by continued restraint in expenditure policy, which will be directed at holding the Central Government's overall expenditures to no more than 18 percent of GDP in 1986 or to a level little changed from 1985. In this regard, an important role will be played by the public sector wage policy described below in paragraph 11. At the same time, policies will be geared toward the containment of transfers from the Central Administration's budget to the social security system. These latter transfers will be limited by the improved level of contributions to the system that is expected to result from the intensification of efforts to reduce evasion on the payment of such contributions. As a result of the increased inspections of enterprises since last October, private sector contributions to the social security system have been raised by some 10 percent in real terms. As regards benefits, on April 1, 1986, the Government announced an average increase in social security benefits of 32 percent. Given the earlier advances in these benefits and the expectation of a deceleration in inflation, the April increase in social security benefits should be sufficient to increase their real value as compared with 1985. As mentioned in our letter of August 1985, a further area where expenditures are to be contained is in the area of government transfers to the Mortgage Bank and to the public enterprises.

6. Since assuming office in March 1985, the Government has made considerable efforts to strengthen the finances of the public enterprises. These efforts have mainly centered on rationalizing expenditures and on making timely and adequate adjustments in public enterprise tariffs. For 1986, it is the Government's intention to continue these policies with a view to attaining an overall surplus equivalent to 1/2 percent of GDP in the public enterprises' operations. To this end, on March 1, 1986 public enterprises' tariffs (excluding ANCAP, the petroleum enterprise) were increased by an average 19 percent, while on April 2, 1986 ANCAP's tariffs were increased by an average 6 percent. Two further adjustments in these enterprises' tariffs and prices are scheduled for July and November, which will at least be equal to the increase in the enterprises' costs since the previous tariff adjustments.

7. The measures outlined in the preceding two paragraphs should be sufficient to reduce the combined deficit of the nonfinancial public sector and of the Central Bank (including any deficit of the Development Corporation referred to in paragraph 10 below) to below 5 percent of GDP for calendar 1986. Consistent with this objective, the Government has set ceilings on the deficit of the nonfinancial public sector for the periods through September 1986 and December 1986, as reflected in Table 1. These ceilings will complement those set last August for the periods through March 1986 and June 1986.

8. .For 1986, the Government intends to pursue a credit and monetary policy consistent with the objectives of strengthening Uruguay's external position and of reducing inflation to around 45 percent by end-1986. In this regard, the principal objective of monetary policy will be to bring down the rate of growth of M-2 from the high rates registered in 1985 to around 50 percent through the end of 1986. In conformity with this objective, the Government has set ceilings on the net domestic assets of the Central Bank as indicated in Table 2. The attainment of these ceilings will be facilitated by the reduction in the public sector borrowing requirement referred to above. However, it will also require the flexible management of the instruments of monetary policy and the pursuit of a credit policy by the Banco de la Republica that would be consistent with the monetary targets of the program.

9. In the first quarter of 1986, the ratio of obligatory treasury bill holdings to local currency deposits for the commercial banks was raised by 3 percentage points. In recent weeks this ratio was raised by a further 2 percentage points to its present level of 10 1/2 percent. These latter increases have more than offset the loss of resources to the Central Bank that resulted from the simplification of legal reserve requirements effected last August. The attainment of the program's monetary objectives presupposes the maintenance by the Banco de la Republica of its combined holdings of vault cash and nonfrozen domestic currency deposits at the Central Bank at a level of no less than NUr$7,000 million during the program period, save in exceptional circumstances and then only for a short duration. Any permanent reduction in these holdings by the Banco de la Republica from the level just specified will be compensated for by appropriate monetary policy measures. More generally, in the remainder of the year, the Central Bank of Uruguay will keep the monetary policy instruments closely under review and will take whatever measures may become necessary to keep the rate of monetary expansion within the bounds referred to above. Such measures would include any needed sterilization of possible further capital inflows that might materialize in the months ahead.

10. Toward the end of 1985, Congress enacted a domestic debt refinancing law. This legislation is primarily aimed at improving the financial structure of over-indebted agricultural and industrial enterprises by providing a framework for the orderly rescheduling of these enterprises' debts with the commercial banks. In addition, the Government's efforts at fostering industrial development should be

promoted by the newly established Development Corporation. It is not anticipated that the domestic debt restructuring will involve any cost to the budget or to the Central Bank in 1986. However, to the extent that any cost to the budget or to the Central Bank should emerge from these operations, fully offsetting measures will be adopted in other areas of policy.

11. In regard to wage policy, the Government's primary objective is to pursue a policy consistent with the programmed deceleration in inflation and with a recovery in the level of employment. To this end, the Government has announced that it will continue with its policy of wage settlements at four-monthly intervals and that these wage settlements will be guided by the programmed future rate of inflation rather than by the actual rate of inflation over the previous four months. On this basis, the Government decreed that the four-monthly wage increases applicable to the private sector for February would be limited to 18 percent. In contrast to previous wage guidelines, this latter limit was applied to all concepts of wage remuneration and not only to the basic wage rate as had hitherto been the case. At the end of March, the Government announced that the average wage increase for the public sector would not exceed 18 1/2 percent and that this percentage increase would be applicable to the overall wage remuneration of public sector employees. For the next four-monthly wage increase, scheduled for June in the private sector and July for the public sector, the Government intends to issue guidelines that would be consistent with the programmed rate of inflation over the subsequent four months after allowance is made for productivity gains that might reasonably be expected over that period.

12. Since last August, substantial progress has been made in the rescheduling of over US$2 billion in Uruguay's debt with the commercial banks. Late last year, Uruguay's commercial bank creditors agreed in principle to the multiyear rescheduling of US$1,760 million or almost the entirety of commercial bank external debt maturities falling due between 1985 and 1989. The Government expects that this rescheduling exercise will be finalized within the next few weeks. Moreover, at the end of February 1986, the Government signed a multiyear rescheduling arrangement covering over US$260 million in U.S. dollar denominated treasury bonds held by a group of foreign-owned banks. In the context of the rescheduling exercise, Uruguay is not requesting fresh funds from the commercial banks on a concerted or pro rata basis. Rather, Uruguay expects to meet its projected external financing needs through a variety of sources including the increased placement of treasury bills and bonds, the receipt of official credits, greater use of revolving funds from the multilateral organizations, and a US$45 million advance by a select group of banks as part of a cofinancing arrangement with the World Bank in the energy sector. The Government intends, however, to limit the increase in the public and publicly guaranteed external debt to levels consistent with the objective of reducing Uruguay's external debt service ratios over the medium term. To this end, as reflected in Table 3, quarterly ceilings have now been established for the second

half of 1986 for the total public and publicly guaranteed external debt, and quarterly sublimits have been set on the public and publicly guaranteed external debt with maturities of up to one year and of between one and five years, respectively.

13. In the external sector, the Government will maintain a floating exchange rate policy, which it believes fundamental to its overall strategy of securing a sustained recovery in economic activity. Consistent with the seasonal pattern of Uruguay's foreign exchange receipts and outlays, quarterly targets have been established for the second half of 1986 for the net international reserves of the Central Bank as shown in Table 4 attached. Moreover, as was envisaged in our letter of last August, complete freedom of exchange transactions is to be maintained on both the current and the capital accounts of the balance of payments.

Table 1. Uruguay: Ceilings on the Overall Deficit of the Nonfinancial Public Sector 1/

(Cumulative amounts in millions of new Uruguayan pesos)

Time Period	Limits
June 30, 1985 - March 31, 1986	8,050
June 30, 1985 - June 30, 1986	11,470
December 31, 1985 - September 30, 1986	6,500
December 31, 1985 - December 31, 1986	11,000

1/ The nonfinancial public sector is defined to include the Central Administration, the autonomous agencies, the social security system, the municipalities, and the state enterprises. It also includes the operations of Salto Grande, the Corporacion de Desarrollo, and the Instituto Nacional de Carne.

Table 2. Uruguay: Ceilings on the Net Cumulative Increase in the Net Domestic Assets of the Central Bank of Uruguay 1/

(In millions of new Uruguayan pesos)

Time Period	Limits
December 31, 1985 - March 31, 1986	-7,800 2/
December 31, 1985 - June 30, 1986	-5,200 2/
December 31, 1985 - September 30, 1986	-1,100 2/
December 31, 1985 - December 31, 1986	11,000 2/

1/ Net domestic assets are defined as the difference between (1) base money (excluding (a) frozen commercial bank deposits at the Central Bank corresponding to interest payments on their deposits and (b) the local currency deposits and the vault cash of the Banco de la Republica) and (2) the net international reserves of the Central Bank. For purposes of calculating the net domestic assets, the changes in international reserves and in the foreign currency deposits of the Banco de la Republica in each quarter are to be valued at the corresponding projected average exchange rate for that quarter.

2/ The net domestic asset ceiling is to be adjusted downward for (i) the full extent that the foreign currency deposits of the Banco de la Republica at the Central Bank exceed their average level as of June 1985; and for (ii) 65 percent of the extent to which the net international reserves of the Central Bank exceed US$1 million at the end of March 1986, minus US$28 million at the end of June 1986, minus US$60 million at the end of September 1986, and minus US$70 million at the end of December 1986. The net domestic assets of the Central Bank are also to be adjusted to account for any changes in the system of legal reserve requirements on the commercial banks from their levels as of February 28, 1986.

Table 3. Uruguay: Ceilings on Public and Publicly Guaranteed External Debt 1/

(Outstanding stocks in millions of U.S. dollars)

	All Maturities Up to 12 Years	Maturities of Less Than One Year	Maturities of Between One and Five Years
March 31, 1986	3,042 2/	320 2/	161 3/
June 30, 1986	3,087 2/	325 2/	161 3/
September 30, 1986	3,100	325	176
December 31, 1986	3,122	330	176

1/ Excludes the external borrowing of the Central Bank at less than one year, excludes foreign currency deposits of nonresidents, but includes foreign currency denominated treasury bills held by nonresidents. As of June 30, 1985 the total stock of this debt was estimated at US$2,838 million while that part of the debt with a maturity of less than one year was estimated at US$232 million.

2/ The differences in these ceilings from those contained in the Memorandum of Understanding on Economic Policies dated August 1985 are entirely due to the revision in the estimates of the corresponding stocks of external debt outstanding as of June 30, 1985.

3/ These stocks correspond to an increase since June 1985 of US$35 million in the stock of external debt outstanding with maturities of between one and five years.

Table 4. Uruguay: Targets for the Net International Reserves of the Central Bank of Uruguay 1/

(In millions of U.S. dollars)

Date	Targets 2/
March 31, 1986	-114.2
June 30, 1986	-129.2
September 30, 1986	-129.2
December 31, 1986	-129.2

1/ Defined as the difference between the foreign assets of the Central Bank and its external liabilities of up to one year including outstanding purchases from the International Monetary Fund. The gold holdings of the Central Bank are to be valued at the fixed accounting rate of US$42 per troy ounce; non-U.S.-dollar denominated foreign assets and liabilities are to be converted into U.S. dollars at the market exchange rates for the respective currencies as of June 30, 1985; and Uruguay's Fund position and SDR holdings are to be converted into U.S. dollars at the SDR value of the U.S. dollar as of June 30, 1985.

2/ Targets to be increased to the extent that BROU foreign currency deposits at the Central Bank exceed US$50 million, which was the average level of these deposits in June 1985.