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Central Intelligence Agency

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Uruguay: Free Market Economics Take Root [redacted] 25X1

Summary

President Sanguinetti, following up on efforts begun by the previous military government, has made steady progress in liberalizing trade and in opening up Uruguay's historically statist economy. Despite a severe recession in the early 1980's caused by external shocks, Sanguinetti's team has led the economy to recovery without abandoning free market policies. Based on increased investment and exports, Uruguay recorded 4.9 percent growth in 1987. Unemployment fell below 10 percent, and fiscal discipline has kept inflation near target levels. While formidable structural problems remain, the governing Colorado Party's economic success has helped solidify civilian rule in Uruguay, and gives the party the upper hand as the country looks toward presidential elections in 1989. [redacted] 25X1

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The liberal policies pursued by Uruguay's military rulers in the 1970's and, since 1985, by the civilian administration of President Sanguinetti stand in marked contrast to the previous six decades, which were characterized by state direction of virtually all economic activity. Early in the 1900's Uruguayans built a huge welfare state, formed a network of pervasive state enterprises, and in the process spawned a vast, overstaffed bureaucracy and unmanageable budget. These problems were compounded early in the post-World War II era by the heavy regulation of trade that resulted from a growth strategy based on import substitution. Public dissatisfaction with the inefficiency of the system grew in the late 1960's, which saw a period of economic decline, and eventually contributed to social unrest and leftist terrorism, which led to a military takeover in 1973. [redacted] 25X1

The Military Changes Direction

Convinced that statist, inward-looking policy approaches had produced the stagnation of earlier decades, the military moved to open the economy and foster growth by:

- -- aggressively promoting key exports such as wool and meat.
- -- revitalizing agriculture by reducing price controls and the role of regulatory agencies.
- -- lifting interest rate ceilings and legalizing foreign currency deposits.

These measures were followed by a decision to float the exchange rate in 1982, which had the effect of further integrating Uruguay into the world economy. [redacted] 25X1

The drop in world commodity prices in the late 1970's critically reduced foreign exchange earnings and demand for Uruguay's exports, demonstrating its acute vulnerability to external economic conditions. At the same time, the country's oil bill skyrocketed and it borrowed heavily in the international market to finance deficits and investment. The world recession of the early 1980's caused a further decline in export earnings and growth. In 1982, the economy contracted by 10 percent; in 1983 by another 5 percent. Burdensome debt payments consumed about 40 percent of meager export revenues because of high world interest rates. Many businesses were also saddled with unmanageable debt, and government bailouts of failed firms contributed to a massive fiscal deficit that totalled 18.3 percent of GDP in 1982. Public discontent mounted as the economy eroded--unemployment as high as 16 percent and a 50 percent loss in real wages spurred increased labor restiveness. [redacted] 25X1

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Civilians Follow Suit

Nonetheless, even the grim experience of the early 1980's failed to dim enthusiasm for the free market when President Sanguinetti ushered in the return to civilian government in March 1985. Although his ruling Colorado party had long been associated with Uruguay's statist tradition, Sanguinetti and his economic team moved to strengthen private enterprise, boost export-led growth, and further integrate Uruguay into the world economy. Shortly after taking office, Sanguinetti negotiated an agreement with the IMF that called for austerity measures in return for new loans and favorable rescheduling terms for existing debt. The administration recognized the need to modernize agriculture and continued the military's efforts, under World Bank auspices, to ease import regulations and lower tariffs. Then-Foreign Minister Iglesias, an economist by training, set out specifically to garner new markets for Uruguayan goods--especially non-traditional products--in an attempt to diversify exports and reduce the risk of damage caused by price fluctuations in any one commodity. Sanguinetti also signed key bilateral commercial agreements with neighboring Brazil and Argentina, Uruguay's two largest trade partners, and pressed for further regional integration. 25X1

Within a year these measures had begun to pay off. Driven by a resurgence of exports, a competitive, floating exchange rate, improved commodity prices, and new investment that modernized and brought back on line idle production capacity in key industries such as textiles, the economy grew by 6.3 percent in 1986--the first significant expansion recorded since 1981. Sanguinetti took a tough stance against violent labor tactics, reducing disruptive and costly strike activity, and unemployment began to fall, dropping below 10 percent in 1987, while real wages crept up. The government's decision to utilize quarterly wage councils to negotiate salaries with labor and business to compensate for inflation complicated Sanguinetti's battle to control rising prices, but increased tax revenue and fiscal restraint helped bring annual inflation down from 83 percent in 1985 to 57.3 percent last year. Capital flight was reversed by 1987, helping to alleviate a chronic lack of investment. Private sector investment increased 27.2 percent last year, according to the Embassy--a significant figure in capital-starved Latin America. 25X1

We believe the visible economic improvement under Sanguinetti's administration is a key factor in further consolidating civilian rule in Uruguay. Since 1985 the ruling Colorados have had to contend with an opposition majority in Congress--but policymaking in the economic realm has been relatively free of the kind of unbridled debate that has often paralyzed decisionmaking in other Latin American countries that have returned to civilian rule in the 1980's. We believe this reflects both a long history of highly developed parties and civilian institutions, and Sanguinetti's skill in appealing to the opposition on the basis of the overriding need to achieve economic and political stability. Sanguinetti's efforts have largely been focused on near-term issues, however, and much remains to be done with regard to building a consensus in favor of needed long-term reforms, particularly in the public sector. 25X1

Unresolved Problems

Despite demonstrable progress, Uruguay's economy still suffers from major structural weaknesses, and the approach of next year's presidential elections will probably sharply limit Sanguinetti's ability to undertake further, major initiatives. Inefficient state operations continue to hamper the private sector by providing expensive, often inferior services, while perpetuating high inflation. The World Bank is helping to sponsor financial reforms to revive the troubled banking sector--the failure of the last private bank in 1987 has left only the huge state-owned Bank of the Republic and some foreign-based institutions. Radical factions have become increasingly active within several unions, causing a wave of textile and transportation work stoppages and creating pressure on Sanguinetti to raise salaries. Further cuts in fiscal spending are proving especially difficult as the government tries to trim the sacrosanct social security program. 25X1

Externally, trade diversification efforts still have not reduced heavy reliance on earnings from a handful of traditional key commodities--primarily wool, meat, and hides--although exports of new products such as citrus fruits and rice have shown some success. Moreover, new investment is being concentrated on updating Uruguay's aging plant and equipment base in traditional industries such as textiles and food processing, pushing the start-up time for new export-oriented projects farther into the future. 25X1

Looking Ahead

In our judgment, the success of the Sanguinetti team's economic policies gives the Colorados the edge as the 1989 election campaign gets underway.[1] Growth in jobs and greater cost of living stability have largely taken the wind out of the sails of the left, and the country's overall economic health leaves the centrist opposition only a handful of credible issues on which to confront the Colorado candidate, according to the Embassy. Moreover, the economic outlook continues to be largely favorable. We believe the economy will continue to grow at 2 to 4 percent annually into the 1990's, given IMF estimates that commodity prices will remain stable through 1992. Even though inflation will probably still be hovering about 5 to 10 percent higher than the government's 50 percent target at the end of Sanguinetti's term, the administration's overall progress on inflation is probably sufficient to avoid public outcry. 25X1

Nonetheless, serious economic challenges remain for Sanguinetti, and the next administration will be faced with the need to continue reform measures. Real wages and per capita income have not yet recovered to 1981 levels, and lag far behind the prosperous conditions of the 1950's. Plans for streamlined public sector investment to improve Uruguay's aging utilities and transportation infrastructure and the current trend toward increased private sector investment bode well for future growth, but diversification into manufacturing will probably take several years, and the agriculture sector requires further modernization. Uruguay's lingering dependence on a few primary product exports means that a worldwide recession could still jeopardize Montevideo's hard-won gains. The $5 billion debt remains a potential hazard in the event of a resurgence of high interest rates, and although Uruguay's oil import bill has benefitted from low world prices, the country remains totally dependent on external fuel sources. Finally, Uruguay's extremely low birth rate may propel social security system funding into the forefront of debate within the next ten years--the ratio of workers to pensioners is currently 1:1, and will only worsen--which will complicate fiscal reform and inflation control efforts. 25X1

[1] Sanguinetti cannot be reelected, according to the Uruguayan constitution. The most likely Colorado candidates are Vice President Enrique Tarigo and Senator Jorge Batlle, while the center-left Blanco Party will probably forward Senator Alberto Zumaran and Senator Luis Alberto Lacalle. 25X1

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