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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/56

10:00 a.m., April 8, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	A. K. Diaby, Temporary
	M. K. Bush
	D. C. Templeman, Temporary
	L. E. J. M. Coene, Temporary
	X. Blandin
	M. B. Chatah, Temporary
H. Fujino	M. Sugita
G. Grosche	
J. E. Ismael	
	L. Leonard
	H. A. Arias
	H. Fugmann
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
P. Pérez	
	J. de Beaufort Wijnholds
	A. V. Romuáldez
	O. Kabbaj
	A. S. Jayawardena
	T. A. Clark
	N. Coumbis
	Wang E.

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

P. Scherer, Latin America and Caribbean Regional Office, IBRD. African Department: A. D. Ouattara, Director; E. A. Calamitsis, D. J. Donovan, C. Enweze, E. K. Martey. Exchange and Trade Relations Department: M. Guitián, Deputy Director; E. H. Brau, M. H. Rodlauer. Fiscal Affairs Department: M. I. Blejer, P. S. Griffith. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; J. M. Ogoola, S. A. Silard. Treasurer's Department: D. Berthet, J. E. Blalock, J. C. Corr, D. Gupta. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; M. Caiola, J. C. Di Tata, D. N. Lachman, L. E. Molho. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: G. R. Castellanos, J. Hospedales, G. W. K. Pickering, M. A. Weitz. Assistants to Executive Directors: J. R. N. Almeida, J. Bulloch, G. Ercel, C. Flamant, R. Fox, Z. b. Ismail, A. K. Juusela, M. Lundsager, K. Murakami, A. Mustafa, W. K. Parmena, C. A. Salinas, A. A. Scholten, A. J. Tregilgas.

1. URUGUAY - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1985 Article IV consultation with Uruguay (SM/85/83, 3/11/85). They also had before them a report on recent economic developments in Uruguay (SM/85/89, 3/20/85) and an information notice on the real effective exchange rate of the Uruguayan peso (EBS/85/91, 4/5/85).

The staff representative from the Western Hemisphere Department remarked that since the consultation discussions had been held in Montevideo in January 1985, a new civilian Administration had taken office on March 1. In its first month in office, the Government had directed much of its attention toward obtaining a national consensus on economic policy and establishing an economic team that reflected the different viewpoints of the main political parties. The economic team was expected to be fully in place by April 12, with the appointment of the President and the Board of Directors of the Central Bank.

While the Government had yet to outline in detail the direction of its economic policy, action had been taken in two areas, the staff representative stated. First, efforts were being made to regularize the difficult domestic debt situation of private enterprises. The authorities hoped to clarify the domestic debt situation by mid-May to facilitate a reactivation of the economy and pave the way for improved collections by the Central Bank on its private sector loan portfolio. Second, the Government had issued guidelines in mid-March requiring that nominal wages be raised in the private sector to ensure a real increase of at least 3 percent over the levels prevailing in December 1983. That decision had not been intended to set the pattern for future wage settlements but to deal at the outset of the new Administration with the disparities that had emerged in the wage structure of the private sector.

The Minister of Finance, in a meeting with the Fund management and staff the previous week, had indicated that he was currently exploring all ways to reduce the global deficit of the public sector in an effort to moderate inflation and strengthen the external accounts, the staff representative from the Western Hemisphere Department remarked. The Minister had asked the staff to visit Montevideo at the end of April to assist the Government in designing an adjustment program that could be supported by Fund resources.

Mr. Nebbia made the following statement:

> The Uruguayan authorities broadly agree with the staff's analysis and with most of its conclusions. They recognize that, despite their efforts to adjust the economy, the outturn in 1984 was less than satisfactory, and that the need now exists for a prompt implementation of a comprehensive set of measures aimed at redressing both domestic and external imbalances.

Despite the difficulties faced by the Uruguayan economy, the authorities have remained fully committed to maintaining complete freedom of exchange transactions on both the current and the capital accounts, and they have been able to reverse the loss of competitiveness that occurred from 1979 to 1982 by adopting a flexible exchange rate policy, which in turn has contributed to significantly narrowing the current account deficit.

It should be stressed that Uruguay is one of the very few countries that, for the time being, have been able to keep their exchange systems free of restrictions. This remarkable achievement has been maintained even in the presence of the serious difficulties faced by the economy.

Behind the weaker than expected performance exhibited by the economy in 1984, the authorities would like to stress the role played by factors affecting confidence in a year of political transition. Not only did those factors fuel the uncertainties normally associated with a major political change, but they were also expressed in the form of delays in the adoption of corrective measures until a new administration was to take office.

Faced with the task of restoring domestic and external equilibrium, the new Administration that assumed office on March 1 is fully aware that it should give, from the very beginning, clear indications about its determination to deal firmly with Uruguay's economic imbalances, so as to restore an appropriate degree of confidence both internally and in the international community.

Within that context, the authorities fully endorse the staff's views on the importance of reducing the current combined deficit of the nonfinancial public sector and the Central Bank, as the cornerstone of the adjustment effort.

They believe, however, that while there is still room for sound improvements on the revenue side, such scope is much more reduced regarding expenditures. They stress the importance that should be given to the fact that almost two thirds of the total fiscal deficit--including that of the Central Bank--reflects interest payments on the external debt, a variable that is far beyond their control.

Regarding measures aimed at strengthening revenues, the Uruguayan authorities have committed themselves to further improving the tax collection mechanism as a first step prior to introducing additional tax measures. Such improvement could be achieved solely by enforcing fully the existing tax collection procedures and regulations.

Further additional tax measures are also under discussion. However, they will require the approval of the Congress before coming into effect, and therefore are not intended to yield any meaningful improvement until end-1985 or the first half of 1986.

In addition, and regarding the need for a prompt reduction of the Central Bank's losses associated with earlier purchases of the commercial banks' loan portfolio, the authorities are seeking a prompt clarification of the situation of a number of enterprises currently experiencing financial difficulties so as to determine the viability of each of them and therefore the nature of the actions that may be deemed necessary to implement. The basic framework is that enterprises that are viable in financial terms should be provided with an appropriate rescheduling scheme that can in turn lead them to become current in their financial obligations to the Central Bank. On the other hand, enterprises that are not viable will be liquidated and treated in accordance with legal procedures.

This general framework will not only permit an improvement in the Central Bank's financial position but also allow for a further strengthening of revenue procedures, as it will permit better supervision of the tax payments of the enterprises involved.

In pursuing this distinction between viable and nonviable enterprises, the Uruguayan authorities have developed a mechanism providing that those enterprises that have not paid at least part of their interest obligations by May 15, 1985 will be automatically liquidated and subjected to legal procedures. On the contrary, those that are current, or partially current in their interest obligations, will be considered eligible for the rescheduling schemes that are to be elaborated.

The above-mentioned mechanism of recovery of the portfolio of private assets acquired by the Central Bank in 1982 and early 1983 will not constitute the only means through which imbalances in the Central Bank are to be reduced. A drastic curtailment of the financial support to the Mortgage Bank, envisaged early in 1984, has been already implemented, and the authorities' intent to reduce such financial assistance further.

The Uruguayan authorities are also aware of the need to raise promptly public enterprises' tariffs so as to allow them to be in line with the overall price increases of the last few months, and to restore their profitability. Action along these lines will be announced soon.

Regarding expenditures, the authorities feel that there is no room for significant further retrenchments, except in social security benefits. They believe that, even if additional expenditure cuts could be implemented, the impact that they would have on the overall fiscal deficit would at best be marginal. They stress that the major problem remains the high interest payments that they have to make. Redressing fiscal imbalances will depend heavily on the attainment of more favorable financial conditions on debt interest payments.

Nevertheless, and despite the serious constraints that the authorities are currently facing, they are fully committed to continuing to explore all the possible avenues in order to redress their budgetary imbalances, as well as to deal appropriately with the inflationary pressures now existing in the economy. They are firmly convinced that, in devising the appropriate solutions to their current problems, they will find Fund assistance most valuable both domestically and externally.

To that extent, the Uruguayan authorities are seeking close collaboration with the Fund in order to be able to negotiate with their creditors a favorable rescheduling of their external debt. An economic program supported by the Fund will be, in that context, highly beneficial for Uruguay's negotiations regarding terms and conditions that can be set forth for their debt payments in the years ahead.

Uruguay will still be in need of further financing from abroad if its adjustment efforts are not to damage further its own economic prospects and its political and social stability. The magnitude of the adjustment undertaken in recent years has already meant a reduction of real GDP by about 16 percent, with imports being less than one half of the 1981 figure. Moreover, investment expenditures are now about 8 percent of GDP, meaning that they are almost below replacement level. Reliance on foreign finance, far from preventing adjustment, will help to smooth the path of the Uruguayan economy toward the achievement of a more viable external position and the resumption of growth and stability.

The Uruguayan authorities have expressed their conviction that they will have to work closely with the Fund in years to come. This conviction calls for a reaffirmation of the open and straightforward relationships that Uruguay has maintained with the Fund in the past. In this spirit, the Uruguayan authorities look forward to Fund collaboration at this difficult time.

Mr. Arias agreed with the staff that only through the steady implementation of the necessary fiscal adjustment measures would international and domestic confidence in the economy be restored. Improved confidence was vital, because the country needed to secure access to financial resources to meet substantial medium-term challenges.

A large part of the country's problems was due to the purchase by the Central Bank of the commercial banks' loan portfolio in 1982/83, Mr. Arias noted. The Central Bank had purchased part--$215 million--of the private sector debt owed to foreign-owned local banks out of the proceeds of a $545 million loan from their headquarters and as well as $420 million of poor-quality assets held by insolvent local banks. Consequently, the central bank deficit, which had been nonexistent before 1982, had increased to 8.2 percent of GDP in that year and was estimated to be 5.1 percent of GDP in 1984, more than one half of the combined deficit of the nonbanking public sector and the Central Bank. He joined the staff in urging the authorities to resist pressures to make additional purchases of the commercial banks' loan portfolios; he only wished that that advice had been given earlier.

The medium-term balance of payments estimates presented in the staff report for the 1984 Article IV consultation (SM/84/70, 4/2/84; EBM/84/71, 5/2/84), in the staff paper prepared for the review that had not taken place (EBS/84/160, 7/30/84), and in the staff report (SM/85/83, 3/11/85) differed considerably, even for the initial years of the projections, Mr. Arias observed. In the earliest paper, the staff had estimated the current account deficit to be 1.9 percent of GDP in 1984, whereas the staff paper distributed in July 1984 had estimated that ratio to be 1.2 percent. The current account deficit had actually been 0.4 percent of GDP. In the two earlier papers, the staff had projected that exports would grow by 6 percent a year and imports by 7-7.5 percent a year. In the staff report currently before the Board (SM/85/83), however, exports were assumed to grow by 12 percent and imports by 10.5 percent per annum. It would have been useful if the staff had explained why those projections had been revised. Given that Uruguay had moved into the downward phase of the cattle cycle and that nontraditional exports were stagnating, even though the competitiveness of the exchange rate had been maintained, he wondered why the projected rate of growth of exports had doubled.

Central government revenues had deteriorated in the past four years owing to mismanagement and the taxpayers' perception that the tax burden was inequitable, Mr. Arias noted. The new Administration must have the strength and courage to improve tax collection and ensure a more equitable tax burden. He was certain that the achievement of a social consensus would enable the authorities to redress the fiscal situation rapidly.

He commended the staff for cautioning the authorities on the dangers of foreign currency substitution, which had gathered pace during the past four years, Mr. Arias stated. An excessive amount of foreign currency in the banking system, with 80 percent of total banking deposits in Uruguay being denominated in foreign currency, inhibited domestic monetary policy and placed an excessive burden of adjustment on fiscal and incomes policies. Uruguay's rate of inflation had been low compared with other Latin American countries', but external factors and inconsistent economic policies had recently induced high and oscillating inflation rates. Clearing prices did not adjust instantaneously, real interest rates, as shown in Chart 9 of the report on recent economic developments, fluctuated widely, a signal that market forces were not working well. He welcomed the technical discussion on currency substitution in the first section of Appendix II to SM/85/89 but was disappointed that the third section of that appendix did not compare the proposals for counteracting currency substitution. He wondered whether the staff could indicate its views on the best option in that respect.

Finally, he commended the authorities for their pragmatic view on exchange rate policy and exchange restrictions, Mr. Arias remarked. They had maintained Uruguay's competitiveness in foreign markets and, despite the difficulties associated with increasing tariff and nontariff barriers, had maintainted an exchange, capital, and trade system that was free of restrictions.

Mr. Pérez noted that the Uruguayan authorities had formulated a medium-term adjustment program in late 1982 aimed at correcting the large financial imbalances that had developed since the second half of the ¿97^s. They had adopted a set of measures that should have reversed the inflationary trend and improved the external balance markedly by the end of 1984. Those measures had included a liberalization of the trade system, a tightening of demand management, and the introduction of a flexible exchange rate. In spite of the adoption of a floating exchange rate and the maintenance of a free trade system, however, the adjustment process had not progressed as expected in 1984, and the targets for 1983 had been met only partially owing to political factors and some slippages in demand management. In particular, the deficit of the nonfinancial public sector and the losses of the Central Bank had contributed to monetary and credit expansion.

The first part of the adjustment initiated by the authorities had been on track, Mr. Pérez considered. Balance of payments pressures, specifically on the current account, had been reduced through the pursuit of a free exchange rate policy and the liberalization of the trade system, and the international competitiveness of Uruguay's tradable goods had been re-established. The second part of the adjustment was yet to come, and the new authorities were aware of the need to adopt appropriate measures promptly in order to contain monetary and credit expansion. A reduction of the nonfinancial public sector deficit would be a key factor in controlling domestic demand and encouraging internal savings. Budgetary adjustment, together with a more cautious monetary policy, should allow for a growth in credit that was compatible with internal and external stabilization objectives.

An increase in government revenues, which had been declining in recent years, was required to improve the financial sector, Mr. Pérez observed. Furthermore, public expenditure and the losses of the Central Bank should be reduced. Appropriate management of the monetary aggregates would be consistent with the objectives of reducing inflation and strengthening the balance of payments position.

On the external side, in addition to the efforts made to restore the competitiveness of Uruguay's exports, a broader set of policy measures aimed at diversifying the export sector was called for, Mr. Pérez considered. Those policies should help the authorities to achieve a sustainable external current account and reduce external debt. He welcomed the newly elected Government's efforts to redress the difficult economic and financial situation which they had inherited, and he wished them success in implementing adjustment policies that should pave the way for a resumption of economic growth and a more stable financial situation.

Mr. Templeman observed that Uruguay's economic performance in 1984 had been disappointing. Admittedly, efforts had been made to preserve the momentum of adjustment begun in late 1982, and the impending political transition had made the environment less than perfect for continuing the adjustment effort. But time had been lost, making it particularly important for the new Administration to take full advantage of its political "honeymoon" by taking strong and comprehensive new adjustment measures and to be seen to be doing so. The economic situation was grave: real GDP had fallen by 16 percent in the past three years, imports in 1984 had been less than one half of their 1981 level, investment had been only about 8 percent of GDP, and the rate of inflation had been 66 percent in 1984.

He agreed with the staff that fiscal policy was the key to further adjustment, Mr. Templeman remarked. A combined deficit of the nonfinancial public sector and the Central Bank of nearly 9.5 percent of GDP in 1984, as opposed to a target of about 6.5 percent of GDP, indicated the magnitude of the problem. Efforts should be made to increase tax revenues, which had performed poorly despite indirect tax rate increases, owing partly to a rise in tax evasion. In a period of high inflation, prompt tax collection and adequate penalties for late payments were particularly important to preserve the real value of tax revenues. On the expenditure side, he recognized that some steps had been taken to reduce the growth of social transfer payments, but he took little comfort from the argument that real social security transfers had been declining because, de facto, they had been tied to the previous year's inflation rate, which had been lower than the current rate of inflation.

Although the staff report stated that public sector wages had tended to decline in real terms in recent years, the unexpected increases in wages of 15 percent in September and 22 percent in December 1984--a total of 66 percent for the year as a whole--suggested a substantial rise in real wages, Mr. Templeman observed. Wage restraint in both government and public enterprises would, therefore, continue to be needed in 1985, in part to set a pattern of wage restraint to be followed in the private sector. He wondered whether the authorities' decision in mid-March to assure a 3 percent rise in real wages in the private sector would be the only wage increase in 1985 or whether negotiations would lead to further rises.

It was encouraging to note that the financial position of public enterprises had improved perceptibly in 1984, even though tariff adjustments had been eliminated in September, Mr. Templeman commented. If, however, the overall public sector deficit were to be reduced further and investment by public enterprises financed from internally generated funds, tariffs must be adjusted promptly. Mr. Nebbia's indications that some action in that area would be announced shortly were encouraging.

He agreed with the staff on the need for the Central Bank to eliminate its quasi-fiscal losses, including those resulting from poor collections under its earlier portfolio purchase scheme, Mr. Templeman remarked. The authorities' intention to liquidate those enterprises that had not paid at least part of their interest obligations to the Central Bank by May 15, 1985 should gain the attention of those debtors who might have been speculating that further generalized debt relief would be granted.

The overshooting of monetary targets in 1984, despite the use of various monetary instruments, had not been surprising in view of the fiscal overruns, Mr. Templeman observed. Persistent and substantial deceleration of the monetary aggregates would be needed to reduce inflation. Chart 5 of SM/85/83 indicated that nominal monetary aggregates had accelerated steadily through end-1984. He wondered whether more recent data showed a slackening in the pace of monetary expansion. While strong action to reduce the monetary impact of the fiscal deficit was necessary, the financial system must also be strengthened. The repeated need to provide emergency assistance to parts of the banking system in the past few years had clearly impeded the free exercise of monetary policy, which might otherwise have been directed more firmly at broader economic objectives. As the staff had suggested, a freeing up of interest rate controls or, at a minimum, the pursuit of a flexible interest rate policy should be an important part of monetary policy aimed at achieving both domestic and external objectives.

On the external side, the staff appeared satisfied with the international competitiveness of the exchange rate, Mr. Templeman noted. Yet a large part of the balance of payments adjustment had been made on the import side, and nontraditional exports were not performing well. Could the staff elaborate on the prospects for exports? The protectionist actions of Uruguay's trading partners, including neighboring countries, while having an adverse effect on exports, did not persuasively explain the relatively poor export performance in Uruguay. He commended the authorities for avoiding the imposition of foreign exchange restrictions on both current and capital account transactions and for remaining current on their foreign obligations, following the rescheduling arrangement of July 1983.

In sum, the core objectives of economic policy--real economic growth, lower inflation, and an improved balance of payments position--were not being met, Mr. Templeman observed. Even the rather optimistic medium-term scenario presented by the staff indicated that Uruguay's debt service ratio would be about 35 percent in 1990. The holding action engaged in by the previous Administration should give way to a renewed comprehensive and forceful adjustment effort. There was a better opportunity at present to deal with those daunting problems than there would be later, so that the Fund could lend its support to the effort.

Mr. Clark observed that Uruguay had made some progress under the previous stand-by arrangement, although developments in a number of areas had been unsatisfactory. It was encouraging to learn from Mr. Nebbia that the recently elected civilian authorities largely endorsed the staff's analysis of Uruguay's problems and of the remedial actions that would be necessary to overcome those problems. He wondered whether, if negotiations on a new program with the Fund were not completed within six months, Uruguay might be a candidate for the kind of supplementary Article IV consultation considered by Directors during their review of the general implementation of surveillance at EBM/85/47 (3/22/85). That type of consultation might be helpful to the Uruguayan authorities and might provide the basis for reassuring Uruguay's creditors that appropriate economic policies were being adopted.

He agreed with Mr. Nebbia and the staff that fiscal policy was the cornerstone of the adjustment effort, Mr. Clark stated. Substantial prior actions in that area should be a requirement for any new Fund-supported adjustment program. On the expenditure side, although public sector wages and salaries had declined as a proportion of GDP for the second successive year in 1984, wage policy had been relaxed appreciably in the second half of that year. It was crucial for the new authorities to act quickly to lower inflationary expectations before they became too firmly established. Social security transfers had continued to decline as a proportion of GDP, reflecting largely the effect of the indexation mechanism--whereby adjustments in benefits were linked to the rate of inflation in the preceding year--during a period when inflation had been accelerating. That effect would be reversed if inflation were reduced, and he therefore encouraged the authorities to look closely at the rationale and, particularly, the formula for indexation. He would be interested to learn from the staff what current expenditures, in addition to central bank transfers to the Mortgage Bank, were included in the category of "other" expenditures in Table 5 of SM/85/83.

On the revenue side, there were clearly problems in both the structure and the administration of taxes, Mr. Clark commented. As the authorities themselves had noted, raising tax rates might not be an effective way of increasing revenues. A major effort was required to improve tax collection, and the authorities should also consider a thorough overhaul of the tax structure.

On the external side, he joined other Directors in commending the authorities for maintaining an open exchange and trade system, Mr. Clark remarked. In the medium term, he was concerned that the strong export growth projected by the staff might not be realized, in which case the outlook would be appreciably more difficult than projected. He agreed with Mr. Templeman's recommendation that the authorities should make good use of their political "honeymoon" to take prompt and substantial action to reduce domestic financial imbalances and improve the external accounts. Uruguay would need to negotiate debt reschedulings in the immediate future. Unless firm action were taken at present, the need for rescheduling would persist in the medium and long term, while the environment in which debt reschedulings would have to be negotiated would become more difficult.

The staff representative from the Western Hemisphere Department stated that the staff shared Directors' concerns about the central bank losses resulting from the loan purchase scheme undertaken in 1982. Those losses, together with the consequent financing needs of the public sector, argued against the Central Bank's making any further purchases of the commercial banks' loan portfolios. If such loan purchase schemes could not be avoided, their costs should be minimized, and offsetting measures should be taken in other areas of the nonfinancial public sector to counteract the expansionary effect of those operations.

Changing circumstances, particularly weaker than expected economic activity, had necessitated the revisions in the medium-term current account balance of payments forecasts for 1984, the staff representative indicated. Imports had been lower than expected, while tourism receipts had been higher than expected. The revisions had, however, not been particularly large--about 1 percent of GDP--especially given the unsettled economic environment. Export performance in 1984 had been weaker than projected, owing partly to a steeper than expected decline in the cattle cycle and partly to slow growth of nontraditional exports, despite a favorable exchange rate. Nontariff barriers in Uruguay's neighboring countries and the weak financial situation of many local enterprises engaging in foreign trade also explained the poor performance of non-traditional exports. The authorities were taking action to strengthen the financial situation of those enterprises, which it was hoped would enable exporters to take advantage of the favorable exchange rate. The staff had projected a strong rebound in meat exports and more favorable meat prices over the next two years. If those optimistic projections did not materialize, the scope for import growth would be limited, and the adjustment effort would have to be all the more severe. The staff would update the medium-term balance of payments scenario when additional information was made available.

On the question of foreign currency substitution, the staff was concerned that the high proportion of foreign currency deposits in the domestic banking system limited the authorities' scope for implementing monetary policy, the staff representative remarked. In Appendix II to SM/85/89, the staff had outlined a number of proposals to counteract currency substitution, the common element of which would be the pursuit of a flexible interest rate policy. To encourage domestic currency deposits, the rate of inflation would need to be reduced and domestic interest rates increased. At present, ceilings on interest rates for loans in domestic currency limited the amount that banks could pay on deposits, a factor that encouraged foreign currency substitution. A reduction in the public sector deficit would be fundamental to the authorities' adjustment effort, as it would allow a reduction in the legal reserve requirements, thereby enabling the banks to pay more attractive interest rates.

On wage policy, it would be difficult for the Government to limit the public sector wage bill in 1985, given the unanticipated increases in wages toward the end of 1984, the staff representative considered. Public sector wage increases for the forthcoming year were still to be defined, although the authorities had indicated their intention to pursue a prudent wage policy that would be within the limits of the country's resources. Social security expenditures and the formula linking social security payments to the past rate of inflation were being re-examined as part of the authorities' effort to reduce the rate of inflation.

Preliminary data for the first quarter of 1985 indicated that the rate of growth of the monetary aggregates had not decelerated, the staff representative stated. Public sector finances would have to be improved before the monetary aggregates could be controlled more effectively.

The staff considered that tax administration and the general structure of taxes should be reviewed in an effort to raise revenues substantially, the staff representative from the Western Hemisphere Department commented. A technical assistance mission would soon be visiting Uruguay with a view to identifying the weaknesses in tax administration and proposing possible solutions to the problem.

The Deputy Director of the Exchange and Trade Relations Department, in response to an Executive Director's suggestion for a supplementary consultation with Uruguay, stated that the staff would of course consider carrying out such a consultation if it would help the authorities to formulate appropriate policies. Surveillance procedures should not, however, become a substitute for the adoption of appropriate policies that could be supported by a Fund-supported arrangement. The need for the authorities to take adjustment measures had clearly emerged from the 1985 Article IV consultation. A follow-up consultation would be ineffective if the authorities were unwilling to implement adjustment measures suggested by the staff.

Mr. Nebbia stated that his authorities remained committed to keeping Uruguay's exchange system free of restrictions despite the difficulties facing the country. In March 1985, exchange rate fluctuations had moderated, reflecting a growing confidence in the appropriateness of the measures envisaged by the authorities to redress domestic financial imbalances. The authorities would soon be taking measures aimed at achieving price stability, fiscal equilibrium, and external viability, as well as ensuring a resumption of economic growth after three years of economic decline.

The authorities would continue to explore all possible avenues for restoring fiscal balance, Mr. Nebbia remarked. The measures to be taken by the authorities to improve collections by the Central Bank of assets purchased from the commercial banks would be an important step toward strengthening the overall fiscal position. The authorities also planned to improve tax collection. Those measures, as well as additional ones that might be required to ensure the success of the adjustment process, would undoubtedly be strengthened if agreement were reached with the Fund on a stabilization program. His authorities looked forward to a positive conclusion of those discussions, which would play an important role in assuring the availability of the new resources needed from commercial banks in the context of a debt rescheduling agreement and its terms and conditions.

The Chairman made the following summing up:

Executive Directors were in general agreement with the views expressed in the staff report for the 1985 Article IV consultation with Uruguay.

Directors observed that, despite the authorities' efforts at adjustment, the economic outturn in 1984 had been disappointing. Output, which had already fallen sharply in 1982-83, had declined by a further 2 percent in 1984; investment had been very weak; the balance of payments had remained under pressure; and inflation had accelerated to an annual rate of 66 percent by end-1984. Directors recognized that factors affecting confidence in a year of political transition had played a role in the weaker than expected performance in 1984. However, there had also been slippages in demand management and in wage policies. Directors drew particular attention to the combined deficit of the non-financial public sector and of the Central Bank, which had been equivalent to about 9.5 percent of GDP in 1984.

Directors emphasized that the new Administration, which had assumed office on March 1, 1985, would need to give from the very start clear signals of its resolve to deal firmly with Uruguay's economic imbalances. This would require the early presentation of a credible and well-defined program of adjustment geared to scaling down inflation and strengthening the external accounts. Directors urged the authorities to proceed promptly toward the adoption of such a program, which would provide the basis for the external debt relief that was needed.

Directors stressed that the adjustment effort would require a major reduction in the combined deficit of the nonfinancial public sector and the Central Bank. In view of the size of the current fiscal imbalance, concerted action would be necessary on the side of both public expenditures and revenues. Directors stressed the need to exercise restraint on public sector wages and on social security expenditures, including a re-examination of their indexation arrangements. In addition, they emphasized the urgent need for measures in tax policy in order to reverse the sizable decline in real tax collections over the past several years and to improve tax equity and structure through tax reform. The new Government's efforts to regularize the debt situation of private enterprises were considered crucial. However, every effort would be needed to increase tax collections on the Central Bank's private sector loan portfolio.

Directors indicated that a clear requirement for a sustainable reduction in inflation would be a monetary policy stance geared toward a progressive scaling down of the excessive growth of the monetary and credit aggregates. The very strong dollarization of the monetary system was noted, and Directors urged the monetary authorities to adopt interest rate policies that could reverse such a trend.

Directors underlined that demand management policy would need to be accompanied by an appropriate incomes policy in order to minimize the cost of stabilization in terms of unemployment. In particular, there was a need for public sector wage restraint for fiscal reasons as well as to provide the right example for a deceleration in private sector wage increases. Concern was expressed about the March 1985 guidelines on wages in the private sector, although it was noted that those guidelines were not to set a pattern for future wage settlements.

Directors welcomed the improvement in Uruguay's international competitiveness and the rapid reduction in the external current account deficit since the floating of the exchange rate in November 1982. They emphasized the importance of maintaining adequate competitiveness in the period ahead.

Directors commended the Uruguayan authorities for having maintained international current and capital transactions free of exchange restrictions. They urged the new Administration to maintain the commitment to an open exchange and trade system.

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

2. THE GAMBIA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1 AND NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATIONS

The Executive Directors considered the report and complaint relating to The Gambia's overdue obligations in the General Department and the notice of The Gambia's failure to settle financial obligations to the Trust Fund (EBS/85/71, 3/25/85).

Mr. Mtei stated that the Gambian authorities wished to assure the Board of the high priority that they accorded to the settlement of their outstanding financial obligations to the Fund. They were fully aware of the importance of an early settlement of those obligations, not only because of the revolving nature of Fund resources but also because they wished to maintain the cordial relationship that had developed between the Fund and The Gambia.

Reflecting their desire to become current with the Fund, the authorities were continuing their efforts to secure a bridging arrangement that would enable them to discharge their repurchase obligations, Mr. Mtei remarked. A bridging arrangement was the only practical solution, as export receipts to cover the repurchases would become available only in late 1985. The line of credit being negotiated could not, unfortunately, be finalized as originally planned. His authorities took a serious view of their commitment to the Fund and intended to discharge their repurchase obligations as soon as the foreign exchange situation permitted. The fact that arrears had accumulated was due entirely to circumstances beyond the authorities' control and did not reflect indifference on their part. He hoped that by the time that the matter came up for substantive discussion by the Board, The Gambia would have secured enough resources to settle its arrears to the Fund.

Mr. Suraisry noted that it was regrettable that the Gambian authorities had not discharged their overdue obligations to the Fund. The accumulation of arrears to the Fund was contrary to the interest of both The Gambia and the Fund, which was the centerpiece of the international financial system. Overdue obligations undermined the revolving character of Fund resources, were unfair to other members that made every effort to be current in their obligations to the Fund, and prejudiced the Fund's liquidity and credit standing.

It was also regrettable to note that the stand-by arrangement with The Gambia, approved April 23, 1984, had become inoperative soon after the first purchase had been made, Mr. Suraisry remarked. The adjustment program, had it been implemented, could have prevented the development of overdue obligations. He agreed with the staff that a comprehensive adjustment program was necessary to bring the economy back on track.

The Gambia's overdue obligations to the Fund were equivalent to only 4.5 percent of exports of goods and nonfactor services, Mr. Suraisry observed. With determined efforts and the pursuit of appropriate policies, the authorities should be able to settle the overdue obligations to the Fund. Any delay, however, would make it more difficult for them to become current. Mr. Mtei's comments had given him some comfort, and he hoped that the authorities would discharge those overdue obligations successfully as soon as possible. With respect to the choice of action that the Fund might take, he would support Option (a)(ii) on page 7 of EBS/85/71, provided that the words "or indicate the circumstances under which, and the extent to which, the member may make use of the general resources" were eliminated. He agreed with the proposals with respect to the Trust Fund and the procedural action outlined on page 8 of the staff paper. Finally, he could support the proposed decision.

Mr. Grosche indicated his agreement with Mr. Suraisry. The tabular presentation of The Gambia's overdue and forthcoming obligations on page 3 of EBS/85/71 was particularly worrying. Urgent action was needed, and he was disappointed that the authorities had failed to pursue the program under the stand-by arrangement. He supported the proposed decision and suggested that the Executive Board review the Managing Director's complaint after four weeks.

Mr. Chatah asked the staff for further information on the amount and nature of The Gambia's total external debt and outstanding arrears, including the proportion of the arrears that was not subject to rescheduling. Could the staff also elaborate on the reasons why the review of the stand-by arrangement had not taken place? He hoped that The Gambia would settle its arrears to the Fund before the Executive Board held a substantive discussion on the country's overdue obligations.

Ms. Bush agreed that the Executive Board should review the Managing Director's complaint in one month.

The staff representative from the African Department stated that The Gambia's total external arrears had amounted to about SDR 50 million at end-December 1984. The Gambia's arrears to the West African Clearing House were not strictly speaking subject to rescheduling, but, under certain conditions, repayments could effectively be stretched out through refinancing. The external debt of the public sector could be rescheduled, although the Government's arrears to international and regional organizations could not be. A consultant from the Central Banking Department's panel of experts had recently provided the authorities with technical assistance on the composition of arrears. The authorities had felt that in the past the amount of public sector arrears had not been sufficient to justify approaching the Paris Club for rescheduling; however, given the recent increase in those arrears, that position would have to be reviewed.

At the time of the program review under the stand-by arrangement in October 1984, the staff, the IBRD, and the authorities had estimated that groundnut exports would reach 100,000 tons in 1984/85, the staff representative indicated. The authorities had informed the staff on January 14, 1985, however, that the estimate for groundnut exports had been revised downward to 75,000 tons for 1984/85. It was difficult to determine at present whether the revised estimate was would turn out to be accurate.

The staff representative from the Legal Department noted that the Executive Board was not taking a substantive decision at the present meeting, and the possible actions that the Fund might take with respect to the General Department would not have to be decided until the Executive Board's substantive consideration of the Managing Director's complaint.

It was important to note, however, that the alternative course of action mentioned in the last part of paragraph (a)(ii) on page 7 of EBS/85/71 was drawn directly from Rule K-2, which was based on the notion that, while the Fund had the authority to declare a member ineligible to use Fund resources, it could indicate the circumstances under which the member might make use of the general resources.

Responding to a further question from Mr. Suraisry, the staff representative remarked that those circumstances did not include rescheduling but referred to the possibility that a member might be able to make use of the Fund's resources on the basis of such safeguards as the Executive Board might wish to establish, even though the member was not meeting its overdue obligations to the Fund. The staff was mindful of the policy adopted by the Executive Board on dealing with overdue financial obligations to the Fund, but considered it appropriate to present in EBS/85/71, as in previous cases of a similar nature, the choice of actions that the Fund had the authority to take. In any event, the Executive Board did not have to take a decision on that issue at the present time.

Mr. Jayawardena observed that The Gambia had become overdue in its obligations at a time when it could be assumed that the authorities had been pursuing appropriate policies under a Fund-supported adjustment program. Could the staff elaborate further on the economic circumstances that had caused The Gambia to become overdue in its obligations to the Fund? He would appreciate receiving more detailed information on the specific problems of the country in the next report on The Gambia's overdue obligations.

The staff representative from the African Department explained that the original estimate of groundnut production had been revised downward as a result of further information on crops, purchases, and weather. In addition, the authorities had recently been paying for oil imports in cash rather than by credit, as under the previous arrangement with the West African Clearing House. The authorities had, thus, found it more difficult to meet their debt service obligations. Finally, however, there had also been a need for more intense adjustment efforts on the part of the authorities.

The Executive Board then took the following decision:

1. The complaint of the Managing Director dated March 25, 1985 on The Gambia, in EBS/85/71 (3/25/85), is noted. It shall be placed on the agenda of the Executive Board for May 8, 1985.

2. The notice of the Managing Director in EBS/85/71 (3/25/85) on the failure by The Gambia to fulfill obligations under Decision No. 5069-(76/72) on the Trust Fund is noted. The notice shall be placed on the agenda of the Executive Board for May 8, 1985.

3. Consideration of the complaint in accordance with Rule K-1 and of the notice particularly affects The Gambia. The member shall be informed by rapid means of communication of this matter and of its right to present its views through an appropriately authorized representative.

Decision No. 7946-(85/56) G/TR, adopted
April 8, 1985

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/55 (4/5/85) and EBM/85/56 (4/8/85).

3. YUGOSLAVIA - EXTENSION OF STAND-BY ARRANGEMENT

In paragraph 1 of the stand-by arrangement for Yugoslavia (EBS/84/65, Sup. 1 (4/19/84)) the words "For a period of one year from April 18, 1984" shall be replaced by the words "For the period from April 18, 1984 to May 15, 1985."

Decision No. 7947-(85/56), adopted
April 5, 1985

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/85/90 (4/4/85) is approved.

APROVED: February 5, 1986

LEO VAN HOUTVEN
Secretary