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IMF Country Report No. 05/235

Uruguay: Request for Stand-By Arrangement—Staff Report; Staff Supplements; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Uruguay

In the context of the request for a Stand-By Arrangement, the following documents have been released and are included in this package:

- the staff report for the Request for Stand-By Arrangement, prepared by a staff team of the IMF, following discussions that ended on April 16, 2005, with the officials of Uruguay on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 25, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- staff supplements of May 27, 2005, on assessment of the risks to the Fund and the Fund's liquidity position, and of June 6, 2005, updating information on recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during its June 8, 2005 discussion that completed the request.

- a statement by the Executive Director for Uruguay.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Uruguay*
Memorandum of Economic and Financial Policies by the authorities of Uruguay*
Technical Memorandum of Understanding*

*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

URUGUAY

Request for Stand-By Arrangement

Prepared by the Western Hemisphere Department
(In collaboration with other Departments)

Approved by Markus Rodlauer and Liam P. Ebrill

May 25, 2005

Discussions. Discussions were held in Montevideo during March 28–April 6 and at headquarters during April 14–16. The mission met with Finance Minister Astori, Central Bank President Cancela, and other senior officials. The staff team comprised A. Wolfe (Head), J. Canales-Kriljenko, S. Eble, and G. Gelos (all WHD), E. Ley (FAD), and H. Shah (PDR). An MFD team (A. Aisen and S. Seelig) overlapped with the mission, which was also assisted by A. Bauer (Resident Representative). D. Vogel (OED) participated in the discussions.

Ex Post Assessment (EPA). The Board concluded discussions on the EPA on March 18, 2005 (IMF Country Report 05/202). Directors considered that continued Fund support would be appropriate in light of Uruguay's still protracted balance-of-payments situation. They underscored the need for a strong program to ensure sustained macroeconomic stability and adequate market access, laying the basis for an exit from future Fund support.

Proposed SBA

- **Key program objectives** are to foster sustainable growth and improve social equity, while reducing vulnerabilities related to the high public debt, widespread financial dollarization, and weaknesses in the banking system. Macroeconomic policies will aim at further fiscal consolidation, building reserves under the flexible exchange rate regime, and keeping inflation low while moving to an inflation-targeting framework. Structural reforms will aim at improving the environment for private investment, strengthening the public finances, and further restructuring of the financial system.

- **Access**. Access under the proposed three-year SBA would be SDR 766 million (250 percent of quota), equivalent to around 60 percent of the repurchases falling due during the program period. This would leave Fund exposure at SDR 1,134 million (370 percent of quota) at mid-2008. Phasing is tailored to financing needs, with larger access during 2006–07. The authorities intend to exit from Fund financial assistance after the proposed SBA and would consider reducing Fund exposure faster if external conditions are better than anticipated.

Fund relations. Outstanding Fund credit as of April 30, 2005 was SDR 1,636 million (534 percent of quota). The last program—approved on April 1, 2002, with total disbursements of SDR 1,989 million (649 percent of quota)—ended on March 31, 2005. The last Article IV consultation was concluded on July 11, 2003, and the next consultation is expected to take place in late 2005, together with the Second Review and the Financial Sector Stability Assessment (FSAP). Uruguay has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system that is free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions.

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Executive Summary

Background

Uruguay has recovered well from the deep recession of 1999-2002. Growth was over 12 percent in 2004, inflation fell to single digits, and the fiscal position has been strengthened considerably. While the external current account shifted to a moderate deficit, mainly reflecting the recovery in imports, export performance has been robust, and gross international reserves are now about three-quarters of their pre-crisis level (but NIR on program definition remain negative). Data for early 2005 suggest continued growth, moderate inflation, and continued strength in exports.

Notwithstanding the good recent economic performance, vulnerabilities remain. The public debt is still high (92 percent of GDP at end-2004), mostly denominated in foreign currency, with gross financing needs averaging some 12 percent of GDP over 2005-08. Public spending pressures are high following the compression of real wages and pensions in recent years, and the social situation remains difficult. Weaknesses also remain in the financial system, including widespread dollarization.

Policy discussions and staff appraisal

The key medium-term challenge—to boost growth in a lasting way—will require maintaining macrostability and implementing structural reforms. The authorities' program appropriately focuses on fiscal consolidation (buttressed by structural fiscal reforms), keeping inflation low through prudent monetary policy, promoting sound credit flows in a strengthened financial system, and other growth-oriented reforms (many being supported by World Bank and IDB lending programs).

Key to maintaining macrostability will be achieving sufficiently large primary surpluses over the medium-term to keep the public debt on a firm downward path. The present outlook suggests that surpluses of at least 4 percent of GDP are needed, and plans for tax reform and reforms of specialized pension funds are crucial to this end. In the near-term, improved tax administration will help fund a two-year social emergency program, which needs to be carefully managed to ensure its effectiveness and envisaged phase-out.

Continued reforms of the financial system are needed to ensure a durable resumption of bank credit. The authorities are giving priority to strengthening financial system oversight and introducing a new bank resolution framework, and they intend to continue reforming the public banks and completing the restructuring of the private banks. An FSAP is planned for later in the year.

Strengthening the conduct of monetary policy is a key plank of the program. The authorities intend to adopt a formal inflation-targeting regime and gradually de-dollarize the economy; a key element of this plan is to increase the autonomy of the central bank and reaffirm its commitment to price stability.

I. Background

1. **Uruguay has shaped an impressive recovery from the deep economic and financial crisis of 2002.**[1] Key achievements under the Fund-supported program include:

- ***Economic growth rebounded sharply following the 1999-2002 recession***, with real GDP growth exceeding 12 percent in 2004.

- ***Inflation was quickly brought under control***. After the float of the currency in 2002, inflation fell steadily and reached single digits in 2004. Real wages fell sharply during the crisis, but have begun to recover since late-2004.

- ***The external position has strengthened, and the peso first stabilized and then came under pressures to appreciate.*** Since late 2003, the peso has appreciated 15 percent in real effective terms, although it remains some 25 percent below its pre-crisis level. The external current account, after improving strongly in 2002, shifted to small deficits in 2003-04—despite rapid export growth—reflecting the sharp recovery in imports. The capital account has also progressively strengthened, on account of both FDI and portfolio inflows. Together with large IFI assistance, this contributed to a buildup of international reserves to US$2.5 billion at end-2004, some 75 percent of the pre-crisis (2001) level.

- ***The fiscal primary balance has strengthened significantly, and the public debt has been set on a downward path.*** The primary balance improved from a deficit of 1.2 percent of GDP in 2001 to a surplus of 3.8 percent of GDP in 2004. The adjustment mainly reflected expenditure restraint, especially on wages and pensions, timely increases of public tariffs, and temporary surcharges on specific taxes. Rebounding growth and peso appreciation also helped bring down the debt-to-GDP ratio from its peak of 104 percent in 2003 to 92 percent at end-2004.

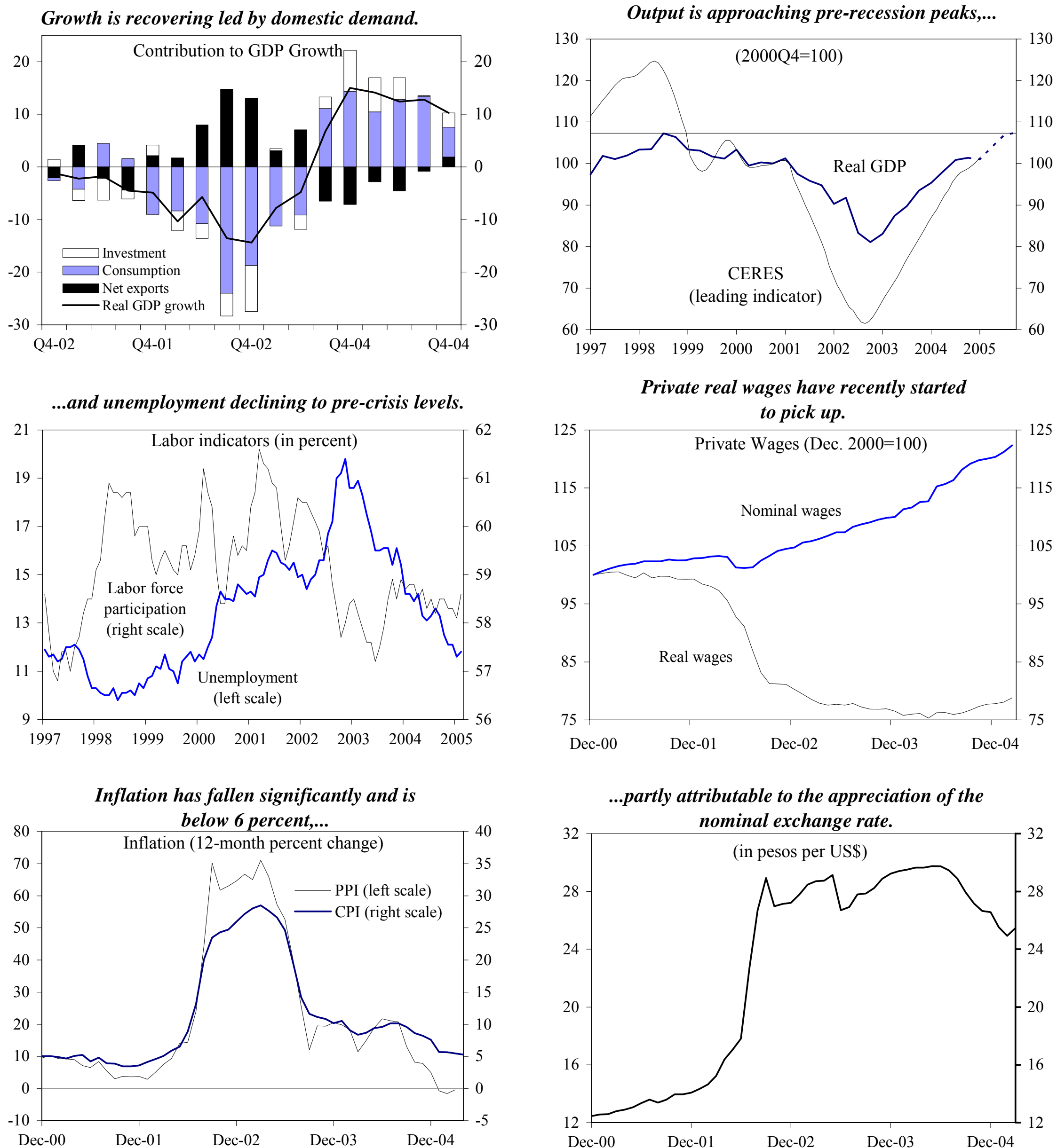
- ***The banking system has been stabilized***. Resident bank deposits of the private sector recovered to about 80 percent of their pre-crisis level by end-2004, although nonresident deposits (almost exclusively off-shore) have recovered only modestly. Dollarization remains high (at about 90 percent of deposits), and real credit growth was still negative in 2004.

- ***Good progress was made in restructuring the financial system***. The state commercial bank (BROU) has been implementing a comprehensive restructuring program and made profits in 2004. The state mortgage bank (BHU) began the transformation process into a mortgage company (with World Bank support). The bank created from the good assets of the failed banks (NBC) is well-capitalized and

[1] For a comprehensive description of developments and policies under the previous SBA, see IMF Country Reports 05/202 and 05/109.

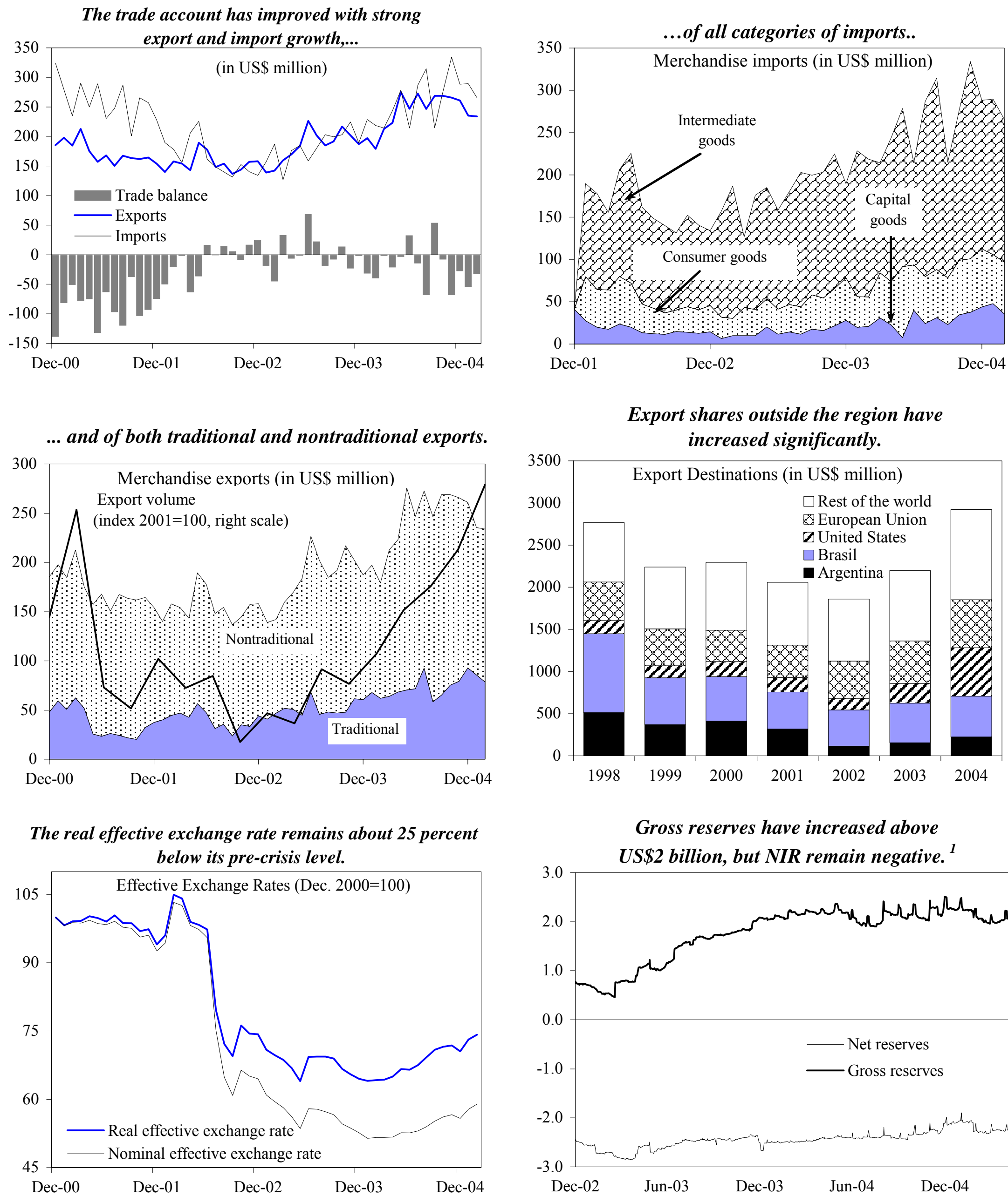
liquid, with asset recoveries of the failed banks well underway. Financial system oversight was strengthened, with a new focus on managing the risks from dollar lending to clients that earn income in pesos.

Figure 1. Uruguay: Real Sector and Price Developments



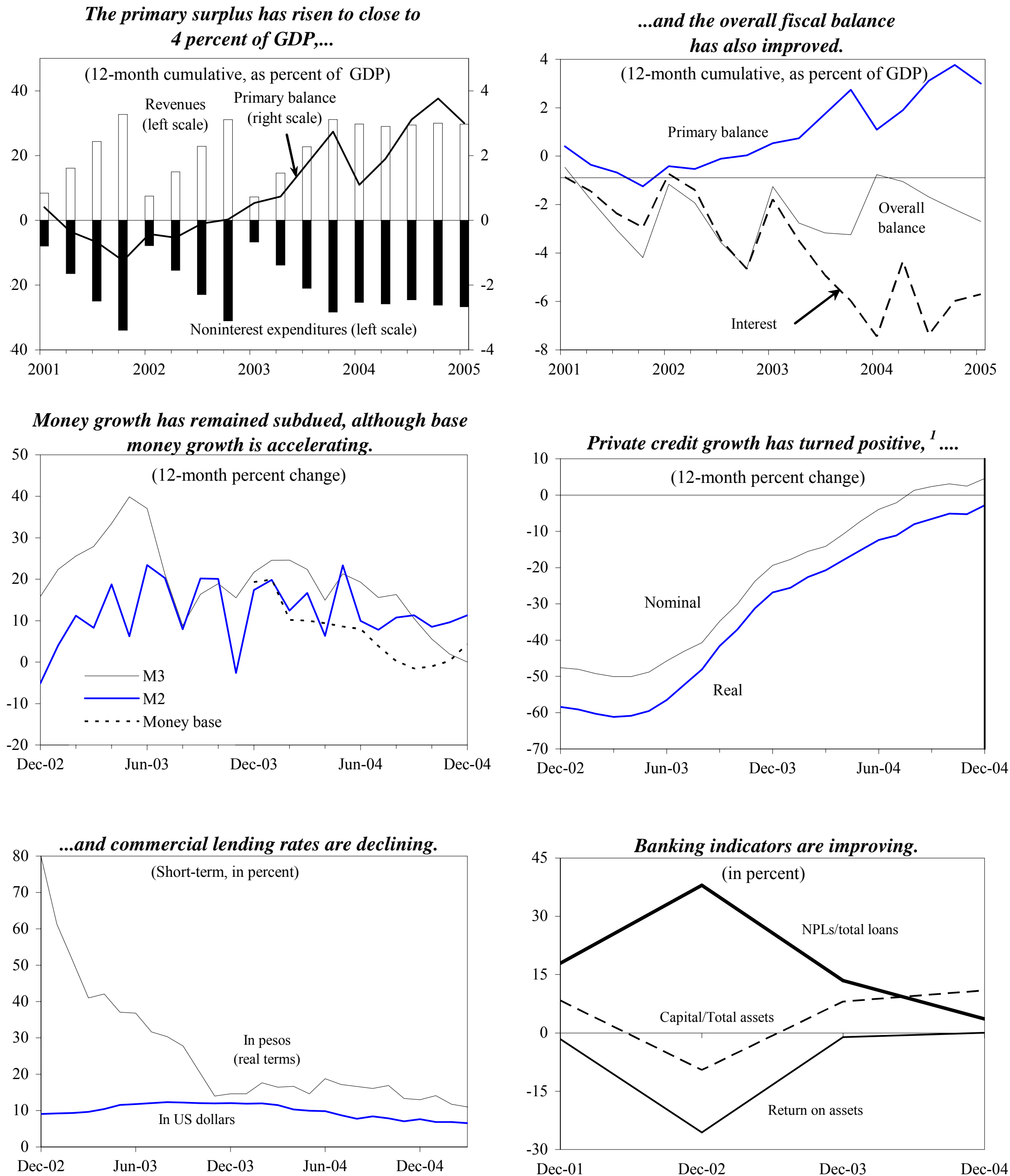
Sources: Central Bank of Uruguay; Ministry of Economy and Finance; and Fund staff estimates.

Figure 2. Uruguay: External Sector Developments



Sources: Central Bank of Uruguay; Ministry of Economy and Finance; and Fund staff estimates.
1/ Includes all liabilities to the Fund and short-term liabilities to resident financial institutions.

Figure 3. Uruguay: Fiscal, Monetary and Financial Sector Developments



Sources: Central Bank of Uruguay; Ministry of Economy and Finance; and Fund Staff estimates.
1/ Covers private non-liquidated banks.

2. **Developments in 2005 continue to be favorable**.

- ***Leading indicators point to a continuing recovery*** in Q1-2005. Domestic demand is benefiting from rising real wages and falling unemployment (12 percent in March, about half the crisis peak).

- ***Annual inflation has been running at 5½ percent since the beginning of the year***, helped by the appreciation of the peso. In March, the central bank (BCU) announced an inflation target of 5–7 percent for March 2006 (½-percentage point lower than the December 2005 target). Domestic short-term interest rates are at their lowest levels in decades, reflecting stabilized inflationary expectations and still-high liquidity in the system.

- ***The external position remains robust***. Export growth in Q1-2005 remained strong (16 percent). Official reserves dropped somewhat in early 2005, reflecting advanced repayments to the Fund and buybacks of Brady bonds,[2] but have rebounded lately with continuing capital inflows. Net international reserves (program definition) are still negative, however, mainly reflecting the large Fund credit outstanding.

- ***Fiscal performance in Q1-2005 was in line with the program***. Real nondiscretionary spending growth was capped at 1.5 percent (y/y), including the January wage and pension increases (nominal) of 3.5 percent and 5 percent, respectively. Revenues were in line with projections, and public tariffs (petroleum products and energy) were adjusted in April to reflect increased input costs.

- ***Banking reforms have proceeded as planned, although the recent suspension of a small cooperative bank indicates the still fragile state of the system***.

  ➢ **Cooperative bank (COFAC)**.[3] The bank was suspended in March 2005, which touched off fairly widespread, albeit relatively small, deposit withdrawals in the banking system. The new government quickly implemented a resolution strategy that involved the capitalization of deposits and introduction of a deposit insurance scheme

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[2] Reserves amounting to US$98 million were used to buy back bonds of a similar face value; US$48 million in collateral were liberated, resulting in a net loss of international reserves of US$50 million.

[3] Before the recent deposit loss, COFAC had about 3 percent of banking system deposits. The bank had been under intensive surveillance as it had not met its capital requirements, and was suspended when it faced liquidity pressures and was on the verge of insolvency.

to protect small depositors.[4] Deposit flows in the banking system subsequently stabilized, and have been recovering since end-March.

➢ **BROU**. The bank continued to make profits in the first quarter of 2005, and a new Board was appointed in March. The release of reprogrammed deposits was completed in April, and 93 percent of them were retained. The bank's asset management company (AMC) is making good progress in working out the nonperforming loan (NPL) portfolio, allowing BROU's trust fund to continue making repayments to BROU on the government-guaranteed note ahead of schedule.

➢ **BHU**. Steps have been taken toward its conversion into a mortgage company, but vulnerabilities remain, including a large NPL portfolio (which is being addressed) and high operating costs (coming down, albeit only slowly). The bank serviced its government-guaranteed note to BROU in Q1-2005, but risks remain as scheduled repayments will rise over the next few years.

➢ **NBC and the liquidated banks**. The authorities are moving forward with the sale of NBC, and potential buyers have submitted preliminary proposals. The private asset manager of the liquidation funds has moved forward in the collection process, broadly on schedule.

➢ **Financial system oversight**. The banking superintendency (SIIF) published its annual work plan that focuses on bolstering on- and off-site supervision, improving the bank resolution process, strengthening accounting and audit standards, and assessing the adequacy of minimum capital requirements. Also, the incorporation of information on non-performing borrowers of the liquidation funds into the credit registry is to be completed by end-May and will be disseminated to creditors in June.

II. VULNERABILITIES AND MEDIUM-TERM OUTLOOK

3. **Despite the good macroeconomic performance in 2004, important vulnerabilities remain that pose risks to the medium-term outlook**.

- **The public debt is still high**, mostly denominated in foreign currency, with about half carrying variable interest rates. The recent volatility in emerging market sentiment caused the authorities to postpone an envisaged debt placement in March (which was later completed in May),[5] and upside risks on interest rates underscore the sensitivity of Uruguay's financing outlook.

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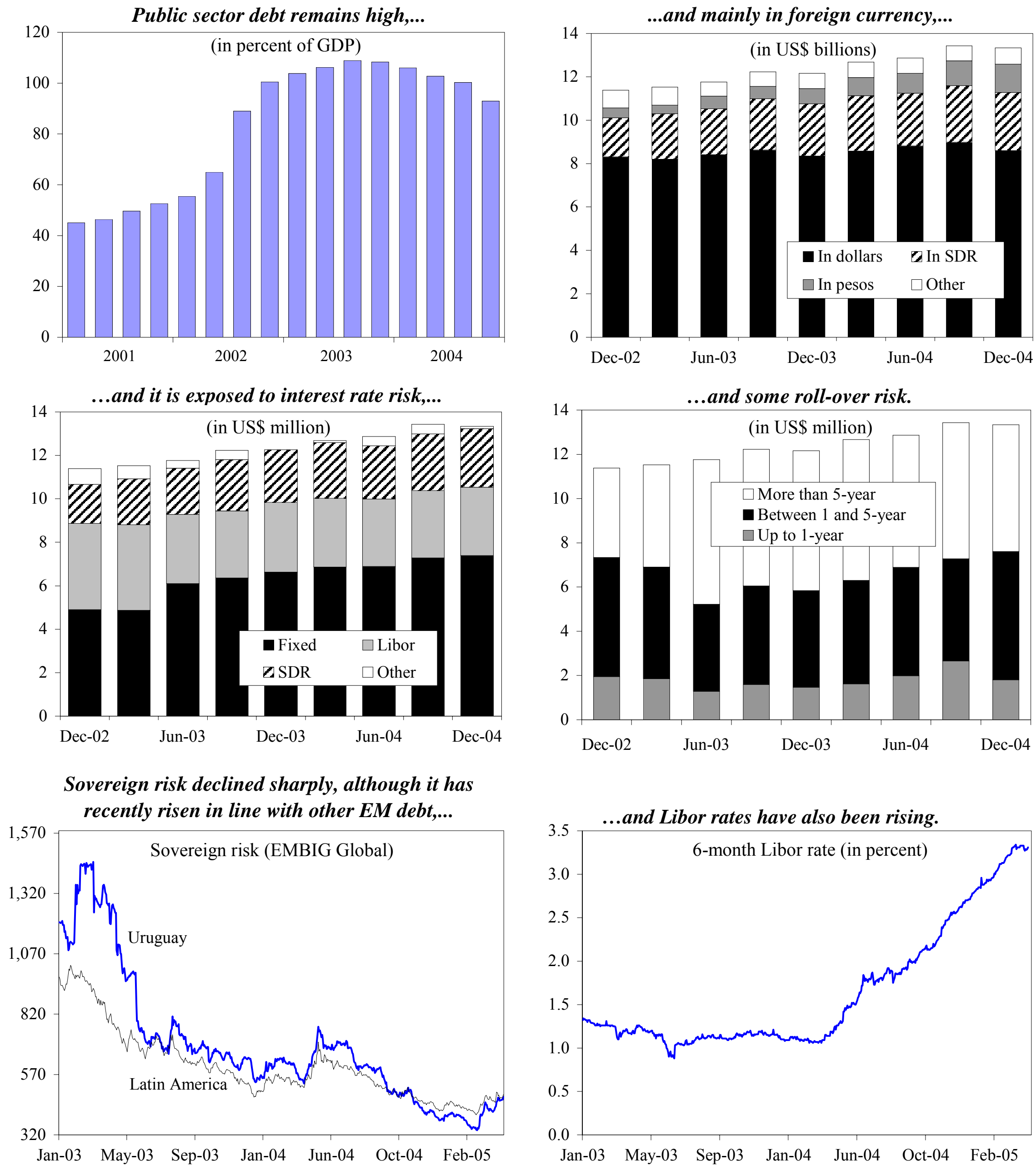
[4] Specifically, a share of deposits above US$15,000 was converted to capital, sight and time deposits were reprogrammed for up to 18 months, and a new business plan was adopted that aims at reducing operating costs by 30 percent.

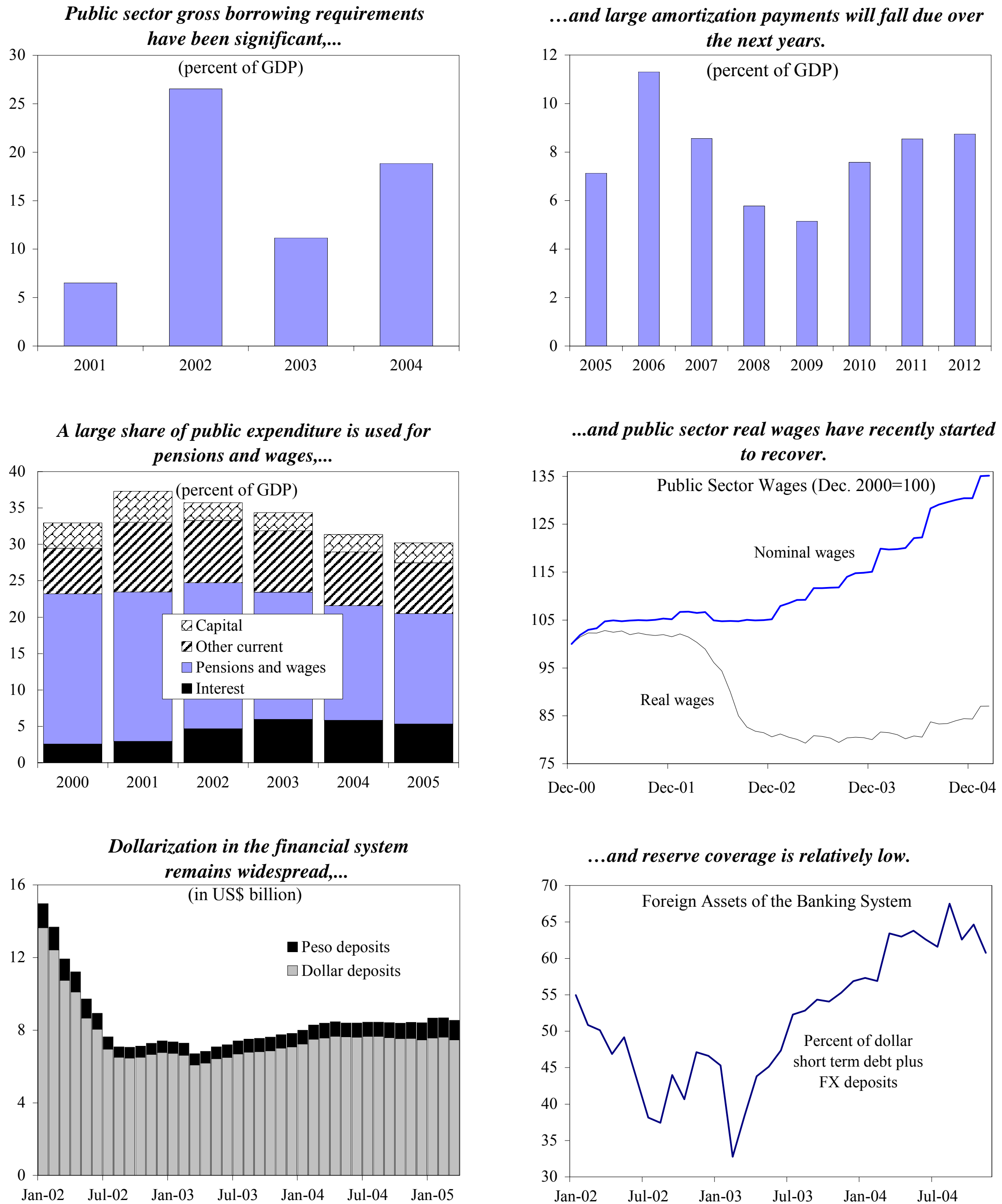
[5] On May 10, Uruguay placed in international markets (at par) US$300 million of 12-year bonds, at a fixed interest rate of 9¼ percent.

Figure 4. Uruguay: Vulnerability Indicators



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

Figure 4. Uruguay: Vulnerability Indicators *(Concluded)*



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

- **Large amortization payments** to the Fund, World Bank, and IDB are coming due over the next three years that will need to be financed in part from new lending—requiring strong implementation of associated IFI-programs. Gross financing needs will average US$2.2 billion (some 12 percent of GDP) over 2005–08.

- **Public spending pressures are high** following the compression of real wages and pensions (by 20 percent) in recent years. The social situation remains difficult, owing to lingering dislocations from the crisis, with some measures of the poverty rate at over 30 percent.

- **Dollarization in the financial system remains widespread** and currency mismatches persist (albeit reduced) on the balance sheets of households, corporations, and the public sector. Central bank reserves cover about a quarter of short-term external debt and dollar deposits, while banking system foreign assets cover about 70 percent, below coverage levels in other dollarized economies in the region.

Comparisons of Banking System Reserve Adequacy Indicators

	2000	2001	2002	2003	2004
Uruguay					
Gross official reserves (US$ million)	2,779	3,099	772	2,087	2,512
As % of ST debt + FX deposits	17.1	17.5	7.0	20.0	27.7
Banking system gross foreign assets	9,218	10,148	5,146	5,928	6,179
As % of ST debt + FX deposits	56.7	57.2	46.6	56.9	68.1
Paraguay					
Gross official reserves (US$ million)	772	723	642	984	1,168
As % of ST debt + FX deposits	39.5	37.2	42.0	60.8	71.0
Banking system gross foreign assets	496	446	288	389	383
As % of ST debt + FX deposits	64.9	60.1	60.9	84.9	93.6
Peru					
Gross official reserves (US$ million)	8,562	8,838	9,690	10,206	12,649
As % of ST debt + FX deposits	57.8	56.7	68.3	72.6	85.9
Banking system gross foreign assets	901	851	822	601	545
As % of ST debt + FX deposits	63.9	62.2	74.1	76.9	89.6

- **Contingent liabilities in the banking sector remain significant.** Legal claims have been initiated against the government to compensate for losses suffered during the financial crisis,[6] and the BHU's ability to service its government-guaranteed note to BROU (about US$600 million in principal and interest) is a near- and medium-term risk. More generally, the presence of a large public bank (BROU), with over half of banking system deposits, is a continuing medium-term risk in the system.

[6] The former owners of *Banco Comercial* won an arbitration award against the government for US$120 million in late 2004, and a local court recently ruled that the BCU should compensate a depositor from the same bank for losses incurred. Final resolution of these cases, however, could take time, owing to pending counter-lawsuits and appeals.

4. **The key medium-term challenge is to boost growth in a lasting way, requiring continued macrostability and structural reforms** (Box 1). Growth in 2005 is estimated at 6 percent, bringing real GDP to about its peak during the 1990s, with growth converging to its underlying rate thereafter.[7] The medium-term potential growth rate is estimated at 3 percent, which assumes continued sound macroeconomic policies and the implementation of the government's structural reform agenda. This agenda centers on strengthening the public finances, promoting efficient financial intermediation, and raising investment and productivity in both the private and public sectors. Downside risks to the growth outlook include a possible downturn in external demand, higher oil prices, a sharp rise in U.S. and domestic interest rates, and slower progress with structural reforms. A near-term risk for 2005 is continued lack of rain that could cause electricity shortages.

5. **While the debt outlook has improved markedly since the height of the crisis, it remains the key medium-term risk** (Box 2). Staff's DSA suggests that medium-term primary surpluses of at least 4 percent of GDP and sustained growth are needed to reduce the public debt below 60 percent of GDP by 2009, and 50 percent by 2012. The outlook is sensitive to exchange rate, interest rate, and growth shocks, as well as to contingent liabilities in the banking system—suggesting that every opportunity should be used to strengthen the public finances further, to buffer against those risks.

Uruguay: Sensitivity of Public Sector Debt 1/
(In percent of GDP)

		Projections							
	2004	2005	2006	2007	2008	2009	2010	2011	2012
Assumptions									
Primary fiscal balance	3.8	3.5	3.7	4.0	4.0	4.0	4.0	4.0	4.0
Growth rate (percent)	12.3	6.0	4.0	3.5	3.0	3.0	3.0	3.0	3.0
Interest spread	600	450	450	450	450	450	450	450	450
Average real exchange rate (percent of the 2001 level)	69	76	79	81	82	83	83	84	85
Debt-to-GDP ratio (excluding costs of bank restructuring)	92	76	70	65	62	59	56	53	50
Sensitivity to bank restructuring costs									
All government-guaranteed notes, legal judgments, deposit insurance	92	78	73	69	66	63	60	58	55
BHU note only, legal judgments, deposit insurance 2/	92	77	71	67	64	61	58	55	53
Sensitivity to GDP growth									
GDP growth higher by 1 percent a year (2005-2012)	92	75	69	63	60	56	52	48	45
GDP growth lower by 1 percent a year (2005-2012)	92	77	71	68	65	63	60	58	56
Sensitivity to the real exchange rate									
Remains constant (2005-2012) (70 percent of 2001 level)	92	81	78	75	73	70	68	66	64
5 percentage points lower by end-2012 (80 percent of 2001 level)	92	76	70	66	63	61	58	56	54
5 percentage points higher by end-2012 (90 percent of 2001 level)	92	76	70	65	61	57	53	50	47
Sensitivity to primary surplus									
Primary surplus 0.5 percent higher a year (2005-2012)	92	75	69	64	60	57	53	49	46
Primary surplus 0.5 percent lower a year (2005-2012)	92	76	71	67	64	62	59	57	55
Sensitivity to growth and primary surplus									
GDP lower by 1 percent a year (2005-2012) and primary surplus 0.5 percent lower a year	92	77	72	69	67	65	64	62	61
Sensitivity to real interest rate									
Interest rate higher by 200 basis points	92	76	71	67	66	64	62	61	60

Sources: Ministry of Finance; Banco Central del Uruguay; and Fund staff estimates.

1/ Framework covers the nonfinancial public sector plus the BCU.

2/ Includes deposit insurance costs of US$60 million and legal judgment costs of US$120 million.

[7] Growth and the current account deficits in 2006–07 are projected above trend owing to large pulp mill projects that will boost investment by up to US$1.5 billion (8 percent of GDP) over this period.

Box 1. The Growth Outlook

Uruguay's weak growth performance since 1960 is largely explained by low investment coupled with low productivity growth. Uruguay's growth per capita averaged about 1.3 percent, almost half the growth rate of strong regional performers such as Brazil and Chile. This is partly explained by low investment, which hovered around 14 percent of GDP—significantly below other countries. Also, growth in total factor productivity lagged, in part reflecting pervasive state intervention and the existence of barriers to private competition.

Uruguay: Growth and Investment
(Average during 1960-2004)

	Per capita growth (percent)	Investment (percent of GDP)
Uruguay	1.3	14.4
Costa Rica	2.0	20.0
Chile	2.3	16.1
Brazil	2.6	19.5

Source: WEO.

Growth is now projected to increase to a medium-term rate of 3 percent by 2008. Growth for 2005 is projected at 6 percent, reflecting the recovery from the last recession. In 2006, growth would remain high, at 4 percent, as a large forestry project takes place, and would then converge to its medium-term potential of 3 percent.

Uruguay: Assessment of the Environment for Business and Innovation 1/

	Uruguay	Brazil	Chile	Costa Rica
Technology	**56**	42	32	55
Business Competitiveness Index	**77**	38	29	48
Quality of the National Business Environment	**76**	44	29	50
Financial market sophistication	**73**	26	22	47
Overall infrastructure quality	**46**	59	30	72

1/ World Economic Forum (2005). Rank out of 104 countries.

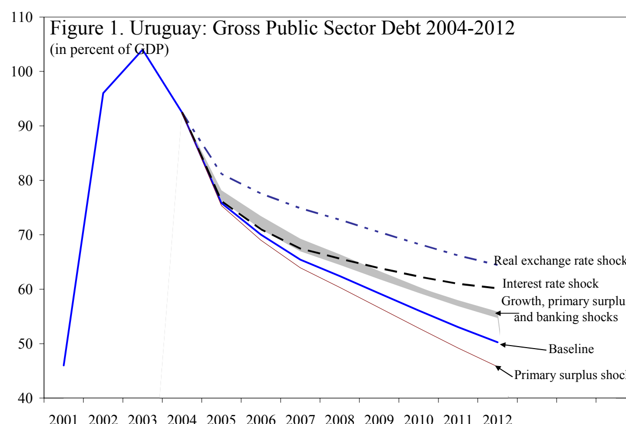
The increased potential assumes implementation of the government's comprehensive structural reform agenda. The agenda aims at increasing the capital stock through private investment, and raising total factor productivity by improving resource allocation and augmenting human capital. It covers the following areas:

- **Developing efficient capital markets** through the establishment of a market for corporate stock and fixed-income instruments, a strengthened regulatory environment, and diversification of pension fund investments in order to provide firms with new sources of financing, which to date are mainly retained earnings and bank lending;
- **Fiscal reforms** to improve the structure and efficiency of the tax system, improve the effectiveness of public institutions, and improve public expenditure management to make room for higher capital outlays;
- **Public enterprise reforms** through improving governance and opening up these sectors for private competition, to bring down the high cost of infrastructure services currently provided by them;
- **Simplifying business start-up procedures** by facilitating business registration and creating an investor relations office;
- **Strengthening corporate governance**, in part by amending bankruptcy procedures to include a Chapter 11 regime;
- **Expanding trade opportunities** by strengthening Mercosur and increasing exports outside the region, including by improving access to industrial countries' agricultural markets;
- **Improving labor market conditions** by facilitating collective bargaining through consultative wage councils at the industry level; and
- **Strengthening the human capital base** by improving education and health services, and promoting scientific research and new technologies.

Box 2. Public Debt Sustainability

- **Baseline scenario**. In the DSA baseline scenario (Appendix I), staff assumes a medium-term primary surplus of 4 percent of GDP in line with the fiscal program; potential real GDP growth of 3 percent; a return of the real value of the peso vis-á-vis the U.S. dollar to 85 percent of its pre-crisis level (from 75 percent at end-2004); and sovereign spreads remaining in line with current levels. Under these assumptions, public debt would decline from 92 percent of GDP in 2004 to 50 percent by 2012 (assuming no contingent liabilities from bank restructuring come due). With nominal debt staying broadly at the 2004 level, this reduction would be mainly achieved through economic growth and appreciation of the real exchange rate.

- **Standard sensitivity analysis**. Uruguay's high public debt will continue to be a significant vulnerability over the next few years. The debt-to-GDP ratio will only fall below 60 percent of GDP after 2008. The large share of foreign currency-denominated debt (90 percent) and floating rate debt (50 percent) and the high amortization payments coming due in the next few years make the debt-to-GDP ratio vulnerable to interest rate, exchange rate and growth shocks. In particular, the standard DSA analysis (Appendix I, Table 2) shows that large shocks to these variables would lead to significant increases in the public debt-to-GDP ratio (to 75–130 percent of GDP in 2010) that would exacerbate doubts about debt sustainability.



- **Additional sensitivity analysis**. In addition, staff has analyzed the impact of: (i) contingent liabilities in the banking system coming due; (ii) lower real GDP growth by 1 percent a year; (iii) weaker fiscal performance of ½ percent of GDP a year; (iv) a constant real exchange rate; and (v) a 200-basis point increase in interest rates over the medium term. In these cases, the public debt ratio rises generally by between 5–10 percent of GDP above the baseline. The debt is particularly vulnerable to the path of the real exchange rate and interest rates. On the other hand, additional fiscal effort of ½ percent of GDP a year would lower the 2012 debt ratio by 4 percentage points and possibly by significantly more, to the extent that the stronger fiscal performance has positive repercussions on interest rates and sovereign spreads.

III. Policy Discussions and the Authorities' Economic Program

A. Program Objectives

6. **The overarching goal of the authorities' program is to improve social conditions by raising growth and sharing its benefits more widely—based on a strategy of prudent macropolicies, deep structural reforms, and well-targeted improvements in the social safety net.** In support of their program, the authorities have requested a three-year SBA from the Fund, which they view as essential in helping them meet these objectives. Domestic political support for the program is strong, as President Vázquez and his left-leaning coalition (FA-EP) hold a majority in congress, with 52 seats (out of 99) in the lower house and 17 seats (out of 31) in the senate. Even so, the program will need to show early positive results for this support to be sustained and

entrenched; hence, the authorities' emphasis on strong frontloaded policies combined with visible actions of social support for the least fortunate.

- **Macroeconomic stability.** The authorities' program focuses on fiscal consolidation to keep the public debt on a firm downward path; a buildup of international reserves while maintaining continued exchange rate flexibility and low inflation; and promoting sound credit flows and de-dollarization in a strengthened financial system.

- **Growth.** The government aims to boost growth through a comprehensive microeconomic reform program, supported by the World Bank and IDB. Both institutions' lending programs will aim at improving infrastructure, in particular, energy, ports, roads, and sewerage. World Bank lending will also cover, inter alia: (i) improving governance and management in the public enterprises, to strengthen their ability to compete with the private sector and prepare some of them for joint ventures with the private sector, and (ii) developing the domestic capital market; while the IDB will also lend in support of continued opening of the economy to domestic and foreign competition.

- **Investment climate**. The authorities see an improved investment climate as key for boosting growth in a sustainable way. Their strategy of prudent macropolicies, strengthening the financial sector, developing capital markets, fiscal reforms, and further trade opening is designed to provide a supportive environment for increased private investment. In addition, with the support of the World Bank, they will carry out an investment climate assessment that would cover, among other areas, corporate governance; and they intend to strengthen the protection of creditor and debtor rights, including by modernizing bankruptcy legislation, while the IDB is supporting a restructuring of business start-up procedures, including the creation of an investor relations office.

Uruguay: New Lending Areas of Multilateral Development Banks, 2005–10 1/

Areas	Amount (US$ million)	Expected disbursement
IDB five-year lending program (total of US$1,225 million)		
Poverty and social inclusion	542	2005-07
of which:		
Social sector policy loan	250	2005-06
Public sector management and fiscal sustainability	170	2006-07
Competitiveness and international integration (business climate, port, tourism)	193	2005-07
of which: Competitiveness policy loan	120	2006
Other projects in main priority areas for 2008-09	320	
World Bank five-year lending program (total of US$800 million)		
Social program (Health, Education)	75	Q3/2005
Other policy loans:	400	2006-10
Public sector reforms	...	...
Tax administration and policy	...	...
Expenditure policy reform	...	...
Strengthening governance at the state-owned enterprises	...	...
General pension system reform	...	...
Establishing a framework for public-private partnerships	...	...
Broadening domestic capital markets	...	...
Demonopolizing markets	...	...
Infrastructure projects (port, energy, water, roads)	275	2005-08
Education and social security	50	2005-08

1/ Still subject to Board approvals.

7. **A key near-term challenge for the government is to effect a lasting improvement in social conditions consistent with its macroeconomic objectives.** To meet this challenge, the government has embarked on a temporary (two-year) social

emergency program (SEP). The program targets those living in extreme poverty and covers healthcare and education, direct income and housing support, and a temporary employment program (Box 3). The SEP has been allocated US$200 million (0.6 percent of GDP on an annual basis). Staff underscored that the SEP needs to be well-targeted, and that preventing it from becoming a permanent institution is crucial for the medium-term fiscal program (described below). The authorities emphasized that efficiency of the SEP is a key concern to ensure rapid progress on improving social conditions, and they recognized the potential

Box 3. Social Emergency Program

The social emergency program (SEP) responds to a core mandate of the government. Since its announcement during the presidential campaign, it has been framed as a temporary program to address the widespread social dislocation from the 2002 financial crisis (about 30 percent of the population is still below the poverty line, and 3 percent live in extreme poverty conditions). The SEP is composed of seven major programs targeting some 20 percent of the one million people living in poverty. The government has committed to spend US$200 million over a two-year period. The SEP will be implemented by the Ministry for Social Development, created in March 2005, and will be supported under the World Bank and IDB social sector reform programs aimed at strengthening social institutions and improving the efficiency of budgetary resources in these areas.

Social Emergency Program: Cost Estimates

	Target Population	Cost Estimate (in millions of U.S. dollar)	Percent
Total	**200,000**	**200**	**100**
Education	66,000	51	26
Minimum income 1/	35,000	45	23
Nutrition	200,000	40	20
Temporary employment	16,500	29	15
Housing	150,000	22	11
Primary health	200,000	11	5
Homeless	2,250	2	1

Source: Uruguay government and staff estimates.
1/ Number of households

- **Education.** Targets 66,000 students at risk and includes extracurricular support, weekend programs, school lunches, and coupons for secondary-school students.
- **Minimum Income Guarantee.** Targets 35,000 households for a guaranteed minimum household income of UR$1,363 (US$55.5) per month, and includes professional training programs for mothers.
- **Nutrition**. Targets 200,000 people, and includes programs for malnutrition, school lunches, and education on nutrition matters.
- **Temporary Employmen**t. Targets 16,500 four-month work contracts.
- **Housing.** Targets 150,000 people in needy neighborhoods, through improving infrastructure, basic services, and housing conditions.
- **Primary Health.** Targets 200,000 people through providing preventive health care, and includes programs for infrastructure, medical and dental care, and medicines.
- **Homeless**. Targets 2,350 homeless individuals by providing night shelters and day centers.

risk regarding the SEP's timely phase-out. They intend to work closely with the World Bank and IDB to ensure that room can be made under the social-sector fiscal envelope to incorporate any elements of the SEP that merit extension, and thus, make sure that the program is terminated as envisaged.

B. Macroeconomic Framework

Uruguay: Medium-term Macroeconomic Framework
(percent of GDP, unless otherwise indicated)

			Program				Proj.	
	2003	2004	2005	2006	2007	2008	2009	2010
Real GDP (percentage change)	2.5	12.0	6.0	4.0	3.5	3.0	3.0	3.0
Real domestic private consumption (percentage change)	2.0	12.8	7.1	2.9	2.1	1.8	2.7	3.4
Gross investment	13.0	13.7	15.3	19.1	17.0	17.6	17.9	18.0
Domestic private savings	14.0	12.5	12.3	13.4	13.9	14.9	14.6	14.9
CPI (percentage change)	10.2	7.6	6.5	5.5	4.5	3.5	3.5	3.5
Primary balance	2.7	3.8	3.5	3.7	4.0	4.0	4.0	4.0
Overall fiscal balance	-3.2	-2.2	-1.7	-1.3	-0.8	-0.8	-0.8	-0.7
Public sector debt 1/	104.4	92.5	75.8	70.1	65.5	62.4	59.3	56.1
External current account balance	-0.3	-0.8	-2.8	-5.3	-1.2	-0.7	-0.8	-0.6
Official reserves	2,087	2,512	2,656	2,866	3,067	3,230	3,339	3,506
As a % of ST debt + FX deposits	20.0	27.7	26.2	25.7	26.5	27.4	26.8	26.8

Sources: BCU; and Fund staff estimates.

1/ Includes debt of the nonfinancial public sector and the central bank.

8. **The authorities' medium-term framework is anchored on a primary surplus target of 4 percent of GDP**. They explained to staff that the underlying surplus would already be at that level from 2005, while the "headline" surplus would be somewhat lower in 2005-06 (3.5 percent of GDP and 3.7 percent of GDP, respectively), taking into account one-off expenditures and surcharges introduced during the economic emergency as well as the SEP, which they consider to be strictly temporary (Box 4). The fiscal path reflects the planned tax reform (see below), tight control on expenditure including for wages and pensions,[8] and timely public tariff adjustments in line with cost developments. Staff urged the authorities to achieve a 4 percent primary surplus already from 2005 to anchor expectations of fiscal discipline under the new government, and urged the authorities to make every effort to achieve this goal as soon as possible. The authorities agreed to save any revenue overperformance under the program, and are committed to pushing ahead with their plan to strengthen tax administration and to refrain from any significant tax reduction before the planned tax reform.[9] They also noted that the fiscal program envisages a

[8] Real public sector wages (y/y) would be unchanged in 2005.

[9] They did not rule out, however, minor changes to the tax system that would be revenue neutral and consistent with the fiscal targets under the program and their efforts to improve the efficiency of revenue collections.

significant decline in the overall deficit, from 2.2 percent of GDP in 2004 to 0.8 percent of GDP in 2007 that, along with growth and real appreciation of the peso, would help lower the public debt from 92 percent of GDP to about 65 percent of GDP by end-2007. Staff welcomed these commitments and pointed to the importance of having fiscal contingency measures given the significant risks on both revenues (such as weaker growth) and expenditures (mainly wages, pensions, and debt service). The authorities explained that the main contingency measure would be spending restraint, as demonstrated in their spending plans for 2005—although recourse could also be taken to increasing revenues if needed.

Box 4. Factors Influencing Analysis of Fiscal Performance in 2004-05

In 2004, the 3.8 percent of GDP primary surplus of the consolidated public sector included transitory components, estimated at 0.4 percent of GDP, implying an underlying primary surplus of 3.4 percent of GDP. Transitory items on the revenue side of 0.9 percent of GDP, associated with concession revenues and the elimination of various emergency surtaxes, were partly offset by transitory spending items of 0.4 percent of GDP, related to last year's general election and regularization of arrears incurred during the 2002 crisis.

A similar calculation for 2005, starting from the program primary surplus target of 3.5 percent of GDP, shows an underlying primary surplus of 3.7 percent of GDP. Assuming social-emergency-program spending of 0.4 of GDP is strictly temporary, the underlying primary surplus would be 4.1 percent of GDP.

Underlying Primary Balance of the Public Sector: 2004-05

	UR$ millions	Percent of GDP
2004 TMU Primary Surplus	**14,284**	**3.77**
Minus: 2004 One-Offs (revenue - expenditure)	**1,538**	**0.41**
Revenue	3,211	0.85
Airport concession	714	0.19
Tax surcharges under 2002 emergency program	2,497	0.66
Expenditure	1,674	0.44
General elections	302	0.08
Abatement of arrears	1,372	0.36
Equals: 2004 Underlying Primary Surplus	**12,746**	**3.36**
2005 Program Primary Surplus	**14,650**	**3.50**
Minus: 2005 One-Offs (revenue - expenditure)	**-665**	**-0.16**
Revenue	274	0.07
NBC Dividend to the treasury	274	0.07
Expenditure	939	0.22
Municipal elections	175	0.04
Abatement of arrears	764	0.18
Equals: 2005 Underlying Primary Surplus	**15,315**	**3.66**
Memorandum item:		
Social Emergency Program: spending planned in 2005	1,812	0.43

9. **The framework for monetary policy (monetary targets and flexible exchange rate) will be maintained, aiming at a steady lowering of the target range for inflation to 2½–4½ percent by end-2008**. Staff supported the authorities' intention to maintain the current framework for monetary policy until conditions are in place to move to a formal inflation targeting framework. In preparation for such a move, the authorities intend to advance institutional reforms of the central bank (see below), and MFD will provide technical assistance (TA) on strengthening monetary policy instruments and operations. Staff supported the authorities' near–term inflation objectives (5½–7½ percent for end-2005

and 5–7 percent for March 2006) and considered the present monetary policy stance as consistent with these objectives, given current inflation and recent surveys of inflationary expectations in line with the 12-month targets. The authorities indicated that inflationary pressures could build over the next few months in light of the ongoing recovery in real wages, higher energy prices, and an economy approaching its pre-recession levels of output and unemployment, and stressed their readiness to tighten the policy stance if necessary.

10. **The program envisages a further strengthening of the international reserves position.** The authorities saw merit in bolstering the central bank's international reserves somewhat, given the high level of financial dollarization, and aim to raise gross reserves over the program period by US$300 million.[10] The program conservatively assumes that this increase of international reserves will be achieved through longer-term debt issuance. The authorities considered that, if monetary conditions permit, the BCU could purchase foreign exchange to accumulate additional reserves, but without announcing a formal intervention strategy. The authorities stressed that such purchases would not aim at influencing the path of the real exchange rate and would be consistent with the program's inflation objective.

C. Structural Fiscal Policies and Debt Management

11. **Structural fiscal reforms are to bolster the public finances' resilience to shocks and improve efficiency**. The authorities' program includes four pillars of fiscal reform: (i) comprehensive tax reform, (ii) modernization of tax administration, (iii) overhaul of the budgetary framework, and (iv) reform of the specialized pension funds.

12. **Tax reform**. The authorities plan to rationalize and broaden the tax base to make revenue collections more robust and distribute the tax burden more equitably. Specifically, they intend to introduce a personal income tax, revamp the corporate income tax to accommodate the personal income tax and unify tax rates across sectors, streamline the current system of tax exemptions and subsidies, rationalize the plethora of minor taxes (of the 30 different taxes, 5 account for 90 percent of total collections), and eventually begin to lower the high statutory rates on indirect taxes. A draft law will be sent to congress by end-2005, for implementation from mid-2006. Staff and the authorities concurred that indirect tax rates should only be reduced after the yield of the tax reform is assured.

13. **Strengthening tax administration.** The authorities intend to implement pending reforms from the last program, including issuance of a decree to implement the domestic revenue service (DGI)'s modernization law (establishing, inter alia, a professional career stream at the DGI) and the establishment of a large taxpayers unit (LTU). They will also formulate an action plan to coordinate tax audits between the DGI, BPS and the Ministry of

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[10] This excludes dollar deposit reserve requirements and is consistent with a US$1.1 billion increase in NIR (program definition).

Labor to reverse last year's weakening of collections of social security contributions. In 2005, joint FAD/World Bank TA will be provided to strengthen the institutional capacity of the DGI, with a view to transforming it into a semi-autonomous agency with responsibility for social security contribution and trade tax collections.

14. **Reforming the budgetary process.**[11] During the first program year, the authorities will incorporate the recommendations of the 2001 fiscal ROSC by complementing the five-year expenditure plan with the submission of revenue projections, deficit targets, and a medium-term macroeconomic framework consistent with the program's fiscal targets. They will also carry out a tax expenditure analysis. In addition, FAD is providing TA to lay the ground for a new budgetary framework that should include a new organic financial management law, introduction of annual budgets within a rolling five-year framework, and improvements in budget classification and coverage, including moving off-budget items on budget and reducing earmarking of revenue. The authorities agreed that once the TA is completed later this year, key elements of the strategy could become part of the government's reform agenda.

15. **Pension reform**. Reforms are needed of the specialized pension funds as well as the general public pension plan, which jointly required Treasury support of 7 percent of GDP in 2004.[12] The reform of the specialized pension fund of the police is most advanced and will be implemented before end-2005. This would be followed by reforms of the pension funds of the military (by end-2006) and of bank employees (by end-2007). Staff cautioned that second-generation reforms of the general pension system (which was overhauled in 1995) are needed to reduce the burden on the Treasury. The authorities saw merit in this view and intend to discuss in June with World Bank staff a reform agenda in this area.

16. **Debt management**. The authorities will establish a debt management unit and investors relation office at the Ministry of Finance, by year-end, with assistance from ICM, MFD, and the IDB. The unit will formulate an appropriate medium-term debt plan, while managing the strategy on the interest, currency, and maturity composition of public debt. Staff supported the authorities' general objective to lengthen the maturity of debt issues (to at least 12 years), and encouraged them to make further progress toward de-dollarizing the debt (including by issuing inflation-indexed peso-denominated debt) and build a local yield curve as part of its strategy to develop local capital markets. Staff urged the authorities to take advantage of favorable market conditions in 2005 to pre-finance at least part of 2006 financing needs.

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[11] The current framework requires a new administration to present a five–year expenditure program to congress by August of their first year in office. No formal deficit targets need to be announced, and the spending plan is subject to annual revisions.

[12] The police and military plans each require Treasury support of about 0.2 percent of GDP. The bank employees' pension plan is purely private, but could become insolvent within two years if reforms are not instituted. Remaining Treasury support goes to the general system.

D. Central Bank and Financial Sector Reforms

17. **Improving BCU autonomy is high on the authorities' reform agenda**. They recognized that this step is critical to further raising the credibility of monetary policy and preparing the move to inflation targeting. To this end, they intend to: (i) submit a law to congress by end-2005 that would strengthen central bank legal independence, including through the staggering of the appointments of BCU board members (de-linking them from the electoral cycle) and establishing price stability as the primary objective; (ii) submit a law to divest the BCU's supervisory responsibilities to allow it to concentrate on monetary policy and avoid any conflict of interest;[13] and (iii) study (with MFD assistance) strategies for strengthening its financial position.[14]

18. **Financial sector supervision will be strengthened further and the framework for bank restructuring overhauled**.

- ***Regulatory and supervisory framework of the financial system***. The authorities intend, with assistance from MFD, to create separate supervisory institutions to regulate and supervise banks, insurance companies, and pension funds through a law that will be sent to congress by December 2005, for implementation from mid-2006. Staff welcomed the authorities' decision to request a joint World Bank/IMF FSAP, which will take place in the second half of 2005.[15]

- ***Bank resolution framework***. The recent suspension of a cooperative bank underscored the need for a new bank resolution framework. Staff commended the authorities for the prompt action taken in resolving that situation, but also noted the ad-hoc nature of those actions—including the deposit insurance scheme introduced—and the risks and potential moral hazard problems of not having a clear and transparent framework. The authorities shared staff's concern and will send to congress by end-2005 a law (on which MFD will provide TA) to establish a formal bank resolution framework (including a refined deposit insurance scheme), for implementation from mid-2006. [16] Staff recommended that deposit insurance

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[13] Presently, the BCU oversees deposit insurance and bank restructuring, while also acting as lender of last resort.

[14] Quasi-fiscal activities over the years have weakened the BCU's financial position, resulting in a negative net worth of US$500 million at end-2004 and a projected cash deficit of 0.5 percent of GDP in 2005.

[15] An FSAP exercise was started in November 2001, but subsequently suspended on account of the financial crisis in 2002.

[16] The deposit insurance scheme has a number of positive elements, including a relatively low limit on coverage of dollar deposits (US$5,000), but operational and legal issues remain, including on its funding and the exact definition and treatment of deposits covered. It is

(continued)

coverage of dollar deposits be expressed in pesos (rather than in U.S. dollars), in line with best practices, but the authorities thought that at this juncture this might raise confidence concerns and spur systemic problems.

19. **De-dollarizing the economy is an important goal**. There was broad agreement between staff and the authorities that this will, most importantly, require a sustained period of macrostability to strengthen private sector confidence in the peso. At the same time, the process will be supported by: (i) regulatory oversight to ensure that banks take into account the credit risk of dollar lending to unhedged borrowers; (ii) higher reserve requirements and deposit insurance premia on dollar deposits; and (iii) capital market development to provide a broader range of savings instruments in pesos, including inflation-indexed government bonds and savings instruments in the banking system.

20. **The bank restructuring program is continuing, for the public as well as the intervened private banks**.

- ***BROU***. The authorities shared staff's concern about the risks of having a public bank dominate the banking system. To address these risks, they intend to pursue vigorously the current restructuring plan of the bank,[17] noting that the recently appointed board, selected solely on the basis of professional qualifications, will help ensure that the bank is well run.[18] The authorities expressed their firm commitment that the bank will not return to politically-influenced lending practices, and that any potential subsidies should be made explicit in the budget. They also agreed with staff that the trust funds managing BROU's nonperforming loans need to remain independent, with their main objective being to maximize loan recoveries, to ensure that they service the government-guaranteed note to BROU of about US$350 million in full.

- ***Housing bank (BHU)***. Staff noted that while progress had been made in restructuring BHU, it was still not operating as a mortgage company and burdened with elevated operating costs and NPLs. It is, therefore, a major risk to the public finances: current projections show that the bank might not be able to service its government-guaranteed note to BROU in the coming years. The authorities shared staff's concern and intend to accelerate the reform of BHU. Specifically, they hope to make a first securitization of part of the bank's mortgage portfolio before the end of this year, and the bank will

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envisaged that the revised scheme will be managed by an agency outside the central bank, responsible for bank resolution and maintain the current guarantee limits while clearly defining funding sources and coverage of accounts.

[17] For details of the plan, see IMF Country Report 04/327.

[18] According to the constitution, appointment of Board members to BROU is the responsibility of the government.

continue to refrain from taking deposits.[19] They also reaffirmed that the bank's obligations to BROU will be financed according to the present timetable and terms.

- ***Nuevo Banco Comercial (NBC)***. The government's strategy is to divest its controlling interest in NBC; although good progress has been made in initiating this process, it could take some time to conclude (the authorities hope by no later than mid-2006). In the meantime, they intend to strengthen the bank's governance by appointing an interim CEO and board with appropriate professional experience.

- ***Liquidation funds***. Staff advised the authorities to closely monitor these collection efforts to ensure that the manager meets its targets, and that revenue should be saved to provide for unforeseen bank restructuring costs or other fiscal contingencies. The authorities agreed with staff's recommendations and noted that to ensure transparency, they will continue to publish audited semi-annual financial reports of the liquidation funds.

IV. Access, Balance of Payments Need, Capacity to Repay the Fund, and Financing Assurances

21. **Proposed access under the SBA balances the need to ensure that the program is adequately financed while providing for a reduction in Fund exposure consistent with a lasting exit from future Fund financial support**. The total gross financing need (including for the programmed buildup in international reserves) during the program period will average about US$2.2 billion a year (12 percent of GDP). Of this, on average, US$400 million a year would be covered by the World Bank and IDB, US$1.4 billion from the market (corresponding to net government bond placements of some US$500 million a year, about 3 percent of GDP, and of which some US$600 million would be financed externally),

Uruguay: External Financing Requirements and Sources

(In millions of U.S. dollars)

		Program				Projections	
	2004	2005	2006	2007	2008	2009	2010
Financing requirement	**1,493**	**1,911**	**2,807**	**2,102**	**1,464**	**1,445**	**1,478**
External current account deficit							
(excludes official transfers)	105	459	956	226	138	181	142
Public sector debt amortization	963	1,308	1,640	1,675	1,163	1,155	1,169
NFPS amortization	563	825	980	801	657	677	752
IMF repurchases	400	483	661	874	505	478	417
Gross international reserves (increase = +)	425	144	210	201	163	109	166
Available financing	**941**	**1,558**	**2,285**	**1,691**	**1,370**	**1,445**	**1,478**
Public sector	630	878	1,017	1,118	972	1,051	1,065
Official creditors (World Bank, IDB, bilaterals)	220	295	520	458	265	316	471
of which: balance of payments financing	100	200	320	75	50	50	50
Private creditors	410	582	497	660	707	734	594
Private sector (net)	311	680	1,268	574	398	395	413
FDI	300	480	1,065	381	347	365	383
Others 1/	12	200	203	193	51	30	30
Financing gap	**552**	**353**	**522**	**410**	**93**	**0**	**0**
IMF disbursement	552	353	522	410	93	0	0
Memorandum item:							
IMF (net)	152	-130	-139	-464	-412	-478	-417

Source: Data provided by the Uruguayan authorities; and Fund staff estimates and projections.

1/ Includes change of commercial banks' NFA, short-term flows and trade credits, and errors and omissions.

[19] The only exception is that the bank will continue to offer, as part of its reform program, peso-denominated, mortgage-related savings accounts.

and the remainder by the Fund (16 percent of the total gross financing need). The proposed access of SDR 766 million (250 percent of quota) would leave Fund exposure at SDR1,134 million (370 percent of quota) by mid-2008 (covering about 60 percent of the repurchases falling due during the period), and requires approval under the exceptional circumstances clause under the Fund's access policy (Appendix II).[20] Phasing would be tailored to external financing needs and somewhat concentrated in 2006 (45 percent of proposed access) when large amortization payments fall due on the shorter-term placements made soon after the 2002 crisis.

22. **Uruguay should be able to fully discharge its obligations to the Fund following the program and exit from further Fund financial support**. While Fund exposure at program's end would remain high (debt service to the Fund would still amount to 20–25 percent of total external debt service in 2009-12), the DSA shows that Uruguay should be able to fully cover its obligations coming due to the Fund—which will average about US$365 million during 2009-12—through placements in international and domestic capital markets (averaging some US$500 million a year on a net basis and implying gross placements in line with those projected during the program period). This will require firm implementation of the proposed program and structural reforms supported by the World Bank and IDB. The authorities will consider reducing Fund exposure at an accelerated pace if external and market conditions turn out more favorable than anticipated.

Uruguay: Public Sector Financing Outlook (2005–2012)
(In millions of U.S. dollars)

	2005	2006	2007	2008	2009	2010	2011	2012
Public sector gross borrowing requirements	**2,044**	**2,356**	**2,400**	**1,935**	**1,912**	**1,949**	**2,540**	**1,821**
o/w: IMF repurchases 1/	483	661	874	505	478	417	397	175
o/w: World Bank/IDB	327	481	453	260	273	301	319	322
o/w: Bond amortizations	619	685	581	684	645	759	1,358	841
o/w: Commercial bank amortization	201	125	132	149	176	153	163	161
Gross financing	**2,044**	**2,356**	**2,400**	**1,935**	**1,912**	**1,949**	**2,540**	**1,821**
IMF disbursements 1/	353	522	410	93	0	0	0	0
World Bank/IDB	376	511	449	257	310	312	328	331
Bond placements	1,044	1,000	1,249	1,278	1,269	1,328	1,892	1,173
o/w: >10 year maturity	429	406	649	708	699	758	1,322	603
Short-term debt	150	150	150	150	150	150	150	150
Banking system credit	101	125	132	149	176	153	163	161
Bilaterals and others	20	48	9	8	6	6	7	5
Memorandum items:								
Fund credit outstanding	1,946	1,362	1,169	977	780	489	197	28
(as a share of quota)	553.7	475.7	351.9	273.1	170.8	103.4	41.8	6.0
Net World Bank/IDB	49	30	-4	-3	37	10	9	9
Net bond placements	425	315	668	594	624	570	533	332
Central bank gross international reserves	2,656	2,866	3,067	3,230	3,312	3,453	3,553	3,653
as a percent of short-term debt and nonresident dollar deposits	52.5	50.0	52.4	58.6	57.4	57.4	57.4	57.4

1/ Includes disbursments under the new program.

23. **The program has adequate financing assurances in place**. Financing needs through August 2005 have been secured, through placements in the domestic market of inflation-linked and dollar-denominated notes, the temporary use of government deposits at the central bank, and the recent international bond placement. The residual financing gap

[20] In Appendix II, as required under exceptional access procedures, the case for exceptional access is evaluated and the impact of the new arrangement on Fund finances is assessed.

for 2005 and the buildup in international reserves would be closed through an international bond issue of US$200 million later in the year. Gross financing requirements for the remainder of the program will need to be met through sustained fiscal discipline, increasing access to domestic and international financial markets, and continued IFI support.

24. **A new full safeguard assessment is underway**. An on-site safeguards assessment of the Central Bank of Uruguay was completed in July 2002, and most of its recommendations have been implemented (see Appendix III on Fund Relations for details). Under the proposed SBA, Uruguay is subject to a new full safeguards assessment of the Central Bank. The authorities have provided the necessary documentation, and the assessment is expected to be completed by end-September 2005.

V. Program Monitoring

25. **The proposed program would be monitored through quarterly reviews, owing to the vulnerabilities of the Uruguayan economy and high Fund exposure**. Conditions permitting, bi-annual reviews could be considered after the first program year.

26. **The proposed program contains standard quantitative performance criteria (PCs), indicative targets and benchmarks, and structural conditionality, including prior actions, which focus on policy priorities and address program risks** (Tables 1 and 2 of the MEFP):

- **Prior actions aim at safeguarding the needed fiscal adjustment in 2005 and advancing financial sector restructuring**. In the fiscal area, these cover the issuance of a decree to implement the DGI modernization law, the establishment of a large taxpayer unit at the DGI, and a plan to coordinate audits between the DGI. BPS, and Ministry of Labor. In the financial sector, an interim CEO and board members with appropriate experience are to be appointed at NBC.

- **Quantitative PCs would focus on the program's fiscal, debt, monetary, and international reserve objectives.** The PC on the combined public sector primary balance is supplemented by a ceiling on non-interest government expenditure to ensure that any revenue overperformance would be saved.[21] Overall budgetary developments will be monitored through an indicative ceiling on the overall fiscal deficit. Debt developments will be monitored through a PC on the stock of the gross debt of the nonfinancial public sector (NFPS),[22] and an indicative target on the stock of floating debt. Standard PCs on the NIR and NDA of the central bank, and an

[21] As in the previous arrangement, one-time outlays related to bank restructuring will be reported under the augmented balance.

[22] This PC is set in line with the DSA projections (which cover the BCU and the NFPS), but provides room for government bond issues to build reserves and excludes changes arising from stock revaluations.

indicative ceiling on base money growth will serve for monitoring monetary and international reserve performance. Quarterly PCs and targets have been set through end-2005, and indicative targets for 2006 and 2007.

- **Structural conditionality has been established for the first program year and focuses on priority reforms identified by the EPA**. PCs and benchmarks would cover reforms aimed at bolstering the public finances, increasing the autonomy of the central bank, and improving financial sector soundness.

27. **Statistical issues**. Uruguay's statistical database has been broadly adequate for program monitoring, but lags in fiscal and public debt data generally exceeded the two-month limit under the previous arrangement. The two-month limit has been maintained under the proposed SBA, and the authorities are committed to taking the necessary steps for timely data provision, which should also help avoid further recourse to waivers of applicability of PCs.

VI. Staff Appraisal

28. **The Fund-supported program that expired in March was successful in overcoming the 2002 financial crisis, promoting a strong economic recovery and improving the outlook for debt sustainability, but key challenges remain**. The authorities need to build on the progress made to date, and their program rightly focuses on boosting medium-term growth prospects, reducing the still high public debt, and addressing remaining weaknesses in the financial system. Delayed or incomplete structural reforms were disappointments under the previous program, and it is crucial that the government's ambitious reform agenda not lose momentum. Early success in implementing the program and achieving results will also be key to maintaining and strengthening the consensus that has been forged on the policy framework.

29. **Boosting growth in a lasting way will require maintaining macrostability and reforms to attract more private investment**. The authorities view a substantial increase in private investment as the linchpin of their strategy for growth and social progress over the medium term. Staff commends the authorities for the quick and close collaboration with the IDB and World Bank in designing a reform strategy that aims at developing capital markets, preparing public enterprises for competition and strategic partnerships with the private sector, strengthening property and creditor rights, facilitating foreign investment, improving infrastructure, and increasing trade opportunities.

30. **A key policy challenge will be to sustain sufficiently large primary surpluses**. Staff supports the authorities' medium-term primary surplus target of 4 percent of GDP, which should be viewed as a floor, and urges them to reach the target as soon as possible, to help anchor expectations of fiscal discipline and take advantage of the current favorable environment. In this context, staff welcomes the authorities' commitment to save any revenue overperformance in 2005-06. Staff underscores that the debt outlook leaves no room for fiscal policy slippages, which could quickly derail the debt dynamics and undermine the credibility of the entire program.

31. **Achieving the fiscal targets will require firm control over discretionary spending and timely adjustments to public tariffs**. Containing wage and pension spending and generating adequate surpluses in the public enterprises is key for creating space in the fiscal program for the authorities' planned increase in social spending. Staff encourages the authorities to work closely with the World Bank and IDB to ensure that the social emergency program is effective and can be phased out as envisaged.

32. **Strengthening tax administration will help achievement of the revenue targets and support the forthcoming tax reform**. Staff welcomes the actions taken to modernize the domestic revenue service (DGI) and create a large taxpayer unit. The coordination plan between the DGI, the social security bank, and the Ministry of Labor should reverse the recent decline in social security collections. Looking forward, strengthening the institutional capacity of the DGI will help reduce evasion, maximize the benefits of the planned tax reform, and improve the efficiency of revenue collections.

33. **A comprehensive tax reform is key to improving the resiliency of the public finances**. Staff supports the authorities' plan to introduce a personal income tax, rationalize the corporate income tax, and streamline the extensive system of tax exemptions and subsidies and large number of small taxes. In this context, the authorities are right to consider reducing indirect taxes only after the tax reform's revenue impact is properly assessed.

34. **Pending reforms of the specialized pension funds and second-generation reforms of the general pension system are needed to improve fiscal flexibility**. Reforms of the police and military pension funds are long overdue, and staff welcomes the authorities' intention to follow through on these pending reforms. To eliminate the risk that the weak finances of the bank employees' pension fund becomes a future fiscal burden, staff encourages the authorities to move expeditiously in reforming this pension plan. Reform of the general pension system will require a broad consensus, which will take time to build; nevertheless, staff welcomes the authorities' intention to work with the World Bank on possible reforms of the system and urges that, once appropriate measures are identified, they be included in the reform agenda.

35. **Staff supports the authorities' strategy of moving over time toward an inflation-targeting framework for monetary policy**. The high priority the authorities have given to strengthening the independence and finances of the central bank is well placed. Staff supports the goal of reducing inflation gradually toward a range of 2½–4½ percent by 2008. The current stance of monetary policy is appropriate, and staff supports the authorities' intention to maintain the current framework for monetary policy (monetary targets and a flexible exchange rate) until conditions are in place for moving to formal inflation targeting. The programmed buildup in international reserves is needed to bolster reserve coverage of dollar-denominated short-term debt and dollar deposits, and staff encourages the authorities to add to this target should conditions permit.

36. **After bringing the banking system back from crisis, financial sector policies are now shifting toward longer-term systemic reforms and development needs**. The forthcoming FSAP will be a good opportunity to take stock and review the strategy. Clear

immediate priorities are revamping the institutional setting of financial system oversight and creating a new bank resolution framework, two key items in the first-year program. Staff welcomes the authorities' plans in this context.

37. **Completing the bank restructuring process is essential to restoring sound credit flows and limiting fiscal contingencies**. The reform agenda is well set: resolve the bad asset overhang from the crisis transparently and rigorously; strengthen the finances of the public banks; and fortify the management of NBC. Staff welcomes the smooth release of the final tranche of reprogrammed deposits at BROU, and the authorities' intention to accelerate the pace of reforms at BROU and BHU. An expeditious transformation of the BHU into a viable mortgage company is key to minimizing contingent fiscal risks. Staff is encouraged by the progress being made toward divesting the government's controlling interest in NBC, and encourages the authorities to bring the process to an early conclusion. The current arrangements for asset recovery are appropriate, and staff welcomes the authorities' commitment to continue publishing semi-annual financial statements of the liquidation funds.

38. **In general, Uruguay's statistical information is adequate for program monitoring purposes, but the provision of fiscal and debt data must become more timely**. Staff welcomes the authorities' commitment to improve the coordination among agencies reporting fiscal and debt data to ensure that they are provided in a timely manner.

39. **Firm implementation of the program is essential to further reduce the vulnerabilities of the Uruguayan economy**. The main macro vulnerabilities stem from the high public debt; continued risks in the banking system; and pressures for increased spending. There is also the risk of inadequate growth and social stagnation which—besides undermining the debt outlook—would sap domestic consensus on the entire policy framework. It is therefore crucial that prudent macro-management be paired with deep micro-reforms—as is the government's strategy—to trigger the needed response of investment and productive enterprise. The authorities have already shown resolve in implementing the program, and staff is confident that their policies, as described in their Letter of Intent of May 24, 2005, are the right ones to achieve these goals. Staff views the proposed level of access as appropriately balancing the need to ensure that the program is adequately financed, while preparing for a lasting exit from Fund financial support. On this basis, staff recommends approval of the requested three-year SBA.

Table 1. Uruguay: Selected Economic and Social Indicators

Population (estimate)	3.4	Physicians per 1,000	3.7
		Hospital beds per 1,000	4.4
Life expectancy at birth (years)	74.6		
Crude birth rate (per thousand)	9.7	Access to safe water (percent of population)	98.0
Infant mortality rate (per thousand live births)	14.0		
Income share held by highest 10 percent of households	33.5	Adult literacy rate	97.7
Income share held by lowest 20 percent of households	4.8	Gross enrollment rate	
Gini coefficient	44.6	Primary education	108.3
Unemployment rate	11.0	Secondary education	101.5
		Tertiary education	37.7
GDP per capita in 2004 (in US$)	4,000		
Human Development Index Rank	46 (out of 177 countries)		

				Program				Proj.	
	2002	2003	2004	2005	2006	2007	2008	2009	2010
				(Percent change)					
				I. Output, prices, and wages					
Real GDP	-11.0	2.5	12.3	6.0	4.0	3.5	3.0	3.0	3.0
Contributions to growth (percent)									
Consumption	-15.2	-1.0	9.2	7.0	5.2	-1.7	1.1	3.0	2.5
Investment	-5.0	2.7	2.9	1.5	3.7	-1.2	0.9	0.7	0.5
Net exports	9.1	0.9	-1.2	-2.8	-5.1	6.3	0.9	-0.8	-0.1
GDP deflator	18.7	17.9	6.9	4.1	5.3	4.3	3.4	3.4	3.4
CPI inflation (average)	14.0	19.4	9.2	5.2	6.5	4.5	3.5	3.5	3.5
CPI inflation (eop)	25.9	10.2	7.6	6.5	5.5	4.5	3.5	3.5	3.5
Exchange rate change (Ur$/US$)(average)	62.1	30.4	-10.8	...	...	...	...	...	...
Exchange rate change (Ur$/US$) (eop)	84.2	7.3	-2.8	...	...	...	...	...	...
Average public sector wage (end-of-period)	0.5	7.9	9.7	6.5	6.5	6.5	5.5	5.5	5.5
GDP (In Ur$ billions)	261	315	379	418	458	495	527	561	598
GDP (In US$ billions)	12.1	11.2	13.3	16.4	18.0	19.4	20.5	21.8	23.1
				II. Monetary indicators 1/					
BCU monetary liabilities	-7.4	25.3	30.0	7.9	9.0	7.7	9.2	...	...
Currency issued	5.8	22.4	15.7	11.6	12.0	9.4	11.5	...	...
M-2	0.8	20.7	9.9	8.1	14.7	9.4	11.5	...	...
M-3	21.3	24.2	-9.5	1.5	7.9	8.0	10.1	...	...
Credit to the private sector (constant exch. rate) 2/	-13.7	-25.5	-20.1	8.6	14.1	12.5	15.3	...	...
				(Percent of GDP, unless otherwise indicated)					
				III. Public sector operations					
Revenue	31.1	31.1	30.0	30.2	29.4	29.3	29.1	29.1	29.1
Noninterest expenditure (incl. discrepancy)	31.1	28.4	26.3	26.7	25.6	25.3	25.1	25.1	25.1
Primary balance	0.0	2.7	3.8	3.5	3.7	4.0	4.0	4.0	4.0
Interest	4.7	6.0	6.0	5.2	5.0	4.8	4.8	4.8	4.7
Overall balance	-4.6	-3.2	-2.2	-1.7	-1.3	-0.8	-0.8	-0.8	-0.7
Public sector debt 3/	96	104	92	76	70	65	62	59	56
				IV. Savings and investment					
Gross domestic investment	11.5	13.0	13.7	15.3	19.1	17.0	17.6	17.9	18.0
Gross national savings	14.7	12.7	12.9	12.5	13.8	15.8	16.9	17.0	17.4
Foreign savings	-3.1	0.3	0.8	2.8	5.3	1.2	0.7	0.8	0.6
				V. External indicators					
Merchandise exports, fob (US$ millions)	1,922	2,273	3,025	3,276	3,463	3,862	4,248	4,525	4,889
Merchandise imports, fob (US$ millions)	1,874	2,092	2,990	3,713	4,429	4,144	4,430	4,734	5,054
Merchandise terms of trade (percentage change)	3.6	3.7	-2.2	-6.4	-1.0	0.4	0.1	-0.3	0.5
Current account balance	3.1	-0.3	-0.8	-2.8	-5.3	-1.2	-0.7	-0.8	-0.6
Overall balance of payments (US$ millions)	-2,323	1,311	425	144	210	201	163	109	166
External debt 4/	87.2	98.3	87.4	70.2	63.4	58.1	54.5	50.9	47.4
Of which: External public debt	68.6	85.3	77.0	61.7	55.7	51.0	47.8	44.5	41.4
Gross official reserves (US$ millions) 5/	776	2,087	2,512	2,656	2,866	3,067	3,230	3,339	3,506
In months of imports of goods and services	3.7	9.3	8.2	7.2	6.6	7.4	7.2	7.0	6.9
In percent of short-term debt 4/	25.1	86.8	158.0	115.0	104.5	115.5	153.8	154.9	160.4
In percent of short-term debt plus bank non-resident deposits	14.3	45.1	61.6	54.2	52.8	56.3	64.8	64.9	66.5
In percent of short-term debt plus FX deposits	7.0	20.0	27.7	26.2	25.7	26.5	27.4	26.8	26.8
Net international reserves (program definition, US$ millions) 6/	-2,391	-2,508	-2,218	-1,938	-1,692	-1,106	-738	-160	358
REER (percentage depreciation -, e.o.p.)	-20.3	-13.2	9.3	...	...	...	...	...	...

Sources: Data provided by the Uruguayan authorities; and Fund staff estimates.

1/ Evaluated at program exchange rates for 2004.
2/ Part of the sharp drop in 2003 is due to the removal of the three liquidated banks from the database in May 2003.
3/ Covers debt of the NFPS and the central bank (excluding monetary policy instruments and free reserves).
4/ Excludes nonresident deposits.
5/ Includes reserve buildup through reserve requirements of resident financial institutions.
6/ Includes all outstanding liabilities to the IMF, and liabilities to resident financial institutions.

Table 2. Uruguay: Medium-Term Balance of Payments

(In millions of US$, unless otherwise stated)

				Program				Proj.	
	2002	2003	2004	2005	2006	2007	2008	2009	2010
				1. Balance of Payments					
Current account balance	**382**	**-33**	**-105**	**-459**	**-956**	**-226**	**-138**	**-181**	**-142**
Trade balance	**48**	**182**	**35**	**-437**	**-966**	**-282**	**-182**	**-209**	**-165**
Exports, f.o.b.	1,922	2,273	3,025	3,276	3,463	3,862	4,248	4,525	4,889
Imports, f.o.b.	1,874	2,092	2,990	3,713	4,429	4,144	4,430	4,734	5,054
Services	153	163	302	351	380	412	447	486	528
Exports, f.o.b.	771	778	987	1,091	1,179	1,275	1,379	1,492	1,615
Imports, f.o.b.	618	615	685	740	799	863	932	1,006	1,087
Income (net)	**109**	**-467**	**-531**	**-454**	**-451**	**-436**	**-483**	**-538**	**-585**
Transfers (net)	**72**	**89**	**89**	**80**	**80**	**80**	**80**	**80**	**80**
Financial and Capital account	**-2,337**	**897**	**-22**	**603**	**1,166**	**427**	**301**	**300**	**319**
Foreign direct investment	**77**	**260**	**300**	**480**	**1,065**	**381**	**347**	**365**	**383**
Portfolio investment	**415**	**-541**	**-187**	**273**	**176**	**479**	**342**	**343**	**309**
Government securities	171	-5	217	124	16	330	325	343	309
Issues	710	613	410	381	372	527	558	558	594
Amortization	539	618	193	256	356	198	232	215	285
Banks	244	-537	-404	148	160	149	17	0	0
Other capital flows (net)	**-2,828**	**1,179**	**-135**	**-150**	**-74**	**-433**	**-389**	**-407**	**-373**
Loans	1,290	375	72	-202	-117	-477	-423	-447	-413
Of which: WB, IDB, commercial (net)	633	237	-150	-72	21	-13	-11	31	4
Disbursements	792	472	220	497	645	590	414	493	471
Amortization	159	235	370	568	623	603	425	462	467
Of which: IMF (net)	883	671	152	-130	-139	-464	-412	-478	-417
Disbursements	1,989	840	552	353	522	410	93	0	0
Amortization	1,105	169	400	483	661	874	505	478	417
Deposits, net	-1,693	267	-151	0	0	0	0	0	0
Other flows, net	-2,426	537	-57	52	43	44	34	40	40
Errors and omissions	**-368**	**447**	**552**	**0**	**0**	**0**	**0**	**0**	**0**
Overall balance	**-2,323**	**1,311**	**425**	**144**	**210**	**201**	**163**	**109**	**166**
Reserve assets (- increase)	**2,323**	**-1,311**	**-425**	**-144**	**-210**	**-201**	**-163**	**-109**	**-166**
				2. Reserve Adequacy and External Indicators					
Gross official reserves	**776**	**2,087**	**2,512**	**2,656**	**2,866**	**3,067**	**3,230**	**3,339**	**3,506**
In months of imports of goods and services	3.7	9.3	8.2	7.2	6.6	7.4	7.2	7.0	6.9
In percent of short-term debt excluding nonresidential deposits	25.1	86.8	158.0	115.0	104.5	115.5	153.8	154.9	160.4
In percent of short-term debt including nonresidential deposits	14.3	45.1	61.6	54.2	52.8	56.3	64.8	64.9	66.5
Net international reserves 1/	**-2,391**	**-2,508**	**-2,218**	**-1,938**	**-1,692**	**-1,106**	**-738**	**-160**	**358**
				(As percent of GDP)					
Exports	15.8	20.3	22.8	20.0	19.2	19.9	20.7	20.8	21.2
Imports	15.4	18.7	22.5	22.6	24.6	21.4	21.6	21.8	21.9
Current account	3.1	-0.3	-0.8	-2.8	-5.3	-1.2	-0.7	-0.8	-0.6
Financial account	-19.3	8.0	-0.2	3.7	6.5	2.2	1.5	1.4	1.4
Of which: foreign direct investment (net)	0.6	2.3	2.3	2.9	5.9	2.0	1.7	1.7	1.7
Of which: government securities (net)	1.4	0.0	1.6	0.8	0.1	1.7	1.6	1.6	1.3
Of which: IMF (net)	7.3	6.0	1.1	-0.8	-0.8	-2.4	-2.0	-2.2	-1.8
Overall balance	-19.1	11.7	3.2	0.9	1.2	1.0	0.8	0.5	0.7
Changes in GIR	19.1	-11.7	-3.2	-0.9	-1.2	-1.0	-0.8	-0.5	-0.7
External debt	87.2	98.3	87.4	70.2	63.4	58.1	54.5	50.9	47.4
Short-term debt (residual maturity)	25.4	21.5	12.0	14.1	15.2	13.7	10.3	9.9	9.5
External public debt	68.6	85.3	77.0	61.7	55.7	51.0	47.8	44.5	41.4
External debt + NR deposits	106.4	118.2	106.2	86.0	78.3	72.5	68.6	64.6	60.8
				(As percent of Exports and Non-factor Services)					
Total external debt	392.8	360.9	289.0	263.8	246.0	219.4	198.6	184.0	168.6
Total external debt (incl. nonres. deposits)	479.2	433.9	351.0	323.0	303.9	273.7	249.9	233.7	216.1
Debt service	55.0	52.9	42.8	51.7	56.9	52.1	39.4	37.5	35.5
Of which: interest payments	24.5	19.4	18.9	16.7	16.7	15.2	14.8	14.6	14.1
				(Annual percent changes)					
Exports	-10.3	18.3	33.1	8.3	5.7	11.5	10.0	6.5	8.1
Imports	-35.6	11.6	43.0	24.2	19.3	-6.4	6.9	6.9	6.8
Export prices in US$ (year-on-year percent change) 2/	-7.7	7.8	6.5	-1.2	-1.3	-0.2	0.2	0.2	1.1
Import prices in US$ (year-on-year percent change) 2/	-10.9	4.0	8.9	5.6	-0.3	-0.6	0.1	0.5	0.6
Terms of trade 2/	3.6	3.7	-2.2	-6.4	-1.0	0.4	0.1	-0.3	0.5
Export volume 2/	-2.2	8.5	24.4	10.0	7.5	7.5	7.5	6.0	6.0
Import volume 2/	-26.8	7.3	30.3	12.0	8.0	6.0	6.0	6.0	6.0

Sources: Data provided by the Uruguayan authorities; and Fund staff estimates.

1/ Includes all liabilities to the Fund and liabilities to resident financial institutions.

2/ Excludes Botnia project that will require imports of US$700 million in 05-06 fully covered through FDI and generate export revenue of about US$250 million a year over the medium term.

Table 3. Uruguay: Public Sector Operations

				Program							
				2005							
	2002	2003	2004	Q1	Q2	Q3	Q4	2005	2006	2007	2008
	(In millions of Uruguayan pesos)										
Revenue	**81,138**	**98,180**	**113,856**	**29,987**	**30,659**	**32,536**	**33,123**	**126,304**	**134,519**	**144,789**	**153,088**
Taxes	57,832	70,096	83,002	21,536	23,016	22,588	23,930	91,070	97,557	105,392	111,167
VAT and excise taxes	29,708	37,667	47,200	13,384	12,673	13,222	14,234	53,513	57,400	62,362	66,803
On income and profits	14,302	15,621	17,683	3,899	5,698	4,533	4,733	18,864	22,813	26,728	29,328
On foreign trade	2,730	3,780	4,958	1,228	1,297	1,441	1,490	5,456	5,164	4,950	4,655
On property and other	11,091	13,028	13,161	3,025	3,348	3,390	3,474	13,237	12,180	11,352	10,380
Social security contributions 1/	12,836	11,794	13,146	4,121	3,838	4,203	3,611	15,774	16,796	18,113	19,875
Nontax revenue 2/	5,274	6,200	7,831	1,983	1,979	2,069	2,084	8,115	8,534	9,203	9,738
Current surplus of public enterprises	5,196	10,090	9,876	2,346	1,826	3,676	3,497	11,345	11,632	12,080	12,308
Noninterest expenditure	**81,066**	**89,529**	**99,572**	**28,598**	**26,577**	**28,320**	**28,162**	**111,657**	**117,523**	**124,990**	**132,005**
Current 2/	74,653	81,721	90,269	24,537	25,386	25,084	26,116	101,123	106,611	111,817	117,492
Wages	18,158	19,701	23,409	6,200	6,560	6,079	6,800	25,639	27,232	29,296	31,257
Goods and services	12,057	15,031	16,291	4,684	4,979	4,840	4,902	19,405	20,406	19,707	20,594
of which: Social Emergency Plan	0	0	0	0	529	645	638	1,812	2,550	688	0
Social security benefits	42,818	44,218	47,702	12,790	12,675	13,040	13,409	51,914	54,593	58,149	60,765
Other	1,619	2,771	2,867	862	1,172	1,125	1,006	4,166	4,381	4,666	4,876
Capital (government and enterprises) 2/	6,413	7,808	9,303	4,061	1,191	3,237	2,046	10,535	10,912	13,173	14,513
Primary balance	**72**	**8,651**	**14,284**	**1,389**	**4,082**	**4,215**	**4,960**	**14,647**	**16,996**	**19,799**	**21,083**
Interest	12,163	18,881	22,666	6,114	4,444	6,588	4,573	21,719	22,791	23,712	25,459
Overall balance	**-12,091**	**-10,231**	**-8,382**	**-4,725**	**-362**	**-2,373**	**387**	**-7,072**	**-5,794**	**-3,913**	**-4,376**

Table 3. Uruguay: Public Sector Operations (concluded)

				Program							
				2005 3/							
	2002	2003	2004	Q1	Q2	Q3	Q4	2005	2006	2007	2008
					(In percent of GDP 4/)						
Revenue	**31.1**	**31.1**	**30.0**	**28.7**	**29.3**	**31.1**	**31.7**	**30.2**	**29.4**	**29.3**	**29.1**
Taxes	22.2	22.2	21.9	20.6	22.0	21.6	22.9	21.8	21.3	21.3	21.1
VAT and excise taxes	11.4	11.9	12.4	12.8	12.1	12.6	13.6	12.8	12.5	12.6	12.7
On income and profits	5.5	5.0	4.7	3.7	5.4	4.3	4.5	4.5	5.0	5.4	5.6
On foreign trade	1.0	1.2	1.3	1.2	1.2	1.4	1.4	1.3	1.1	1.0	0.9
On property and other	4.3	4.1	3.5	2.9	3.2	3.2	3.3	3.2	2.7	2.3	2.0
Social security contributions 1/	4.9	3.7	3.5	3.9	3.7	4.0	3.5	3.8	3.7	3.7	3.8
Nontax revenue 2/	2.0	2.0	2.1	1.9	1.9	2.0	2.0	1.9	1.9	1.9	1.8
Current surplus of public enterprises	2.0	3.2	2.6	2.2	1.7	3.5	3.3	2.7	2.5	2.4	2.3
Noninterest expenditure	**31.1**	**28.4**	**26.3**	**27.3**	**25.4**	**27.1**	**26.9**	**26.7**	**25.6**	**25.3**	**25.1**
Current 2/	28.6	25.9	23.8	23.5	24.3	24.0	25.0	24.2	23.3	22.6	22.3
Wages	7.0	6.2	6.2	5.9	6.3	5.8	6.5	6.1	5.9	5.9	5.9
Goods and services	4.6	4.8	4.3	4.5	4.8	4.6	4.7	4.6	4.5	4.0	3.9
of which: Social Emergency Plan	0.0	0.0	0.0	0.0	0.5	0.6	0.6	0.4	0.6	0.1	0.0
Social security benefits	16.4	14.0	12.6	12.2	12.1	12.5	12.8	12.4	11.9	11.7	11.5
Other	0.6	0.9	0.8	0.8	1.1	1.1	1.0	1.0	1.0	0.9	0.9
Capital (Government and enterprises) 2/	**2.5**	2.5	2.5	3.9	1.1	3.1	2.0	2.5	2.4	2.7	2.8
Primary balance	**0.0**	**2.7**	**3.8**	**1.3**	**3.9**	**4.0**	**4.7**	**3.5**	**3.7**	**4.0**	**4.0**
Interest	4.7	6.0	6.0	5.8	4.2	6.3	4.4	5.2	5.0	4.8	4.8
Overall balance	**-4.6**	**-3.2**	**-2.2**	**-4.5**	**-0.3**	**-2.3**	**0.4**	**-1.7**	**-1.3**	**-0.8**	**-0.8**
Memorandum items:											
Augmented balance 3/ 4/	**-56,106**	**-10,231**	**-1,229**	**-4,725**	**-362**	**-2,373**	**387**	**-7,072**	**-5,794**	**-3,913**	**-4,376**
In percent of GDP	-21.5	-3.2	-0.3	...	...	...	...	-1.7	-1.3	-0.8	-0.8
GDP (billions of pesos)	261	315	379	...	...	...	...	418	458	495	527

Sources: Ministry of Finance; and Fund staff estimates.

1/ Excludes contributions that are transferred to the private pension funds.

2/ Includes extra-budgetary operations.

3/ Amounts as percentage of one-fourth of annual GDP.

4/ Includes the following bank-restructuring costs: US$33 million of capital transfers for bank recapitalization, US$564 million of liquidity supplied by BCU, US$444 million for the Fondo de Fortalecimiento del Sistema Bancario (FFSB), and US$993 million for the FSBS. Asset recoveries in 2004 are credited.

Table 4. Uruguay: Summary Accounts of the Banking System 1/
(In millions of U.S. dollars)

	2002	2003	2004	Program 2005	2006	2007	2008
1. Banco Central del Uruguay							
Net foreign assets	-689	-52	-51	228	579	1,260	1,822
Net international reserves 2/	-1,014	-321	-164	115	466	1,148	1,709
Gross international reserves	772	2,087	2,512	2,656	2,866	3,067	3,230
Reserve liabilities 2/	-1,786	-2,407	-2,675	-2,541	-2,400	-1,920	-1,521
Other net foreign assets	325	269	113	113	113	113	113
Net domestic assets	1,120	553	775	577	307	-319	-797
Net credit to the public sector	1,541	2,464	2,626	2,391	2,150	1,570	1,171
Net credit to the financial system	-343	-2,091	-1,781	-1,826	-1,936	-2,037	-2,200
Credit to the private sector	80	71	62	62	62	62	62
Securities issued by the BCU	-34	-243	-563	-482	-401	-346	-262
Other	-124	352	431	431	431	431	431
Monetary liabilities	431	501	724	805	886	941	1,025
Currency issued	368	418	538	618	699	755	838
Currency in circulation	288	332	405	466	527	569	632
Vault cash	80	86	132	152	172	186	206
Private sector deposits	63	83	186	186	186	186	186
Memorandum item:							
Monetary base	440	488	601	726	803	867	921
2. Public and Private Banks 3/							
Net foreign assets	589	1,362	1,866	1,718	1,558	1,409	1,392
Net domestic assets	5,366	5,493	4,855	5,276	6,057	6,709	7,525
Net credit to the public sector	443	255	318	217	217	217	217
Net credit to the financial system	962	2,729	2,129	2,173	2,283	2,384	2,547
Credit to the private sector	6,424	4,704	4,180	4,686	5,407	6,008	6,911
Other	-2,464	-2,195	-1,771	-1,800	-1,850	-1,900	-2,150
Liabilities to the private sector (residents)	5,955	6,855	6,721	6,993	7,615	8,119	8,917
Public banks	3,258	3,618	3,510	3,615	3,908	4,132	4,500
Local currency	339	440	536	589	688	742	822
Foreign currency	2,919	3,178	2,975	3,026	3,219	3,390	3,678
Private banks	2,697	3,237	3,210	3,378	3,708	3,987	4,417
Local currency	371	347	426	470	552	597	665
Foreign currency	2,326	2,890	2,785	2,908	3,156	3,390	3,752
3. Banking System							
Net foreign assets	-100	1,310	1,815	1,945	2,137	2,669	3,214
Net domestic assets	6,406	5,959	5,498	5,700	6,192	6,205	6,521
Credit to the public sector	1,984	2,719	2,944	2,608	2,368	1,787	1,388
Credit to the rest of financial system	539	551	215	215	215	215	215
Credit to the private sector	6,504	4,775	4,242	4,748	5,469	6,070	6,973
Local currency	1,323	1,106	1,185	1,472	1,586	1,821	2,162
Foreign currency	5,181	3,669	3,058	3,276	3,883	4,249	4,811
Other	-2,621	-2,086	-1,903	-1,903	-1,903	-1,903	-1,903
Broad money (M3)	6,306	7,270	7,313	7,646	8,329	8,874	9,735
Currency outside banks	288	332	405	466	527	569	632
Residents' deposits	6,018	6,938	6,907	7,180	7,802	8,305	9,103
Local currency	712	789	964	1,059	1,240	1,339	1,487
Foreign currency	5,306	6,149	5,943	6,120	6,561	6,966	7,616

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

1/ Presentation used for program monitoring. May differ from presentation and definitions used in IFS.

2/ Includes all outstanding liabilities to the IMF, but excludes liabilities to resident financial institutions.

3/ The Banco de la Republica Oriental de Uruguay (BROU), Banco Hipotecario de Uruguay (BHU; mortgage institution), private banks, and cooperatives.

Table 5. Uruguay: Vulnerability Indicators

	2002	2003	2004	Program 2005
	(Percent change, unless otherwise indicated)			
Financial sector indicators				
Broad money	21.3	24.2	-9.5	1.5
Credit to the private sector (const. exch. rate)	-13.7	-25.5	-20.1	8.6
Share of nonperforming loans in total loans (in percent)	31.5	12.7	3.6	…
Capital adequacy ratio (in percent)	-9.6	8.1	10.9	…
Interbank interest rates (percent, end of period)	45.0	2.5	1.3	…
FX deposits held by residents (in percent of total deposits)	88.3	88.8	87.6	…
FX loans to residents (in percent of total loans)	80.4	77.6	73.3	…
Public debt indicators				
Public sector gross debt (PSGD, in percent of GDP)	95.5	104.4	92.5	75.8
Of which: Exposed to rollover risk (in percent of total PSGD)	14.8	6.0	13.5	...
Exposed to exchange rate risk (in percent of total PSGD)	96.0	94.3	91.4	...
Exposed to interest rate risk (in percent of total PSGD)	62.1	47.6	51.3	...
External indicators				
Merchandise exports	-10.3	18.3	33.1	8.3
Merchandise imports	-35.6	11.6	43.0	24.2
Merchandise terms of trade	3.6	3.7	-2.2	-6.4
REER appreciation (+)	-20.3	-13.2	9.3	…
	(Percent of GDP, unless otherwise indicated)			
Current account balance	3.1	-0.3	-0.8	-2.8
Capital and financial account balance	-19.3	8.0	-0.2	3.7
Of which : Net foreign direct investment	0.6	2.3	2.3	2.9
Government securities	1.4	0.0	1.6	0.8
Other net inflows	-21.3	5.7	-4.1	0.0
Total gross external debt (ED) in percent of GDP	87.2	98.3	87.4	70.2
Of which: ST external debt (original maturity, in percent of total ED)	25.4	21.5	12.0	14.1
ED to foreign official sector (in percent of total ED)	43.8	45.7	26.9	27.4
External interest payments to exports GNFS (in percent)	24.5	19.4	18.9	16.7
External amortization payments to exports GNFS (in percent)	30.5	33.5	23.9	35.0
	(U.S. million, unless otherwise indicated)			
Central Bank reserve liabilities 1/	1,786	2,407	2,675	2,541
Short term foreign assets of the banking system	3,140	4,989	5,988	5,989
Short term foreign liabilities of the banking system 1/	4,916	4,597	4,389	4,250
Gross official reserves	776	2,087	2,512	2,656
In months of imports GNFS	3.7	9.3	8.2	7.2
In percent of short-term external debt excl. nonres FX deposits	25.1	86.8	158.0	115.0
In percent of short-term external debt plus bank NR deposits	14.3	45.1	61.6	54.2
In percent of short-term debt plus FX deposits	7.0	20.0	27.7	26.2
In percent of broad money	12.2	28.7	34.3	34.7
In percent of base money	175.4	427.3	418.1	365.6
Banking system foreign assets as percent of short-term external debt plus all FX deposits 2/ 3/	46.6	56.9	68.1	60.9
Financial market indicators				
Foreign currency debt rating (Moody's) 4/	B3	B3	B3	B3
Foreign currency debt rating (S&P) 4/	B-	B-	B	B
EMBI secondary market spread (bps, end of period) 4/	1,228	624	388	462
Exchange rate (per U.S. dollar, period average)	21.6	28.2	28.6	…

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

1/ Includes all use of Fund credit.

2/ By remaining maturity.

3/ Excludes nonreserve assets from the BCU.

4/ On May 11, 2005.

Table 6. Uruguay: Schedule of Purchases Under the Stand-By Arrangement, 2005–08

Availability Date	Amount of Purchase		Conditions
	SDR	**Percent Quota**	
June 8, 2005	30.65	10.0	Program approval
August 31, 2005	30.65	10.0	Completion of first review and observance of structural PCs and end-June quantitative PCs
November 30, 2005	30.65	10.0	Completion of second review and observance of structural PCs and end-September quantitative PCs
March 7, 2006	85.82	28.0	Completion of third review and observance of structural PCs and end-December quantitative PCs
May 31, 2006	85.82	28.0	Completion of fourth review and observance of structural PCs and end-March quantitative PCs
August 31, 2006	85.82	28.0	Completion of fifth review and observance of structural PCs and end-June quantitative PCs
November 30, 2006	85.82	28.0	Completion of sixth review and observance of structural PCs and end-September quantitative PCs
February 28, 2007	67.43	22.0	Completion of seventh review and observance of structural PCs and end-December quantitative PCs
May 31, 2007	67.43	22.0	Completion of eighth review and observance of structural PCs and end-March quantitative PCs
August 31, 2007	67.43	22.0	Completion of ninth review and observance of structural PCs and end-June quantitative PCs
November 30, 2007	67.43	22.0	Completion of tenth review and observance of structural PCs and end-September quantitative PCs
February 28, 2008	30.65	10.0	Completion of eleventh review and observance of structural PCs and end-December quantitative PCs
May 31, 2008	30.65	10.0	Completion of twelfth review and observance of structural PCs and end-March quantitative PCs
Total access	**766.25**		
Percent of quota	**250.0**		

Source: Fund staff estimates.

Table 7. Uruguay: Projected Payments to the Fund and Indicators of Capacity to Repay the Fund

	2003	2004	2005	2006	2007	2008	2009	2010
				(In SDR million)				
Fund disbursements (existing and prospective)								
Principal Disbursements	364.2	372.8	231.8	343.3	269.7	61.3	0.0	0.0
On old programs	364.2	372.8	139.8	0.0	0.0	0.0	0.0	0.0
On new program	0.0	0.0	92.0	343.3	269.7	61.3	0.0	0.0
Fund repurchases and charges (existing and prospective)								
Principal (repurchases) 1/	57.1	270.3	317.3	434.3	574.4	332.3	314.2	274.2
On old programs	57.1	270.3	317.3	434.3	574.4	320.8	203.9	17.5
On new program	0.0	0.0	0.0	0.0	0.0	11.5	110.3	256.7
Charges and interest 2/	45.9	64.0	76.6	80.1	63.8	49.7	34.7	21.5
On old programs	45.9	64.0	75.2	67.7	35.5	16.1	6.4	1.4
On new program	0.0	0.0	1.4	12.4	28.3	33.6	28.3	20.1
Total payments to Fund 1/	103.0	334.4	393.9	514.4	638.2	382.0	348.9	295.7
In millions of U.S. dollars	144.3	495.2	599.6	782.7	971.3	581.1	530.5	449.2
In percent of exports of goods and NFS	5.0	13.3	14.9	18.4	20.6	11.2	9.6	7.5
In percent of GDP	1.3	3.7	3.7	4.3	5.0	2.8	2.4	1.9
In percent of quota	33.6	109.1	128.5	167.8	208.2	124.6	113.8	96.5
In percent of overall external debt service	8.9	28.8	26.6	29.6	36.1	26.0	23.3	19.3
In percent of gross reserves	6.9	19.7	22.6	27.3	31.7	18.0	15.9	12.8
				(End of period)				
Fund credit outstanding								
In millions of SDRs	1,625.9	1,728.4	1,642.8	1,551.8	1,247.1	976.1	661.9	387.7
In millions of U.S. dollars	2,416.0	2,684.2	2,500.4	2,361.1	1,897.9	1,484.9	1,006.9	589.8
In percent of exports of goods and NFS	83.6	72.4	62.3	55.4	40.2	28.7	18.2	9.9
In percent of GDP	21.6	20.2	15.2	13.1	9.8	7.2	4.6	2.6
In percent of quota	530.5	563.9	536.0	506.3	406.9	318.5	216.0	126.5
In percent of public sector external debt	25.3	26.3	24.7	23.5	19.2	15.2	9.3	4.9
In percent of overall external debt	21.9	23.1	21.6	20.6	16.8	13.3	8.2	4.4
In percent of gross reserves	115.8	106.8	94.1	82.4	61.9	46.0	30.2	16.8
				(In millions of U.S. dollars unless otherwise noted)				
Memorandum items:								
Exports of goods and NFS	2,889	3,710	4,016	4,262	4,725	5,180	5,531	5,976
Quota (millions of SDRs)	306.5	306.5	306.5	306.5	306.5	306.5	306.5	306.5
GDP	11,202	13,267	16,410	18,011	19,394	20,487	21,754	23,110
U.S. dollar per SDR, e.o.p.	1.49	1.55	1.52	1.52	1.52	1.52	1.52	1.52
U.S. dollar per SDR, average	1.40	1.48	1.52	1.52	1.52	1.52	1.52	1.52
Public sector debt	11,705	12,272	12,445	12,624	12,706	12,800	12,900	12,981
Public sector external debt	9,557	10,209	10,131	10,034	9,884	9,793	10,845	12,000
Overall external debt service	1,614	1,718	2,256	2,646	2,692	2,231	2,274	2,323
Overall external debt	11,012	11,597	11,554	11,472	11,307	11,201	12,238	13,378
Gross foreign reserves	2,087	2,512	2,656	2,866	3,067	3,230	3,339	3,506

Sources: Finance Department; and Fund staff estimates and projections.

1/ Projections on obligations basis.

2/ Projections are based on current rates of charge (3.48 percent as of end-March 2005), including burden-sharing of 12 basis points, for purchases in the GRA, and applying a surcharge of 100 basis points for credit over 200 percent of quota and 200 basis points for credit over 300 percent of quota. The current SDR interest rate is assumed for net use of SDRs.

Table 1. Uruguay:Public Sector Debt Sustainability and Cash Flow 1/

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
A. Assumptions												
Real GDP growth (percent)	-3.4	-11.0	2.2	12.3	6.0	4.0	3.5	3.0	3.0	3.0	3.0	3.0
Interest rate spread (bps)	284	1400	900	600	450	450	450	450	450	450	450	450
Real U.S. dollar exchange rate (avg.) (change in percent)	-13.7	-11.0	-22.1	-0.2	9.4	4.1	2.5	1.0	1.0	1.0	1.0	1.0
Primary balance: Consolidated public sector	**-1.2**	**0.0**	**2.7**	**3.8**	**3.5**	**3.7**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**
Non-financial public sector	-1.0	0.2	2.9	4.0	3.7	3.9	4.2	4.2	4.2	4.2	4.2	4.2
BCU	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Overall Balance: Consolidated public sector	**-4.1**	**-4.6**	**-3.2**	**-2.2**	**-1.7**	**-1.3**	**-0.8**	**-0.8**	**-0.8**	**-0.7**	**-0.6**	**-0.7**
Non-financial public sector	-3.8	-4.3	-2.9	-1.2	-1.2	-0.8	-0.3	-0.3	-0.4	-0.2	-0.2	-0.2
BCU	-0.3	-0.3	-0.4	-1.0	-0.5	-0.5	-0.5	-0.5	-0.5	-0.4	-0.4	-0.4
B. Debt Dynamics (in percent of GDP)												
Gross nonfinancial public sector debt 2/	**46**	**96**	**104**	**92**	**76**	**70**	**65**	**62**	**59**	**56**	**53**	**50**
Of which:												
Contribution from REER (cum since 2004)	...	...	...	0	7	10	11	11	11	11	11	11
Contribution from Growth (cum since 2004)	...	...	...	0	11	15	19	23	27	30	34	37
C. Cash Flow (in millions of U.S. dollars)												
Gross borrowing needs	**1,210**	**3,209**	**1,251**	**2,504**	**2,044**	**2,356**	**2,400**	**1,935**	**1,912**	**1,949**	**2,540**	**1,821**
Augmented public sector deficit	707	2,524	324	161	194	137	53	71	77	56	39	61
Public sector deficit	707	526	324	161	194	137	53	71	77	56	39	61
Bank assistance	0	1,998	0	0	0	0	0	0	0	0	0	0
Buildup in free reserves at the central bank	-7	-364	6	631	100	100	100	100	100	100	100	100
Amortization	510	1,049	921	1,711	1,749	2,120	2,248	1,764	1,735	1,793	2,401	1,659
Long-term bonds and inflation-indexed bonds	403	349	221	29	241	583	136	184	145	259	858	341
Letras (2 years)	...	...	...	...	378	102	445	500	500	500	500	500
Peso bonds (short-term)	0	209	209	637	79	150	189	150	150	150	150	150
Commercial bank loans	0	214	217	307	201	125	132	149	176	153	163	161
IDB/WB and other official debt	97	205	234	339	367	499	471	276	285	314	332	332
IMF	10	72	40	400	483	661	874	505	478	417	397	175
Gross Financing 3/	**1,209**	**3,209**	**1,251**	**2,500**	**2,044**	**2,356**	**2,400**	**1,935**	**1,912**	**1,949**	**2,540**	**1,821**
Long-term bonds (>10 years maturity)	1,292	143	405	371	429	406	649	708	699	758	1,322	603
Inflation-indexed instruments	...	...	...	...	170	94	100	70	70	70	70	70
Letras (2 years)	...	...	...	...	445	500	500	500	500	500	500	500
Peso bonds (short-term)	-15	677	637	544	150	189	150	150	150	150	150	150
Commercial bank	33	-16	-475	365	101	125	132	149	176	153	163	161
Use of deposits	26	-21	-543	200	0	0	0	0	0	0	0	0
Loans	7	5	68	165	101	125	132	149	176	153	163	161
IDB/WB and other official debt	198	789	461	366	396	520	458	265	316	318	335	336
IMF	0	1,603	484	552	353	522	410	93	0	0	0	0
Other inflows (net)	-299	13	-261	303	0	0	0	0	0	0	0	0
Residual financing needs	**0**	**0**	**0**	**4**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
D. Other Indicators												
Total debt service (in percent of GDP)	5.6	13.1	14.0	18.1	15.5	16.4	16.1	13.2	12.5	12.2	14.1	10.8
Average interest rate (in percent)	6.3	5.5	5.7	6.6	6.9	7.1	7.3	7.8	8.2	8.4	8.7	9.3
Memorandum items:												
GDP (millions of dollars)	18,561	12,089	11,211	13,267	16,410	18,011	19,394	20,487	21,754	23,110	24,554	26,089
Nominal debt (millions of dollars)	8,538	11,551	11,705	12,272	12,445	12,619	12,701	12,794	12,893	12,972	13,033	13,117
Commerical bond placements (net) (millions of dollars)	889	-207	184	342	425	315	668	594	624	570	533	332
World Bank/IDB (net)	...	...	...	...	49	30	-4	-3	37	10	9	9
Rollover of Fund obligations (in percent)	...	...	...	...	73	79	47	18	0	0	0	0
Fund credit outstanding (millions of dollars)	145	1,754	2,416	2,684	2,500	2,361	1,898	1,485	1,007	590	192	17
Fund credit outstanding (in percent of GDP)	0.8	14.5	21.6	20.2	15.2	13.1	9.8	7.2	4.6	2.6	0.8	0.1
Fund credit outstanding (as a share of quota)	0.5	5.5	530.5	563.9	536.0	506.3	406.9	318.5	216.0	126.5	41.3	3.8

Sources: Ministry of Finance, Banco Central del Uruguay, and Fund staff estimates.

1/ Includes the non-financial public sector and the central bank.
2/ Net of free reserves and monetary policy instruments.
3/ Includes short-term debt on a gross basis; previous DSA presentations were on a net basis.

Table 2. Uruguay: Public Sector Debt Sustainability
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						**Debt-stabilizing primary balance 11/**
1 **Public sector debt 1/**	38.5	45.6	95.5	104.5	92.5			**75.8**	**70.1**	**65.5**	**62.4**	**59.3**	**56.1**	**1.1**
o/w foreign-currency denominated	35.7	42.8	76.6	94.8	90.0			73.6	67.3	62.2	59.3	56.3	53.3	
2 Change in public sector debt	0.5	7.1	49.9	8.9	-12.0			-16.7	-5.8	-4.6	-3.0	-3.2	-3.1	
3 Identified debt-creating flows (4+7+12)	5.9	9.9	57.9	-7.9	-14.4			-6.7	-5.3	-4.4	-3.2	-3.0	-3.0	
4 Primary deficit	1.5	1.1	-0.1	-2.7	-3.8			-3.5	-3.7	-4.0	-4.0	-4.0	-4.0	
5 Revenue and grants	28.8	32.9	31.1	31.1	30.1			30.2	29.3	29.3	29.1	29.1	29.1	
6 Primary (noninterest) expenditure	30.4	34.1	31.1	28.4	26.3			26.7	25.6	25.3	25.1	25.1	25.1	
7 Automatic debt dynamics 2/	4.4	8.8	41.1	-5.2	-10.6			-3.2	-1.6	-0.4	0.8	1.0	1.0	
8 Contribution from interest rate/growth differential 3/	1.7	2.0	2.6	-10.3	-11.9			-3.2	-1.6	-0.4	0.8	1.0	1.0	
9 Of which contribution from real interest rate	1.1	0.7	-2.2	-8.6	-1.3			1.8	1.1	1.8	2.6	2.7	2.7	
10 Of which contribution from real GDP growth	0.5	1.3	4.8	-1.7	-10.6			-5.0	-2.8	-2.3	-1.8	-1.8	-1.7	
11 Contribution from exchange rate depreciation 4/	2.7	6.8	38.5	5.1	1.3			...	...	...	...	...	...	
12 Other identified debt-creating flows	0.0	0.0	16.9	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	16.9	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	-5.4	-2.8	-8.0	16.8	2.4			-10.0	-0.4	-0.1	0.2	-0.2	-0.2	
Public sector debt-to-revenue ratio 1/	133.4	138.5	306.9	336.2	307.6			251.2	239.1	223.5	214.6	203.7	192.9	
Gross financing need 6/	8.2	7.2	12.0	14.1	13.8			12.5	13.0	12.4	9.4	8.8	8.4	
in billions of U.S. dollars	1.6	1.4	1.4	1.6	1.8			2.0	2.3	2.4	1.9	1.9	2.0	
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	-1.4	-3.4	-11.0	2.2	12.3	0.9	6.4	6.0	4.0	3.5	3.0	3.0	3.0	3.8
Average nominal interest rate on public debt (in percent) 7/	7.0	7.8	10.7	7.5	6.8	8.0	1.2	6.5	7.1	7.3	7.8	8.2	8.4	7.6
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.0	1.6	-7.0	-10.5	-0.6	-7.3	11.0	2.4	1.8	3.0	4.4	4.8	5.0	3.6
Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.2	-15.3	-45.7	-6.8	-1.5	-14.3	12.6	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	4.0	6.1	17.7	17.9	7.4	15.4	11.8	4.1	5.3	4.3	3.4	3.4	3.4	4.0
Growth of real primary spending (deflated by GDP deflator, in percent)	-3.6	8.5	-18.9	-6.2	3.6	0.6	9.4	7.6	-0.3	2.3	2.2	3.0	3.0	3.0
Primary deficit	1.5	1.1	-0.1	-2.7	-3.8	-0.5	1.8	-3.5	-3.7	-4.0	-4.0	-4.0	-4.0	-3.9
								II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 10/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 8/								**75.8**	**69.0**	**62.9**	**57.5**	**52.3**	**47.4**	**-3.7**
A2. No policy change (constant primary balance) in 2005-09								**75.8**	**70.1**	**66.0**	**63.5**	**60.9**	**58.3**	**1.2**
B. Bound Tests														
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**75.8**	**79.0**	**83.0**	**80.3**	**77.4**	**74.7**	**1.5**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**75.8**	**87.9**	**108.2**	**115.6**	**122.9**	**130.6**	**2.6**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**75.8**	**76.8**	**79.3**	**76.5**	**73.6**	**70.8**	**1.4**
B4. Combination of B1-B3 using one standard deviation shocks								**75.8**	**83.9**	**93.0**	**90.4**	**87.7**	**85.1**	**1.7**
B5. One time 30 percent real depreciation in 2005 9/								**75.8**	**109.5**	**104.8**	**102.5**	**100.1**	**97.8**	**2.0**
B6. 10 percent of GDP increase in other debt-creating flows in 2005								**75.8**	**80.1**	**75.5**	**72.6**	**69.6**	**66.7**	**1.3**

1/ Framework covers the public sector (net of free reserves and monetary policy instruments).
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - p (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
10/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 3: Uruguay: External Debt Sustainability
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						**Debt-stabilizing non-interest current account 6/**
External debt	44.3	47.8	87.2	98.3	87.4			**70.2**	**63.4**	**58.1**	**54.5**	**50.9**	**47.4**	**-2.3**
Change in external debt	4.8	3.5	39.4	11.1	-10.9			-17.2	-6.8	-5.3	-3.6	-3.7	-3.4	
Identified external debt-creating flows (4+8+9)	3.1	4.8	22.3	4.8	-16.6			-4.4	-3.2	-2.9	-2.7	-2.4	-3.6	
Current account deficit, excluding interest payments	1.3	0.2	-7.7	-2.8	-3.5			-1.2	1.6	-2.3	-2.8	-2.7	-2.8	
Deficit in balance of goods and services	-39.1	-37.4	-42.7	-51.4	-57.9			-53.7	-54.8	-52.3	-53.6	-54.0	-54.7	
Exports	18.2	17.5	22.2	27.2	30.2			26.6	25.8	26.5	27.5	27.7	28.1	
Imports	-20.9	-19.9	-20.5	-24.2	-27.7			-27.1	-29.0	-25.8	-26.2	-26.4	-26.6	
Net non-debt creating capital inflows (negative)	-1.4	-1.7	-0.1	-2.3	-2.3			-2.9	-5.9	-2.0	-1.7	-1.7	-2.7	
Automatic debt dynamics 1/	3.1	6.3	30.1	9.9	-10.8			-0.3	1.2	1.4	1.8	1.9	2.0	
Contribution from nominal interest rate	1.5	2.7	4.6	3.1	4.3			4.0	3.7	3.5	3.5	3.5	3.4	
Contribution from real GDP growth	0.6	1.6	8.1	-2.0	-10.2			-4.2	-2.6	-2.1	-1.7	-1.5	-1.4	
Contribution from price and exchange rate changes 2/	1.0	2.0	17.5	8.9	-4.9			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	1.7	-1.3	17.1	6.3	5.7			-12.8	-3.6	-2.4	-0.9	-1.3	0.1	
External debt-to-exports ratio (in percent)	243.1	272.8	392.8	360.9	289.0			263.8	246.0	219.4	198.6	184.0	168.6	
Gross external financing need (in billions of US dollars) 4/	3.2	3.5	3.8	2.9	1.8			2.6	3.3	2.6	2.0	2.0	2.0	
in percent of GDP	15.8	18.9	31.2	26.2	13.6			16.1	18.3	13.5	9.7	9.2	8.8	
Key Macroeconomic Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	-1.4	-3.4	-11.0	2.2	12.3	0.9	6.4	6.0	4.0	3.5	3.0	3.0	3.0	3.8
GDP deflator in US dollars (change in percent)	-2.6	-4.4	-26.8	-9.2	5.2	-2.9	10.2	16.7	5.5	4.0	2.6	3.1	3.1	5.8
Nominal external interest rate (in percent)	3.6	5.6	6.2	3.2	5.1	5.3	1.0	5.6	5.9	5.9	6.3	6.8	7.2	6.3
Growth of exports (US dollar terms, in percent)	5.2	-10.5	-17.8	13.3	31.5	3.1	15.0	8.9	6.3	10.7	9.5	6.9	8.1	8.4
Growth of imports (US dollar terms, in percent)	4.9	-11.2	-33.1	8.6	35.8	2.1	18.0	21.2	17.4	-4.2	7.1	7.1	7.0	9.2
Current account balance, excluding interest payments	-1.3	-0.2	7.7	2.8	3.5	1.5	2.6	1.2	-1.6	2.3	2.8	2.7	2.8	1.7
Net non-debt creating capital inflows	1.4	1.7	0.1	2.3	2.3	1.2	0.7	2.9	5.9	2.0	1.7	1.7	2.7	2.8
								II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 5/								**70.2**	**72.9**	**75.7**	**79.5**	**83.3**	**89.5**	**5.5**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**70.2**	**64.4**	**59.9**	**56.4**	**52.7**	**49.3**	**-2.3**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**70.2**	**74.5**	**81.1**	**77.2**	**73.2**	**69.5**	**-3.2**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**70.2**	**86.6**	**109.7**	**105.4**	**100.9**	**97.0**	**-4.2**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**70.2**	**65.6**	**66.4**	**62.9**	**59.3**	**55.9**	**-2.2**
B5. Combination of B1-B4 using one standard deviation shocks								**70.2**	**84.2**	**106.8**	**100.5**	**94.1**	**88.2**	**-4.0**
B6. One time 30 percent nominal depreciation in 2005								**70.2**	**90.1**	**83.5**	**79.6**	**75.6**	**71.9**	**-3.3**

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

EXCEPTIONAL ACCESS FOR REQUEST OF STAND-BY ARRANGEMENT[23]

A. Introduction

1. **As set out in the framework for exceptional access cases, this appendix evaluates the case for exceptional access under the proposed SBA, based on the four substantive exceptional access criteria in capital account crises**. In cases where one or several of the four criteria are not met, exceptional access can be granted based on the exceptional circumstances clause and the considerations that apply to members that had exceptional access and need further access as part of their exit strategy.

B. Exceptional Access Criteria in Capital Account Crises

2. **Criterion 1—The member is experiencing balance of payments pressures on the capital account resulting in a need for Fund financing that cannot be met within normal limits**. Uruguay is not in such a circumstance, but it has substantial balance of payments needs over the next three years. Gross external financing needs will average US$2.2 billion over 2005-08, which cannot realistically be covered fully through market access, even under the current benign market conditions. The large need reflects mainly large public sector bond amortizations (from the shorter-term debt issued just after the 2002 financial crisis) and repayments to international financial institutions, and also includes the need to strengthen further the international reserve position of the central bank.

3. **Criterion 2—A rigorous and systematic analysis indicates that there is a high probability that debt will remain sustainable**. Staff's DSA (Box 2 and Appendix I) shows that Uruguay's public debt ratio is on a firm downward path under the proposed program's fiscal targets. Under a baseline scenario, the public debt-to-GDP ratio would decline from 92 percent at end-2004 to 62 percent by end-2008 and to 50 percent by 2012. In addition to the need for fiscal discipline, the debt path is sensitive to confidence shocks that would raise sovereign spreads or reduce the demand for pesos, as well as shocks that deteriorate growth prospects or raise interest rates.

4. **Criterion 3—The member has good prospects of regaining access to private capital markets within the time Fund resources would be outstanding, so that the Fund's financing would provide a bridge**. Uruguay has already regained market access, but this access is still below what it enjoyed prior to the financial crisis when the country was investment grade. Already this year, Uruguay has tapped the international market for US$300 million, and the authorities plan to go back to the market later in the year for another

[23] In light of the authorities' request for a new three-year stand-by arrangement in the amount of SDR 766 million (250 percent of quota), and given the level of Uruguay's outstanding use of Fund resources, the proposed program qualifies as exceptional access. The authorities are seeking to exit from further Fund financial support after the proposed arrangement expires.

placement of similar size. Discussions with market participants suggest that with continued good policies, Uruguay should be able to continue tapping international markets in the US$500-600 million range annually over the next few years, consistent with its financial program.

5. **Criterion 4—The policy program of the member country provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment**. Uruguay's macroeconomic performance under the previous program was excellent, although progress in several structural areas fell short of program goals. The new government is committed to maintaining the prudent macropolicy course, and to implementing a comprehensive structural reform effort to spur growth and strengthen the resiliency of the public finances. The government's majority in congress (a first in Uruguay since the return to democracy in 1984) and the authorities' success in building domestic consensus for their program bode well for successful implementation of their policies.

C. Overall Assessment

6. **Staff supports the authorities' request for a new three-year arrangement; and since not all four criteria governing exceptional access are met, it is proposed to approve such access by invoking the exceptional circumstances clause**. The authorities have formulated a strong policy framework that addresses the key structural weaknesses and vulnerabilities in the Uruguayan economy. In providing financial support at this critical juncture, when financing needs are large and policy implementation is ambitious, the Fund can assist Uruguay in the needed buildup of reserves and lay the basis for a lasting exit from future Fund financial assistance. The proposed access is at the low-end of other exceptional access cases.

Uruguay: Proposed Access, 2005

			High-Access Cases 1/				Normal Access Cases		
	Original Arrangement (as of 4/1/2002) 2/	Proposed Arrangement	Proposed Arrangement (Percentile)	20th Percentile (Ratio)	80th Percentile (Ratio)	Average	Proposed Arrangement (Percentile)	20th Percentile (Ratio)	80th Percentile (Ratio)
Access									
In millions of SDRs	2,128	766	0	3,490	15,103	9,845	90	34	406
Average annual access	347	83	8	137	380	263	94	21	51
Total access in percent of: 3/									
Actual quota	694	250	12	309	820	639	99	30	75
Calculated 11th review quota	703	253	60	106	381	251	100	13	42
Gross domestic product	26	8.8	82	2.8	7.7	6.4	100	0.7	2.8
Gross international reserves	393	44	42	27	103	78	80	5	45
Exports of goods and nonfactor services	97	36	72	10.8	46.3	29.8	100	1.9	7.4
Imports of goods and nonfactor services	108	31	67	12.9	61.2	35.8	100	1.7	6.5
Total debt stock									
Of which: Public	29	10	39	7	17	16	...	...	...
External	28	11	58	5	15	11	92	2	6
Short-term	36	57	84	19	51	45	...	...	...
M2	95	15	71	5	23	18	85	1	12
Total financing package	100	100	28	62	100	84	…	…	…

Source: Executive Board documents, MONA database, and Fund staff estimates.

1/ High access cases include all available data at approval and on augmentation for the 25 requests to the Board since 1994 which involved the use of the exceptional circumstances clause or SRF resources. Exceptional access augmentations are counted as separate observations. For the purpose of measuring access as a ratio of different metrics, access includes augmentations and previously approved and drawn amounts.

2/ Amounts include augmentations.

3/ The data used to calculate ratios is the actual value for the year prior to approval for public and short-term debt, and the projection at the time of program approval for the year in which the program was approved for all other variables.

FUND RELATIONS
(As of April 30, 2005)

I. **Membership Status**: Joined March 11, 1946; Article VIII

I. FINANCIAL RELATIONS

II. **General Resources Account**:	In millions of SDRs	In percent of Quota
Quota	306.50	100.0
Fund holdings of currency	1,942.11	633.64
Reserve position	0.0	0.0

III. **SDR Department**:	In millions of SDRs	Percent of Allocation
Net cumulative allocation	49.98	100.0
Holdings	19.38	38.77

IV. **Outstanding Purchases and Loans**:	In millions of SDRs	In percent of quota
Stand-By Arrangements	1,635.60	533.64

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Millions)	Amount Drawn (SDR Millions)
Stand-By	4/01/02	3/31/05	1,988.50	1,988.50
Of which: SRF	6/25/02	8/08/02	128.70	128.70
Stand-By	5/31/00	3/31/02	150.00	150.00
Stand-By	3/29/99	3/28/00	70.00	0.00

VI. **Projected Obligations to Fund:**[1] (SDR millions; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	84.75	434.43	574.40	268.35	133.98
Charges/interest	57.92	70.71	37.12	16.68	6.34
Total	142.67	505.04	611.52	337.46	210.21

II. Nonfinancial Relations

VII. **Safeguards Assessment:** A new full safeguard assessment is underway. The last on-site assessment of the BCU was conducted in July 2002, and approved by Fund Management in January 2003. The assessment identified a need to strengthen the control and oversight framework within the BCU, in particular in the external audit area. To this end, staff recommended the establishment of an audit committee, the hiring of a private audit firm with international affiliation to perform a financial audit of the BCU, and the establishment of similar external audit procedures for the FSBS. An external audit of the BCU's 2003 accounts and two of four supplementary external audits of each bank's FSBS have been completed, with the remaining two audits near completion. The BCU has created an independent audit committee to oversee the bank's financial reporting practices. Limited action has been taken to implement International Financial Reporting Standards in published financial statements. The recommendation to publish by end-April the audited financial statements of the central bank of the previous year cannot be guaranteed as this depends on the approval of the national audit office.

VIII. **Exchange Rate Arrangement**: The currency is the Uruguayan peso (Ur$). Uruguay has followed an independently floating exchange rate regime since July 29, 2002. On May 20, 2005, buying and selling interbank rates for the U.S. dollar, the intervention currency, were Ur$24.55 and Ur$24.60, respectively. Uruguay's exchange system is free of restrictions on payments and transfers for current international transactions.

[1] Except for 2005, this schedule is not the currently applicable schedule of payments to the IMF. Rather, the schedule presents all payments to the IMF under the illustrative assumption that repayment expectations would be extended to their respective obligation dates by the IMF Executive Board upon request of the debtor country.

IX. **Article IV Consultation:** The 2003 Article IV consultation was concluded by the Executive Board on July 11 (IMF Country Report 03/247). Uruguay is on the standard consultation cycle governed by the provisions approved by the Executive Board on July 15, 2002.

X. **Ex Post Assessment:** The Ex Post Assessment of Longer-Term Program Engagement was considered by the Executive Board on March 18, 2005 (IMF Country Report 05/202).

XI. **FSAP participation and ROSCs:** The ROSC-module on fiscal transparency was published on March 5, 2001. A ROSC-module on data dissemination practices was published on October 18, 2001. An FSAP exercise was started in November 2001, but was subsequently suspended on account of the financial crisis in 2002.

XII. **Technical Assistance**: Technical assistance in tax policy and tax administration was provided by FAD in May and July 2003, and on budget preparation in March 2005. In April 2003, STA provided technical assistance on adequate recording of loans funded by the FSBS. MFD has been providing substantial technical assistance since 2002 in the resolution of intervened banks and the restructuring of the public bank BROU.

XIII. **Resident Representative**: Mr. Andreas Bauer.

Relations with the World Bank Group

(As of May 3, 2005)

The Board considered the last Country Assistance Strategy (CAS) on May 5, 2000 and a CAS Progress Report on July 25, 2002. Following the 2002 crisis, the Bank increased its financial support, shifting to a high case lending scenario of US$550 million for fiscal years 2002–04, concentrated in adjustment lending. A Structural Adjustment Loan (SAL I) and a Special Structural Adjustment Loan (SSAL I) were approved with the CAS Progress Report, totaling US$303 million, to assist Uruguay in addressing structural weaknesses and in managing the economic crisis. On April 8, 2003, another structural adjustment package (SAL II and SSAL II) was approved totaling US$252.5 million, focusing on improving public services and human development policies. Progress in implementation of SAL I and SSAL I has been satisfactory, and the last tranches in an aggregate amount of US$100 million (US$50 of SAL I and US$50 of SSAL I) were released in October 2004.

A new CAS has been prepared with the new administration which took office in March 2005, and will be presented for consideration to the Board of Executive Directors on June 9, 2005. The proposed CAS envisages a base case scenario of up to US$800 million in new lending over the period FY05–10. The lending program will be modulated on the strength of the Government's program and its ability to implement it, as well as the evolution in the country's creditworthiness.

The Bank's strategy proposed in the new CAS will be anchored around a series of programmatic development loans that are expected to be multi-sectoral in focus and support the Government in key policy areas including public sector management, financial sector reform, and reform of social programs. The CAS also proposes to rebuild the investment portfolio with new operations planned to support priority investments in infrastructure, social programs and innovation. Two investment operations for Integrated Natural Resources and Transport Infrastructure and Rural Access, in the amount of US$30 million and US$70 million respectively, will be presented to the Board together with the CAS.

In the context of the new CAS, the Government has reaffirmed its commitment to the objectives of SAL II taking into account the results of the 2003 referenda on petroleum products and water. With regard to SSAL II, the objectives of the program have been achieved. However, with the immediate crisis over and the beginning of a new CAS period, the Government has requested the cancellation of the outstanding second and third tranches of this operation. The social reform agenda would continue to be supported by a new development policy loan (DPL1) under the CAS. The proposed DPL1 in an amount of US$75 million would support reform progress in social policies over the last two years, as well as early but important measures that the new Government has taken with respect to health, education and social protection. The DPL1 will be presented to the Board of Executive Directors together with the CAS.

The current investment portfolio comprises six projects totaling US$289.5 million in commitments, with an undisbursed amount of US$102.7 million as of May 3, 2005. The performance of the investment portfolio has improved significantly in CY04, with disbursements for investment operations aggregating to US$43.8 million. This is a reflection of the substantially improved economic situation, as well closer portfolio monitoring, with portfolio performance reviews being conducted every six months.

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 May 3, 2005)			
Agriculture	18.5	16.0	2.5
Central Government and Administration	252.5	77.5	175.0
Telecommunication	6.0	1.5	4.5
Education	42.0	11.6	30.4
Power	125.0	88.3	36.7
Transportation	71.0	57.9	13.1
Water Supply	27.0	11.5	15.5
Total	**542.0**	**264.3**	**277.7**

II. IFC Operations (as of April 30, 2005)

	Loans	**Equity**	**Quasi**	**Participation**
Held	20.27	0.21	10.71	0.0
Disbursed	20.27	0.19	10.71	0.0

III. IBRD Loan Transactions (calendar year)

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**[1]
Disbursements	38.7	50.4	143.9	66.3	134.2	64.7	233.5	97.4	143.8	11.7
Repayments	69.7	67.9	64.1	63.2	57.9	72.5	75.3	78.2	80.2	23.4
Net Lending	**-31.0**	**-17.5**	**79.8**	**3.1**	**76.3**	**-7.8**	**158.2**	**19.2**	**63.6**	**-11.6**

[1] As of April 30, 2005

Relations with the Inter-American Development Bank

(As of May 4, 2005)

The IDB is currently preparing a new Country Strategy for Uruguay for 2005–2009. The strategy supports the newly elected Government's policy, which seeks to consolidate growth and improve the population's social welfare. The new Strategy will focus on the following priority areas: (i) improvements in public sector management, to increase its efficiency and efficacy, while supporting fiscal and debt sustainability; (ii) enhancing regional and international competitiveness of domestic output and encouraging private investment in order to promote sustainable growth; and (iii) reducing poverty and increasing equity.

As of May 4, 2005 the Bank's active portfolio in Uruguay included 16 loans for the financing of investment projects; one sector loan, for strengthening the banking sector; and 29 nonreimbursable technical cooperation operations for US$16.7 million. The lending portfolio amounts to US$936.7 million, of which US$504.5 million are pending disbursement. Portfolio performance was affected by the Government's fiscal constraint, which entailed cuts in budgetary allocations to levels below the required amounts in order to maintain a normal pace of project implementation. A main challenge ahead will be to increase the pace of project execution while setting the stage for a normal implementation of the new projects.

The Bank's preliminary lending program for 2005–2007 amounts to an estimated US$900 million; the lending program for the two later years, 2008-2009, will be defined as the Government moves ahead with its development program. For 2005, the program includes financing for a project to support livestock competitiveness, for US$15.6 million, and a social sector program (policy-based loan) forUS$250 million. The lending program for 2006-2007 includes financing for several investment projects and sectoral reform programs, in line with the Bank's priority areas: (i) to support improvements in public management, a modernization program for tax administration and another program to improve public sector management, with the estimated financing for both projects to be determined; (ii) to increase competitiveness, the modernization of the Montevideo Port for US$35 million; a sectoral program to improve competitiveness, tentatively for US$120 million; and tourism development; and, (iii) to support social welfare improvement, the fourth stage of the sanitation plan in Montevideo for US$80 million; a sanitation and environmental program in Ciudad de la Costa for US$64 million; and a waste management project in Montevideo, for an amount to be determined.

FINANCIAL RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(In millions of U.S. dollars)

Total outstanding loans: US$2,202.8[1]

Loan transactions:

	1998	1999	2000	2001	2002	2003	2004[2]
Disbursements	150.8	358.5	162.9	214.2	558.6	373.2	57.6
Amortization	48.3	57.0	59.4	60.7	73.1	103.2	113.0
Net Loan Flows	**102.5**	**301.5**	**103.5**	**153.5**	**485.5**	**270.0**	**-55.4**

Source: Inter-American Development Bank.

[1] IDB, as of March 31, 2005.
[2] IDB, as of December 31, 2004.

STATISTICAL ISSUES

The statistical database in Uruguay is generally adequate for the assessment and monitoring of macroeconomic policies. Uruguay subscribed to the SDDS in February 2004, and meets the SDDS specifications for the data dimension of all data categories. In the fiscal sector, however, Uruguay uses the flexibility option for timeliness of central and general government operations.

Real sector

National account statistics have a number of shortcomings, including the use of an outdated benchmark year (1983), limited coverage of the enterprise survey, long publication lags, inadequate information on the informal economy, and incomplete quarterly accounts. The BCU compiles and disseminates annual GDP estimates in current and constant prices by production and expenditure approach, as well as quarterly constant price GDP estimates by production and expenditure approach. Gross national income, gross disposable income and gross savings are also available annually. The November 1999 multisector mission recommended a range of improvements including the completion of the revision of data and methods that had already been partially carried out, introduction of annually chained volume measures, incorporation of new benchmark survey data, and compilation of quarterly estimates of GDP at current prices.

The authorities do not provide trade price and volume indices for publication in the *International Financial Statistics (IFS)*.

Both the consumer and wholesale price indices are reported on a regular and timely basis for publication in the *IFS*. The consumer price index has a base period of March 1997 = 100, and the wholesale price index's base has been updated to 2001. Coverage of the CPI is limited to the capital city.

Government finances

Official data on the central administration, the state enterprises and the social security system are complete and current, but there are problems with the timeliness of the data on local governments; there are also problems with the timeliness of financing and debt data reported for inclusion in the Fund's statistical publications. However, the reporting lag on central government operations has been reduced by one month and the authorities have started the publication of information on the stock of floating debt. The multisector mission that visited Uruguay in November 1999 reviewed the sources used for the compilation of central government financing data and identified sources of information for local governments. The mission made recommendations for the compilation of this data and its reporting to STA. The information reported for publication in the *Government Finance Statistics Yearbook* includes data on the central government; however, complete annual central government debt data have not been reported for periods after 1994 and data on local governments have not been reported for periods after 1997. Following the recommendations of the multisector mission, however, significant improvements have been made in the compilation and dissemination of financing and debt data. Information on a monthly and quarterly basis for financing and debt data

respectively, are disseminated on the Central Bank's website from 1999 onwards for the central government and total public sector.

Monetary accounts

Two STA money and banking statistics missions visited Montevideo in July 1998 and March 1999. The missions reviewed the timeliness, coverage, and classification of the monetary accounts for the banking system and developed a unified system for reporting data to the Fund. The 1999 multisector mission continued work on improving the basic source data and the methodology for compiling monetary statistics, and recommended a new reporting system, which has since been adopted by the Central Bank. The mission developed a database that contains the data needs for publication in *IFS* and for operational use by WHD.

The STA mission that visited Montevideo in April 2003 provided recommendations for the adequate recording of the loans funded from the Fund for the Stabilization of the Banking System (FSBS) in the Central Bank's balance sheet. The mission's recommendations have been implemented and were reflected in the *IFS* June 2003 issue.

Since the beginning of 2003 no interest rate data are being reported to STA for publication in the *IFS*.

Balance of payments

Balance of payments statements are compiled and published on a quarterly basis. Data are compiled following the recommendations of the fifth edition of the *Balance of Payments Manual (BPM5)*. The authorities have made significant progress in implementing the multisector mission recommendations in order to improve the coverage and quality of balance of payments estimates. The directory of direct investment enterprises has been updated and measures have been introduced to improve the survey on inward investment; quarterly surveys have been introduced in the case of services, and other activities not currently covered; the coverage of reserve assets has been revised to exclude certain assets that are not available to finance balance of payments needs. Uruguay compiles and reports to STA quarterly data on balance of payments and annual data on the international investment position (IIP) for publication in the *IFS* and the *Balance of Payments Statistics Yearbook*. The new surveys would also allow for improved coverage of the private sector in the IIP.

In October 2003, Uruguay disseminated the international reserves and foreign currency liquidity data template on the Central Bank's website for the first time. Monthly information on the data template is currently available for August 2003–March 2005 on the Central Bank's website. The Central Bank also disseminates quarterly external debt statistics on its website, although not in the format prescribed by SDDS.

URUGUAY: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of May 10, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]
Exchange Rates	1/30/05	1/31/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]					
Reserve/Base Money	1/30/05	1/31/05	D	D	M
Broad Money	Nov. 2004	1/21/05	M	M	M
Central Bank Balance Sheet	Dec. 2004	1/21/05	M	M	M
Consolidated Balance Sheet of the Banking System					
Interest Rates[2]	1/30/05	1/31/05	D	D	D
Consumer Price Index	Feb. 2005	Apr. 2005	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]					
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government					
Stocks of Central Government and Central Government-Guaranteed Debt[5]					
External Current Account Balance	Dec. 2004	Apr. 2005	Q	Q	M
Exports and Imports of Goods and Services	Dec. 2004	Apr. 2005	Q	Q	M
GDP/GNP	Q3/04	Dec. 2004	Q	Q	Q
Gross External Debt					

[1]Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).

Montevideo, Uruguay
May 24, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
700 19th Street NW
Washington, D.C. 20431

Dear Mr. de Rato:

The newly elected government is implementing a comprehensive development strategy which seeks to improve the living conditions of Uruguay's population in a lasting and equitable way. Our strategy is based on three fundamental pillars: (i) a comprehensive economic program which aims at raising investment, stimulating employment and achieving growth and macroeconomic stability; (ii) a temporary social emergency plan to alleviate the most pressing social hardship originating from the recent economic crisis; and (iii) a set of essential and long delayed structural reforms that are key to reducing Uruguay's vulnerability to shocks and raising medium-term growth potential.

The attached policy memorandum and annexes describe in detail the economic policies and objectives of the Government of Uruguay for the period June 2005–June 2008, in support of which the Government requests a 36-month stand-by arrangement from the Fund, in an amount equivalent to SDR 766 million (250 percent of quota). The Government believes that the described policies and the continued support of the international financial organizations will promote a sustainable expansion of the economy, while keeping inflation low and reducing the country's high debt burden. Successful implementation of our program should provide a lasting exit from future Fund financial support. Should the balance of payments position turn out to be stronger than anticipated, we would consider reducing our Fund exposure at an accelerated pace, including by either making repurchases on an expectations basis, foregoing purchases, or treating the arrangement as precautionary.

Performance criteria and indicative targets under the program are set out in Tables 1 and 2 of the Memorandum of Economic and Financial Policies and defined in the Technical Memorandum of Understanding. The Government believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of its program, but we will take any further measures that may become appropriate for this purpose. We will consult with the

Fund on the adoption of these measures, in accordance with the Fund's practices on such consultations.

Sincerely yours,

/s/	/s/
Walter Cancela President Central Bank of Uruguay	Danilo Astori Minister of Economy and Finance Oriental Republic of Uruguay

Attachments:
Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

A. General Objectives

1. The Government of Uruguay is committed to maintaining macroeconomic stability and implementing a comprehensive structural reform agenda to promote sustainable high growth and sharply reduce poverty. Key to meeting these objectives is to raise investment from its current low level of 13 percent of GDP to 20 percent over the medium term. We expect that the higher investment will boost potential growth of the economy to at least 3 percent, compared with an historic growth rate of just 2 percent during 1960–2000. The anchors for our policy framework will be a disciplined fiscal stance that will sharply reduce the public debt-to-GDP ratio, monetary policy aimed at low inflation, and wide-ranging structural reforms aimed at ensuring durability in the public finances, strengthening the credibility of the central bank's (BCU's) commitment to low inflation, improving the efficiency of the public enterprise sector (which dominates several key areas of economic activity), and restoring the banking system to its fundamental role of financial intermediation while broadening financing options for investment.

2. Concurrent with our commitment to macroeconomic stability, the Government of Uruguay is dedicated to addressing the problem of poverty in the country. Achieving high sustainable growth will allow for a lasting reduction in poverty, but over the short-term the government is committed to providing important poverty alleviation while growth-oriented structural reforms take hold. Toward this end, we are implementing a two-year, temporary social emergency program (SEP) that targets individuals living in extreme poverty and unable to meet basic living necessities. The numbers of such persons increased sharply as a result of the dislocations of the 2002 financial crisis. The safety net will provide about 200,000 persons with coupons for food purchases and free preventive health care. In addition, about 35,000 of the poorest households will benefit from a direct income transfer scheme of about US$55 a month and another 16,000 adults will participate in a temporary employment program. The SEP will also contain education and housing projects, as well as programs targeted for homeless individuals. Throughout the two-year period we will continue to work with the World Bank and IDB to improve the efficiency of the social safety net to ensure that the SEP delivers its objectives and can then be phased out as planned. The SEP will cost US$200 million over two years (about 0.6 percent of GDP on an annual basis).

B. Macroeconomic Policies

3. Our fiscal program aims at converging to our medium-term primary surplus target of 4 percent of GDP by 2007, which will put the public debt on a firm downward path, and which will be kept under review to ensure that it is fully consistent with debt sustainability. In the near term, we are targeting primary surpluses in 2005 and 2006 of at least 3.5 and 3.7 percent of GDP, respectively, and we will save any revenue exceeding program projections in order to reach the medium-term target at an accelerated pace. Fundamental to meeting our fiscal objectives, in August we will submit to Congress a five-year spending plan that will go beyond legal requirements and include a full-fledged macroeconomic framework with explicit revenue

and deficit targets consistent with our fiscal program. The rising primary surplus target will reflect the benefits from improvements in tax administration, a comprehensive tax reform (described below), timely adjustments to public tariffs to cover operating cost changes, and tight control over general government discretionary expenditure. Our fiscal program will also make room for important public investment projects to reduce risks to growth from structural bottlenecks, especially in the areas of port expansion and electricity transmission and generation.

4. The BCU will maintain the current monetary policy framework of achieving inflation objectives (set 12 months ahead) through base money target ranges and a flexible exchange rate, until conditions are in place for a move to a full-fledged inflation-targeting regime. Our inflation target range for 2005 of 5½–7½ percent was lowered to 5–7 percent for the year ending March 2006. We are targeting a gradual reduction in the midpoint of our inflation target range to 3.5 percent by 2008. We will continue to allow flexibility in the exchange rate, intervening primarily to maintain orderly market conditions and smooth out excessive exchange rate volatility. The BCU money base targets are indicative targets under the program, and consistent with the program's floor on net international reserves and ceiling on net domestic assets of the central bank. The BCU will aim to build up its level of gross reserves by US$300 million over the three-year program period to raise its capacity to manage the risks from adverse shocks and address financial and external vulnerabilities. The envisaged increase in gross reserves will be consistent with an increase in net international reserves (program definition) of US$1.1 billion through mid-2008, compared with a negative US$2.2 billion at end-2004. Moreover, should market conditions prove more favorable than envisaged, we would seek to bolster further our international reserve position.

C. Structural Reforms

5. Our policy reform agenda focuses on strengthening the public finances; reforming the central bank to increase its autonomy; improving the framework for financial sector oversight; continuing to reform the public banks to reinvigorate financial intermediation and minimize fiscal contingencies; and bolstering growth prospects through public enterprise reform and improvements in the investment climate.

Fiscal reform

6. We will strengthen the public finances through (i) a comprehensive tax reform; (ii) modernization of tax administration; (iii) reform of the specialized pension funds; and (iv) an overhaul of the budgetary framework.

7. Reforming the current tax system is essential for ensuring a strong fiscal position over the medium term and we have given this our highest priority. We will submit to Congress a comprehensive tax reform plan by December 2005 that would widen the tax base to increase the efficiency and strengthen the durability of revenue collections and distribute more equitably the tax burden by raising the weight of direct taxation. The reform, which we intend to implement starting in mid-2006, will introduce a personal income tax, streamline the complex

system of tax exemptions and subsidies, and rationalize other taxes (including the corporate income tax). Over time, once the yield from the tax reform can be properly assessed to ensure consistency with the program fiscal targets, we intend to reduce the heavy burden of indirect taxes and eliminate a number of small distortionary taxes. We anticipate that the reform will begin yielding net revenue increases in the second half of 2006.

8. To further strengthen revenue collections, we also plan to overhaul the tax administration, with a particular emphasis on reducing evasion, improving the efficiency of the tax collection agencies (the domestic tax service, DGI, the social security, BPS, and the customs service, DNA), and preparing for the introduction of a comprehensive personal income tax. We will begin this process by issuing a decree to implement the DGI's modernization law, establishing a Large Taxpayers Unit (LTU) at the DGI, and formulating a plan to coordinate tax audits between the DGI and the BPS, all prior actions for the program. Looking ahead under the program, we will assess the feasibility of establishing an autonomous agency with responsibility for the collection of domestic taxes, social security contributions, and trade taxes; we expect this assessment to be completed by end-2006.

9. Sustaining an appropriate fiscal position over the medium term requires addressing the financial weaknesses of the specialized pension funds for the police, military, and bank employees. Such reforms are needed to align benefits and contributions to contain the need for government transfers. A reform of the police pension plan is the most advanced and will be implemented before the end of 2005. We will proceed with reforms of the other plans immediately thereafter. We are committed to ensuring a sound general public pension system, and are discussing with the World Bank how to improve the system's finances, both through administrative improvements at the BPS and an assessment of the adequacy of the system's current parameters. We expect to have the results of this assessment by mid-2005, and the resulting policy plans will be a topic for the first program review.

10. Modernization of the budgetary process in line with international best practice will help to ensure appropriate resource allocation and expenditure control over the medium term. In the near term, we will implement recommendations of the 2001 fiscal ROSC by complementing our five-year expenditure plan with a full medium-term macroeconomic framework and will carry out an analysis of tax expenditures for inclusion in the documentation of the 2005 spending plan as well. The government has begun to receive technical assistance from the Fund to evaluate the overall institutional budgetary framework and we will incorporate this work in its plans for further fiscal reform.

11. Improving public debt management is critical to minimize the country's vulnerabilities. Toward this end, we have requested technical assistance from the Fund's International Capital Markets Department and Monetary and Financial Systems Departments and are working to establish a comprehensive debt management strategy while delegating the operational decisions to a debt management unit within the Ministry of Finance (which will be in place by end-2005). The debt management strategy will set guidelines for the composition of the public sector debt in terms of interest, exchange rate, and roll over (maturity) risks and be carried out in coordination with the BCU, which will remain the financial agent of the government.

Central bank reform and financial system oversight

12. Given our medium-term objective of moving to a full-fledged inflation-targeting regime, it is imperative that the autonomy and structure of the central bank be improved to enhance its credibility and capability to conduct monetary policy. Toward this end, we will submit this year to congress a proposal to modify the BCU's charter to strengthen its legal independence, including by setting staggered terms for Board members, de-linking the appointment cycle from the electoral cycle, and identifying the bank's principal objective as the control of inflation. We intend to begin implementing this reform no later than mid-2006. In addition, credibility for an independent central bank will require strengthening the BCU's financial position, and we will seek technical assistance from the Fund's Monetary and Finance Department to determine the adequate level of BCU capital and recapitalization modalities; we expect that this assistance can be provided within the next twelve months.

13. Strengthening the financial system will require bringing financial sector supervision up to international standards. To ensure adequate oversight of the financial system, supervisory institutions separate from the BCU will be charged with regulating and supervising banks, insurance companies, securities firms, and pension funds. A law establishing the regulatory framework will be sent to Congress concurrent with the law on BCU autonomy, and we will start implementing it by June 2006. Looking ahead, we have requested a Financial Sector Assessment (FSAP) for this year. Such an assessment was begun in 2002, but it was interrupted by the onset of the financial crisis, and we are committed to make the changes that are needed to meet the benchmarks of international standard setting bodies for financial sector regulation, payment systems, and corporate governance.

Financial system restructuring

14. Based on our experience in the financial crisis of 2002 and the temporary suspension of a cooperative bank earlier this year, it is crucial that an adequate framework for dealing with insolvent financial institutions be put in place. Toward this end, we will submit to congress before the end of this year a law to overhaul the bank resolution framework that will allow for resolution techniques that are less disruptive to the financial system than outright liquidation (the only option presently available) and that can be implemented rapidly to minimize the disruption of banking services to the public. This framework should begin to be implemented in mid-2006. As part of the resolution strategy for the cooperative bank, the government introduced (by decree) a limited deposit insurance program and made clear that the government will not use fiscal resources to bail out financial institutions. Given the importance of a well designed deposit insurance regime and the need for depositor confidence grounded in legal certainty, we intend to further develop the scheme and incorporate it into the bank resolution framework law. The key aspect of limited insurance per depositor will be maintained (at US$5,000 for dollar deposits and 250,000 UIs (units whose peso value is indexed to the CPI)—currently about US$14,500—for deposits in pesos per depositor per bank). The deposit insurance and bank liquidation functions of the central bank will be placed into a newly created deposit insurance agency that will reside outside the central bank.

15. The high degree of dollarization in Uruguay's very open economy has left the country vulnerable to exchange rate and other shocks. We recognize that de-dollarization cannot be forced on economic agents and that it will take time to consolidate confidence in sustained macroeconomic stability. Nevertheless, we are committed to supporting de-dollarization and fostering an increase in financial intermediation in domestic currency through institutional and structural measures. In particular, we will keep higher reserve requirements and deposit insurance premiums on dollar deposits than on peso deposits, and we will encourage banks to develop inflation-indexed savings instruments in local currency, while the Treasury and the BCU continue issuing inflation-indexed notes and bonds. Prudential regulations will ensure that banks take into account the implicit credit risk in lending to clients that do not generate dollar income streams.

16. Strengthening the outlook for the state commercial bank, BROU, which makes up about half of the banking system, is essential for reactivating financial intermediation. We have begun the process of strengthening the bank's governance by appointing a board on the basis of professional experience rather than political considerations. The banks' restructuring will continue through strengthening credit-granting procedures, streamlining operations to reduce costs, improving internal financial reporting, and fortifying internal controls and risk management. The bank will not return to past practices of politically-directed lending, and any credit subsidies will be made explicit in the government's budget.

17. The fiduciary trusts that own and manage the nonperforming loans formerly on the books of BROU will continue to be managed independently of the bank. It will make every effort to maximize the recoveries on the loans so as to minimize the risk to the government (which guaranteed the service of the trusts' debt to BROU). The debt to BROU will be serviced by the trusts or the government in accordance with the agreed payment schedules.

18. The ongoing conversion of the housing bank (BHU) to a mortgage company, a process initiated with the World Bank, is an essential reform for minimizing contingent fiscal risks and improving the BHU's financial health. We intend to accelerate the pace of the BHU's reform program such that the bank will continue to refrain from taking deposits other than pre-saving in local currency for mortgages, while it shifts its revenue base toward the securitization of its mortgage portfolio. In addition, the new president and board of the bank are committed to reducing its operating costs, which remain very high. The debt to BROU will be serviced by the BHU or the government in accordance with the agreed payment schedules.

19. The bank formed with the good assets of the failed banks during the 2002 crisis, *Nuevo Banco Comercial* (NBC), still remains in the government's hands. The bank, which amounts to 10 percent of the system, is highly liquid and well capitalized, but needs to resume normal lending operations. The Government of Uruguay is committed to an active search for a buyer for the bank before the end of the first program year, but in the interim, as a prior action for the program, we will appoint a Board of Directors with appropriate professional experience and an interim CEO with banking experience.

20. The liquidation funds for three of the private banks that failed during the 2002 crisis will continue to collect their nonperforming loans so as to reduce the cost incurred by the government in addressing the crisis. The funds will continue to publish audited semi-annual financial statements to ensure transparency of their operations. By May 2005, all of the information on the nonperforming loans of the failed banks will be included in the credit registry of the bank supervisor.

Growth-oriented reforms

21. To encourage private sector investment, which is the only means for sustaining high growth, we are working with the IDB and World Bank to improve the investment climate, expand room for private sector activities in public utilities and infrastructure, and promote the development of domestic capital markets.

22. To improve the climate for private investment, we plan to streamline conditions for establishing new businesses in Uruguay and ensure that creditor and debtor rights are well protected. In particular, we will establish a one-stop office for investors for information on all requirements regarding documentation, applications, and regulations. We will protect creditor and debtor rights through strict adherence to established property rights and contracts and by strengthening the framework for firm restructuring by amending the current bankruptcy legislation to include a "Chapter 11-type regime" (restructuring); the current framework only has provision for "Chapter 7-type" actions (liquidation).

23. Public enterprise reform would involve improving governance and preparing them for competition with the private sector. To this end, the government is committed to appointing the managements of public enterprises on the basis of professional experience rather than political considerations, expanding management accountability through enhanced transparency and outside control, and seeking associations in joint ventures with private or public capital partners.

24. We will also seek to develop capital markets to allow firms to diversify their sources of financing, which to date has been almost exclusively carried out through retained earnings or bank borrowing.

25. The Government of Uruguay is committed to the market determination of prices and wages as part of its strategy to improve the investment climate. Labor negotiations will be conducted under a framework of wage councils, with participation of representatives of employees, companies, and the state, that will provide a means for collective bargaining at the industry level. Such a framework will allow for an orderly wage determination and reduce the scope for costly labor disruptions.

26. The government is also committed to implement a number of additional reforms to raise medium-term growth potential and improve living conditions of the population at large. Intended policies include, among others, reforming the National Health Service, improving public education, and providing better access to housing for the most vulnerable segments of the population. We believe that these measures will go a long way to

protect and further expand Uruguay's traditionally strong human capital base. In addition, we intend make the promotion of scientific research and the introduction of new technologies a key priority for the government and part of a broader strategy to position the country as a regional and global provider of high quality products and services.

D. Program Monitoring and Financing Assurances

27. The government’s program has adequate financing assurances. Financing needs for 2005 have been identified and financing requirements for the remainder of the program will average about US$2.2 billion a year (about 12 percent of GDP). These will need to be met through sustained fiscal discipline, increasing access to domestic and international financial markets, and continued IFI support. We will implement reforms supported by the IDB and the World Bank lending to ensure timely disbursements from these multilateral lenders.

28. The first program year will have quarterly reviews to assess overall performance and observance of the performance criteria and structural benchmarks (Tables 1 and 2). Quarterly quantitative PCs and targets have been proposed through end-2005, with indicative targets for 2006 and 2007. Quarterly targets for the first half of 2006 will be proposed at the second review of the program and no later than the fourth quarter of this year. The Government of Uruguay will also observe the standard performance criteria against imposing exchange restrictions, multiple currency practices, and import restrictions for balance of payments reasons. The government is working with the Fund on a new safeguards assessment of the BCU, which is envisaged to be completed by end-September 2005.

29. We will provide timely information to the IMF for monitoring performance under the program. The BCU will provide data for assessing observance of the quantitative performance criterion on net international reserves no later than one week after each test date, and data for assessing all other quantitative performance criteria and indicative targets will be provided by the BCU no later than two months after each test date. Data, reports, and other relevant information for assessing progress on structural reforms will be provided to staff in a timely manner.

Table 1. Quantitative Performance Criteria and Indicative Targets Under the 2005–08 Economic Program 1/

	2004 Stock	2005 PC			2006 IT			2007 IT
	Dec. 31	June 30	Sept. 30	Dec. 31	March 30	June 30	Dec. 31	Dec. 31
A. Quantitative performance criteria								
	(In millions of Uruguayan pesos)							
1. Combined public sector primary balance (floor) 2/	...	5,471	9,687	14,647	2,458	7,990	16,996	19,799
2. General government noninterest expenditure (ceiling) 2/	...	23,561	34,643	46,561	12,380	25,010	50,406	52,470
3. Net domestic assets of the BCU (ceiling) 2/	74,079	3,983	3,928	-4,628	5,143	-1,612	-4,580	-13,369
	(In millions of U.S. dollars)							
4. Net international reserves of the BCU (floor) 2/	-2,218	-130	-110	280	-226	50	241	580
5. Nonfinancial public sector gross debt (ceiling) 3/	12,189	12,510	12,575	12,550	12,775	12,740	12,775	12,925
6. Accumulation of external payment arrears of the public sector (on a continuous basis) 2/	0	0	0	0	0	0	0	0
B. Indicative targets								
	(In millions of Uruguayan pesos)							
7. Combined public sector overall balance (floor) 2/	...	-5,086	-7,459	-7,072	-3,939	-3,564	-5,794	-3,913
8. Monetary base (ceiling) 2/	15,648	557	1,029	2,750	-824	-294	1,770	1,914
9. Floating debt of the central government (ceiling)	3,081	3,081	3,081	3,081	...	...	...	...

PC= performance criterion; IT=Indicative target.

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

1/ As defined in the Technical Memorandum of Understanding.
2/ Cumulative changes from end-December of the previous calendar year.
3/ All maturities.

Table 2. Structural Conditionality Under the June 2005–June 2006 Program

Area	Structural Conditionality	Date
A. Prior actions		
Tax administration	Issue a decree to implement the DGI's modernization law.	
Tax administration	Establish a large taxpayers unit at the DGI.	
Tax administration	Formulate a plan to coordinate tax audits between the DGI, the BPS, and the Ministry of Labor.	
Financial sector	Appoint a Board of Directors for NBC with appropriate professional experience and an interim CEO with banking experience.	
B. Structural performance criteria		
Fiscal	Submit to congress a five-year spending plan, complemented with revenue projections and deficit targets consistent with the program's fiscal targets.	August 31, 2005
Fiscal	Have in place a five-year spending plan, complemented with revenue projections and deficit targets consistent with the program's fiscal targets.	February 28, 2006
Pension	Begin to implement reform of the pension fund for the police.	November 30, 2005
Tax reform	Submit to congress a comprehensive tax reform as described in paragraph 7.	December 31, 2005
Tax reform	Begin to implement the comprehensive tax reform.	June 30, 2006
Central Bank	Submit simultaneously three laws to congress to: (i) give appropriate autonomy to the central bank (as described in paragraph 12); (ii) strengthen the regulation of the financial system (as described in paragraph 13); and (iii) provide a suitable bank resolution framework (as described in paragraph 14).	December 31, 2005
Central Bank	Begin to implement these laws.	June 30, 2006
BROU & BHU	Government to ensure timely service of BHU note and BROU fiduciary notes to BROU in accordance with the current payment schedules.	Continuous
C. Structural benchmarks		
Fiscal	Establish quarterly revenue collection targets (floors) at the social security bank (BPS).	June 30, 2005
Debt management	Create a debt management unit at the Ministry of Finance.	December 31, 2005
Financial sector	Sell shares of NBC in amounts that yield managerial control to the private sector.	June 30, 2006

TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum presents the definitions of the variables included in the performance criteria and indicative targets annexed to the Memorandum of Economic and Financial Policies.

1. **Cumulative floor on the overall balance of the combined public sector (indicative target).** The combined public sector comprises the non-financial public sector (NFPS) and the Central Bank (BCU). The NFPS comprises the central government,[26] the social security system (*Banco de Previsión Social, Caja Militar,* and *Caja Policial*), the local governments (*Intendencias*), the public enterprises (AFE, ANCAP, ANCO, ANP, ANTEL, INC, OSE, and UTE (including Salto Grande)). The below-the-line overall balance will be measured as the negative of the *sum* of: (a) the net financing of the NFPS[27] minus (b) the operating balance of the BCU.

(a) The net financing of the NFPS would include the *sum* of: (i) increase in net claims of the domestic financial system on the NFPS (excluding government bonds and treasury bills); (ii) the increase in the net amount of NFPS bonds and treasury bills held outside the NFPS (excluding any debt issued for the recapitalization of BCU and debt issued to finance the capitalization of the deposit insurance scheme up to a limit of US$20 million); plus (iii) the increase in net non-bank loans, external bank loans, and supplier credits to the NFPS; plus (iv) the net increase in liabilities arising from the forward sale of NFPS assets; *minus* (v) the net increase of NFPS financial assets held by the NFPS outside the domestic financial system (including the loan component of the deposit insurance scheme); plus (vi) gross revenues from the sale of public assets (net of associated fees and commissions); plus (vii) all upfront payments related to future concessions (including the sale of mobile phone licenses); plus (viii) recoveries of financial assistance provided to the banking system.

(b) The operating balance of the BCU is defined as interest earnings on gross international reserves, as defined below, and other earnings including those on other foreign and domestic assets minus operating expenses, commissions paid, and interest paid on domestic and foreign debt administered by the BCU.

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[26] This includes the funds managed directly in the ministries (*Fondos de Libre Disponibilidad*).

[27] Excluding any cash outlays related to government guarantees (principle plus interest) on the BHU and BROU's fiduciary trusts notes that are called; and the final outcome of the arbitration with the former shareholders of Banco Comercial.

- The floor on the overall balance of the combined public sector will be adjusted *downward* (*upward*) by the amount by which the actual social security contributions transferred to the private pension system exceeds (falls short of) the projected amounts in the program, specified in Schedule A. The downward adjustor will be capped at a maximum of Ur$250 million. This adjustor will be eliminated after December 31, 2005.

Schedule A (In millions of Uruguay pesos, cumulative basis)			
	Jun-05	Sep-05	Dec-05
Projected social security contributions	1,798	2,712	3,587

2. **Cumulative floor on the primary balance of the combined public sector.** The combined public sector primary balance will be calculated as the overall balance measured from below the line plus interest payments. Interest payments are defined to exclude commissions and fees.

- The floor on the overall balance of the combined public sector will be adjusted downward (upward) by the amount by which the actual social security contributions transferred to the private pension system exceeds (falls short of) the projected amounts in the program, specified in Schedule A. The downward adjustor will be capped at a maximum of Ur$250 million. This adjustor will be eliminated after December 31, 2005.

3. **Cumulative ceiling on general government expenditure** applies to total (current and capital) noninterest expenditure of the central administration and the social security system (BPS). The noninterest expenditure of the central administration includes *Fondos de Libre Disponibilidad* but excludes transfers to the social security system, automatic transfers to the private pension funds (AFAPs), and earmarked revenue as of December 31, 2004.

- The ceiling on general government expenditure will be adjusted downward for any expenses arising from pension adjustments which exceed the increase in the legal minimum adjustment. The ceiling on general government expenditure will be adjusted *upward* (*downward*) by the amount by which the actual revenues from the *Fondos de Libre Disponibildad* (FLD) *exceeds* (*falls short of*) the projected amounts in the program, specified in Schedule B. This adjuster will be eliminated after December 31, 2005.

Schedule B (In millions of Uruguayan pesos, cumulative basis)			
	Jun-05	Sep-05	Dec-05
Projected revenues from the FLD	3,044	4,664	6,277

4. **Cumulative ceiling on the monetary base (indicative target).** Money base is defined as the sum of (i) currency issue; (ii) nonremunerated and remunerated peso sight deposits of BROU, BHU, private banks, and other institutions defined below at the BCU; and (iii) call peso deposits of BROU, BHU, private banks, and other institutions at the BCU. Other institutions include pension funds (AFAPs), local governments, public enterprises, trust funds of the liquidated banks (FRPB), investment funds, offshore institutions (IFEs), insurance companies, exchange houses, stock brokers, and the nonfinancial private sector. The monetary base excludes central government and BPS peso deposits held at BROU subject to a 100 percent reserve requirement. The indicative target is defined as the cumulative change calculated using the monthly averages relative to the base month average.

5. **Cumulative floor on the net international reserves (NIR) of the BCU.** NIR is defined as the difference between the gross international reserves and BCU reserve liabilities. Gross international reserves include all foreign exchange assets that are claims on non-residents and that are in the direct effective control of the BCU and are readily available for such purposes of the BCU as intervention or direct financing of payment imbalances. Such assets may be in any of the following forms, provided that they meet the test of effective control and ready availability for use: currency, bank deposits in nonresident institutions and government securities and other bonds and notes issued by nonresidents (with a rating not below "A" in the classification of Fitch and IBCA and Standard and Poor's or "A2" in the classification of Moody's). In addition, holdings of SDRs or of monetary gold would be included under gross international reserves (provided they meet the test of effective control and ready availability of use) as would the reserve position in the IMF.

(a) Excluded from gross international reserves are all foreign currency claims arising from off-balance sheet transactions (such as derivatives instruments), capital subscriptions to international financial institutions, any assets in nonconvertible currencies, claims on any nonresident Uruguay-owned institutions, or any amounts (in all components of assets, including gold) that have been pledged in a direct or contingent way.

(b) BCU reserve liabilities include (i) all foreign currency-denominated liabilities of the BCU with original maturity of one year or less to residents and nonresidents; (ii) all certificates of deposit used to constitute reserve requirements against bank deposits; (iii) the total use of Fund credit by Uruguay; and (iv) any net position on foreign exchange derivatives vis-à-vis the peso with either residents or nonresidents undertaken directly by the BCU or by other financial institutions on behalf of the BCU, as measured in items II.2 and III.4 of the IMF's Data Template on International Reserves and Foreign Currency Liquidity.

(c) For the purpose of the NIR calculation, (i) the gold holdings of the BCU will be valued at the accounting rate of US$42 per troy ounce; (ii) liabilities to the IMF will be valued at the rate of US$1.54784 per SDR; (iii) gains or losses from gold swaps and other operations will be excluded; and (iv) non-U.S. dollar denominated foreign assets and liabilities will be converted into U.S. dollars at the market exchange rates of the respective currencies as of December 30, 2004.

- **The NIR floor will be adjusted** upward by the full amount of pre-financing operations for 2006. Prefinancing is the portion of nonproject related foreign currency nonfinancial public sector debt that is issued in 2005 but will be used in 2006 or later, and is clearly earmarked for such later use.

6. **Cumulative ceiling on net domestic assets (NDA) of the BCU.** NDA is defined as the difference between end-of-period monetary base and net international reserves (NIR) of the BCU as defined in paragraphs 4 and 5 below. The flow of NIR will be valued at the accounting exchange rate of Ur$26.35 per US$1.

- **The NDA ceiling will be adjusted** downward by the Ur$ equivalent of any upward adjustment in the NIR target of the BCU.

7. **The overall nonfinancial public sector gross debt ceiling** refers to the outstanding stock of debt[28] [29] measured on a *gross* basis[30] in domestic and foreign currency *owed or guaranteed by the NFPS*, valued in U.S. dollars at the accounting rates of Ur$26.35 per U.S. dollar, U.S. dollar 1.3637 per Euro, U.S. dollar 0.0097 per Yen, U.S. dollar 1.54784 per SDR, and Ur$1.4345 per UI. If the Ur$ to UI rate exceeds 1.5420 the UI debt will be valued at Ur$ 1.4345 plus the difference between the actual rate and Ur$1.5420. The debt ceiling will exclude (i) the government guaranteed BHU note (with outstanding obligations estimated at US$624 million at end-December 2004) and the government guaranteed notes issued by the fiduciary trusts associated with the transfer of BROU's nonperforming loans (with outstanding obligations estimated at US$429 million at end-December 2004); and

[28] The term "debt" has the meaning set forth in point No. 9 of the Fund's Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 6230-(79/140, August 3, 1979), as amended).

[29] The suppliers' contracts of ANTEL with equipment providers Ericsson and NEC, which predate the Fund's consideration of lease contracts for programming purposes, are expensed under goods and services as rental outlays and, therefore, excluded from the definition of nonfinancial public sector gross debt for program purposes.

[30] Debt outstanding with the domestic financial system (excluding BCU) will be measured net of gross deposits.

(ii) net debt of the NFPS with the BCU. It will include the total stock of Fund credit outstanding to Uruguay.

- The NFPS debt ceiling will be adjusted (i) upward (downward) by revisions made to the actual nonfinancial public sector gross debt stock at end-2004; (ii) upward by a maximum of US$500 million for the amount of debt issued to recapitalize the BCU; (iii) upward by a maximum of US$150 million (downward) for the cumulative reduction (increase) in the net credit position of public enterprises with the BCU; (iv) upward by a maximum of US$150 million for the costs associated with the final outcome of the arbitration award to the former shareholders of Banco Comercial; (v) upward by a maximum of US$100 million for debt issued to finance below-the-line operations of public enterprises (such as recapitalization of ANCAP's subsidiary abroad); and (vi) upward to reflect pre-financing operations for 2006 up to a limit of US$500 million.

8. **External payments arrears of the public sector** are defined on the residency principle and relate to public sector debt with foreign creditors. This performance criterion is monitored on a continuous basis.

9. **Floating debt of the central government** is defined as expenditure which have already been billed but no checks been issued. The ceiling will be adjusted upward (*downward*) by revisions made to the actual stock of floating debt at end-2004. This indicative target will apply through December 31, 2005; and afterwards—once approved in the 2006 budget— monitored by including the floating debt in the definition of the combined public sector overall balance measured from below the line, and in the stock of the NFPS debt.

10. **Continuous performance criterion on the timely service of bank restructuring debt to BROU in accordance with the current payment schedule**. The bank restructuring debt to BROU includes the notes to BROU guaranteed by the government and issued by the BHU and the fiduciary trusts that own and manage the nonperforming loans formerly on the books of BROU. Timely service is defined as the payment of agreed principal and interest by the BHU, the trusts, or the government in accordance with the timetable and terms presented in Schedule C.

Schedule C. Scheduled Service of Bank Restructuring Debt to BROU
(In millions of U.S. dollars)

	BHU Note				Fiduciary Trusts 1/			
	Service				Service			
	Principal	Interest 3/	Total	Balance 2/	I	II	III	Balance 2/
2005 Q2	2.5	3.7	6.2	611.8	70.7	4.6	3.6	350.7
2005 Q3	2.5	3.7	6.2	605.7				
2005 Q4	2.5	3.6	6.2	599.5	82.2	5.3	8.9	254.2
2006 Q1	3.8	3.6	7.4	592.1				
2006 Q2	3.8	3.6	7.4	584.7	81.0	5.3	8.8	63.4
2006 Q3	3.8	3.6	7.4	577.3				
2006 Q4	3.8	3.5	7.3	569.9	8.1	0.3	5.8	0.0
2007 Q1	5.1	3.5	8.6	561.4				
2007 Q2	5.1	3.5	8.5	552.8				
2007 Q3	5.1	3.4	8.5	544.3				
2007 Q4	5.1	3.4	8.5	535.8				
2008 Q1	6.4	3.3	9.7	526.1				
2008 Q2	6.4	3.3	9.7	516.5				

1/ Fiduciary trusts that own and manage the debt formerly on the books of BROU.
2/ Estimated balance of outstanding principal and interest obligations.
3/ Estimate. The contractual interest rate is the 60-day U.S. dollar-denominated time-deposit rate of BROU plus 50 basis points, and is revised on June 30 and December 31 every year based on the rate prevailing on that date.

INTERNATIONAL MONETARY FUND

Uruguay—Assessment of the Risks to the Fund and the Fund's Liquidity Position

Prepared by the Finance and Policy Development and Review Departments

In consultation with other Departments

Approved by Michael G. Kuhn and Juha Kähkönen

May 27, 2005

1. **This note assesses the risks to the Fund arising from the proposed new Stand-By Arrangement (SBA) for Uruguay and its effect on the Fund's liquidity, in accordance with the policy on exceptional access.**[1] The authorities are requesting a three-year SBA with access of SDR 766 million (250 percent of quota) following the expiration of the previous arrangement in March 2005. The new SBA is proposed to be in effect from June 2005 to June 2008, phased with thirteen purchases (the first upon approval) and quarterly reviews (Table 1).[2]

Table 1. Proposed SBA - Access and Phasing

Date		Purchases	
		SDR mn.	% of quota
2005	June (approval)	30.65	10.00
	August (1st review)	30.65	10.00
	November (2nd review)	30.65	10.00
2006	March (3rd review)	85.82	28.00
	May (4th review)	85.82	28.00
	August (5th review)	85.82	28.00
	November (6th review)	85.82	28.00
2007	February (7th review)	67.43	22.00
	May (8th review)	67.43	22.00
	August (9th review)	67.43	22.00
	November (10th review)	67.43	22.00
2008	February (11th review)	30.65	10.00
	May (12th review)	30.65	10.00
Total		766.25	250.00

Background

2. **Uruguay's recent financial relationship with the Fund has involved a succession of SBAs, including four that were treated as precautionary upon Board approval** (Table 2). Since 1985, the Fund has approved eight SBAs, including virtually continuous arrangements from March 1996 to March 2005.[3]

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[1]See Public Information Note No. 03/37, 3/21/03.

[2]See *Uruguay—Request for Stand-By Arrangement*.

[3]See *Uruguay—Ex Post Assessment of Longer-Term Program Engagement* (Country Report No. 05/202).

3. **Following a sustained period of limited use of Fund resources, Uruguay's recourse to Fund credit increased rapidly in the context of its capital account crisis in 2002**. Fund credit outstanding remained well below 100 percent of quota between 1990 and 2001, but jumped by SDR 1.2 billion (400 percent of quota) between February and August 2002 and continued to rise through August 2004 when it peaked at SDR 1.8 billion, or 577 percent of quota (Figure 1). Specifically, the SDR 594.1 million (193.8 percent of quota) 24-month SBA approved on March 25, 2002 was augmented in June 2002 by SDR 1.16 billion (to SDR 1.75 billion, 571 percent of quota), of which one-third was approved under the Supplemental Reserve Facility (SRF). In August 2002, the undrawn SRF credit was replaced with credit tranche resources on a rephased schedule, together with a further augmentation of SDR 376 million (to SDR 2.13 billion, 695 percent of quota).[4] In March 2003, the Board approved a one-year extension of the SBA through end-March 2005, and rephased projected disbursements over the remainder of the arrangement.[5]

4. **Uruguay currently ranks fifth in terms of the size of total Fund exposures**. As of end-March 2005, credit outstanding to Uruguay stood at SDR 1.6 billion, or 3.2 percent of total credit outstanding. In absolute terms, the Fund's exposure to Uruguay is significantly smaller than the four largest exposures (Table 3). However, when scaled by measures reflecting economic size, Fund exposure to Uruguay is very large. This is particularly the case vis-à-vis GDP, where Fund credit to Uruguay, at 18 percent of 2004 GDP, is by far the largest among the membership and more than twice the size of the second largest exposure (Argentina). This is also true vis-à-vis quotas, where Uruguay's Fund credit outstanding (534 percent of quota) is second only to Turkey, whose quota is unusually low. The high level of Fund credit outstanding in relation to the size of Uruguay's economy underlines the considerable risks associated with Uruguay's capacity to repay.

5. **Fund credit represents a large share of Uruguay's debt and debt service** (Tables 4, 5, and 6). At end 2004, Uruguay's outstanding Fund credit accounted for about 26 percent of public external debt, 22 percent of total public debt, and over 100 percent of gross reserves. Uruguay's debt service to the Fund in 2004 accounted for about one-third of public external debt service and over one-quarter of total external debt service. For all these ratios, the Fund's relative exposure to Uruguay exceeds that for other large borrowers, with the Fund's share in total public debt being particularly large.

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[4] Of the SDR 387 million available under SRF terms, SDR 129 million was drawn.

[5] The rise in Fund exposure to Uruguay came in the context of increased concentration of Fund GRA exposure since 1994. The share of the top-five users of Fund resources in total Fund credit outstanding has risen from 51 percent in 1994 to over 88 percent at end-March 2005. It should be noted that the potential for high concentration in the Fund's exposure versus other financial institutions is inherent to its mandate.

6. **Uruguay began to make net repurchases to the Fund in 2005** (Figure 2). Although all repurchase expectations arising from May to December 2005 have been extended, the authorities made advance repurchases totaling SDR 374 million in late 2004 and early 2005, effectively covering over 80 percent of all repurchases due in 2005.[6]

7. **Uruguay's capacity to repay the Fund hinges on its gradual return to international capital markets**. Uruguay's success in regaining access to capital markets in October 2003, four months after concluding its debt restructuring and about one and one-half years after last tapping markets reflects a combination of: (i) a collaborative approach to debt restructuring; (ii) investors' confidence in the conduct of economic policy; (iii) macroeconomic strengthening; and (iv) favorable global conditions in capital markets.[7, 8] Uruguay's sovereign spreads have followed a consistent downward trend and now compare favorably with those of other emerging market economies, suggesting an improvement in the market's assessment of Uruguay's country risk (Figure 3). As a result, the differential between EMBIG rates for Uruguay and the marginal cost of Fund resources has declined from over 1,500 basis points (bps) in mid-2002 to about 330 bps at end-March 2005.[9, 10] Nonetheless, Uruguay's financing requirements over the proposed program period remain well above its current market access.[11]

The new SBA—Risks and Impact on Fund Finances

8. **Under the proposed successor arrangement, Fund exposure to Uruguay would remain around its current high level for an extended period**. Indeed, outstanding use of Fund resources will actually increase by a small amount initially, and will not begin to decline until mid-2006. Moreover, Fund exposure would still amount to 370 percent of quota at the end of the new arrangement, significantly above the threshold for exceptional access and would not fall below that threshold until March 2009 (Figure 2). By end-2008, the share of Fund exposure in Uruguay's public external debt is projected to decline to about

[6] A total of SDR 790 million has been extended.

[7] In October 2003, Uruguay issued a global peso-denominated, inflation-indexed bond of US$200 million, with a coupon of 10.5 percent and a three-year maturity.

[8] See "Assessing the Determinants and Prospects for the Pace of Market Access by Countries Emerging from Crises—Further Considerations."

[9] EMBIG (J.P. Morgan's Global Emerging Market Bond Index) covers sovereign US dollar-denominated debt instruments issued by major emerging market economies. Collateralized debt has been stripped from the EMBIG index. The marginal cost of Fund resources is defined as the highest level-based surcharge rate applicable plus the adjusted rate of charge.

[10] In February 2004, Uruguay reopened the October 2003 bond for an additional placement of US$100 million and an interest rate 200 bps below the original issuance. In May 2005, the government issued a US dollar-denominated global bond for US$300 million, with a coupon of 9.25 percent and 12-year maturity.

[11] The gross financing requirement for the period 2005–08 is estimated at about US$2.2 billion a year or 12 percent of the projected GDP for the period — see *Uruguay—Request for Stand-By Arrangement*.

15 percent, but total payments to the Fund would remain sizeable in 2008 at about 33 percent of the public external debt service (Table 6). Compared with other cases where exceptional access has been followed by successor arrangements, Fund exposure to Uruguay would remain at or near peak levels for a relatively longer period (Figure 4).

9. **The main risks to Uruguay's capacity to repay the Fund include:**[12]

- **Low economic growth and potentially significant challenges in achieving the necessary fiscal consolidation path under the program.**

- **The scale, currency composition, and variable interest rates of Uruguay's public debt**. Such a profile underscores the risks posed by Uruguay's high gross financing needs, and vulnerability to exchange rate fluctuations and increases in short-term interest rates.

- **Uruguay's large amortization payments over the medium term to private bondholders and multilateral creditors, including the Fund**. Total payments to the Fund alone are projected to peak in 2007 at over 40 percent of the public external debt service and 21 percent of exports of goods and non-factor services (Table 6).

- **Uruguay's widespread dollarization in the financial system and balance sheet mismatches**. Persistent weaknesses in the financial system imply significant contingent liabilities on the government.

- **The potential for a deterioration in the currently favorable environment for emerging market economies (EME)**. The narrowing of EME bond spreads, which were near eight-year lows in early 2005, could unwind rapidly in the face of a major shock to investors' confidence. Such an event could lead to a rapid decompression of sovereign spreads with a potentially negative effect on Uruguay's capacity to access large volumes of market financing.

10. **The above profile of risks underscores the importance of sustained fiscal efforts and growth to improve Uruguay's debt dynamics and help mitigate these risks**.[13] Maintaining fiscal surpluses—heretofore, unprecedented in Uruguay's history—and an enabling environment for sustained growth are critical.[14]

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[12]For a more detailed discussion about vulnerabilities and medium-term risks see *Uruguay—Request for Stand-By Arrangement*.

[13]According to staff estimates, a consistent fiscal effort leading to primary surpluses of at least 4 percent of GDP per year from 2007 onward—in addition to sustained growth and favorable external conditions—would be required to bring total public debt to more sustainable levels, below 60 percent of GDP by 2009.

[14]See *Uruguay—Ex Post Assessment of Longer-Term Program Engagement* (Country Report No. 05/202).

11. **The authorities' resolve to implement their Fund-supported program provides a key safeguard to Fund resources**. The administration that took office in March 2005 sees Fund support as critical to addressing remaining economic vulnerabilities and strengthening access to private capital markets. The ruling coalition's majorities in both houses of congress should support the achievement of these goals. These positive factors have to be weighed against the strong social pressure for higher spending.[15]

12. **In addition, the authorities are determined to reduce reliance on Fund finances**. The authorities view the current SBA as a means to exit from future Fund financial support. Moreover, they have indicated that, should the balance of payments position turn out to be stronger than anticipated, they would consider to either make repurchases to the Fund on an expectations basis, forego purchases, or treat the arrangement as precautionary.[16]

13. **Given the size of the proposed new arrangement, and the Fund's current satisfactory liquidity situation, its impact on the Fund's liquidity position can be readily accommodated**. The proposed SBA would reduce the one-year forward commitment capacity (FCC) by SDR 766 million, compared with an FCC of SDR 94 billion as of end-March 2005.[17, 18]

14. **While Fund exposure to Uruguay is significantly less than that of each of the four largest users of Fund resources, it remains sizable**. The Fund's average exposure during the proposed SBA would represent about one-fifth of the Fund's total precautionary balances as of end-2004 (Table 7)**.** This share would reach about one-quarter by end-2005, before declining to about 14 percent by end-2008. These ratios suggest that the Fund's resources are currently adequate to handle the potential impact of a Uruguay-specific problem.[19] This would most likely not be the case, however, if there are difficulties involving also other countries in the region with high Fund exposure.[20]

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[15]See *Uruguay—Request for Stand-By Arrangement*.

[16]See the authorities' Letter of Intent.

[17]The FCC, introduced in December 2002, is the principal measure of Fund liquidity. The (one-year) FCC indicates the amount of quota-based, nonconcessional resources available for new lending over the next 12 months (see, for instance, IMF's Financial Resources and Liquidity Position, 2003–April 2005).

[18]This amount compares with the current impact of Uruguay's exposure on the FCC (SDR 1.6 billion) at end-May 2005, which is measured as credit outstanding and undrawn balances as of this date, less repurchases one-year forward on an obligations basis. At end-May 2005, there were no undrawn balances.

[19]In February 2004, Directors reconfirmed as broadly appropriate the decision taken in 2002 for a target level of precautionary balances of some SDR 10 billion (see Public Information Notice No. 04/16, 3/5/04). See also *Financial Risk in the Fund and the Level of Precautionary Balances*, pp. 24–25, and the accompanying background paper, Chapters II and III.

[20]Fund exposure is highly concentrated in the region. By end March 2005, the exposure to Brazil, Argentina, and Uruguay together represented about 50 percent of total GRA credit, and 350 percent of the Fund's precautionary balances.

15. **Uruguay is projected to pay charges to the Fund averaging about SDR 70 million a year in the coming three years, equivalent to about one-third of the Fund's annual residual burden-sharing capacity at end-March**. [21, 22] Therefore, arrears incurred in the payment of charges would trigger, under the current rules, a reduction in the remaining burden-shared resources to cover other events of the same nature. Burden sharing such arrears in the payment of charges would imply an increase in the rate of charge of about 7 bps.[23]

16. **The above considerations suggest that an Uruguay-specific problem would have a sizable but manageable impact on the Fund's finances**. However, it could have broader ramifications, including reputational and credibility risks for the Fund and could also raise further questions about the relative size and prolonged nature of the Fund's financial engagement with Uruguay.

Assessment

17. **Uruguay represents a significant risk for the Fund**. This risk arises from the high level of credit outstanding, the very large size of this exposure in relation to Uruguay's economy, and the prolonged nature of the exposure. Uruguay is currently the Fund's fifth largest debtor. The level and phasing of access under the proposed SBA will lead to a projected peak in Fund exposure to Uruguay, during the program period, at 592 percent of quota by May 2006. Moreover, Fund exposure to Uruguay would still amount to 370 percent of quota at the end of the new arrangement, significantly above the threshold for exceptional access, and would not fall below that threshold until March 2009. While the Fund's resources are currently adequate to handle a Uruguay-specific problem, its financial impact would still be sizable, and it could also have broader ramifications, including reputational and credibility risks for the Fund.

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[21]The burden-sharing mechanism shares costs of overdue obligations equally between creditors and debtors through a decrease in the rate of remuneration and an increase in the rate of charge. The mechanism is used to accumulate precautionary balances in the special contingent account (SCA-1) and to compensate the Fund for a loss in income when debtors do not pay charges. Article V, Section 9 (a) of the Articles of Agreement sets a floor for remuneration at 80 percent of the SDR interest rate (Article V, Section 9) and presently there is an 85 percent limit set by the Executive Board. No corresponding ceiling applies to the rate of charge.

[22]Residual burden-sharing represents "free capacity" and is equal to total burden-sharing capacity under current rules minus the amount currently being utilized to offset unpaid charges and build balances in the SCA-1. The estimated impact is based on the floor for remuneration at 85 percent of the SDR interest rate. Under this floor, the maximum burden sharing capacity at end-March, 2005 was SDR 317 million, out of which SDR 201 million represented the residual capacity.

[23]Based on credit outstanding at end-March 2005 of SDR 50.3 billion.

18. **The authorities' commitment to strong program implementation will be a crucial factor in mitigating risks to Uruguay's capacity to repay**. The authorities' commitment to strong program implementation is critical, including in the context of the unprecedented primary surpluses required to bring total public debt to more sustainable levels. In addition, given the substantial contingencies and sensitivity of debt dynamics to macroeconomic developments, the authorities will need to stand ready to take additional fiscal actions to reinforce debt sustainability if necessary. Moreover, strong implementation of structural reforms supported by the proposed SBA would allow for higher sustained growth, which is also important to reduce the risks associated with high debt ratios.

19. **In addition, the authorities are determined to reduce reliance on Fund resources and see the successor SBA as a means to exit from Fund financial support**. The proposed access level and phasing would allow Uruguay to reduce its use of Fund credit in a gradual and likely sustainable manner, while re-accessing capital markets. In this regard, Fund exposure to Uruguay may be reduced at a faster pace given the authorities' intention to consider either making repurchases to the Fund on an expectations basis, foregoing purchases, or treating the arrangement as precautionary should the balance of payments position turn out to be stronger than currently anticipated.

Table 2. Uruguay: Approved Arrangements, Purchases and Repurchases, 1984-2008 1/
(In millions of SDRs)

Year	Type of New Arrangement	Date of Arrangement	Date of Expiration or Cancellation	Amount of New Arrangement	Amount Drawn	Purchases	Repurchases	Fund Exposure 2/
1984						0	0	226.8
1985	SBA	Sep-27-1985	Mar-26-1987	122.9	122.9	101.2	9.5	318.6
1986						52.7	48.2	323.1
1987						35.1	81.5	276.6
1988						0.0	46.9	229.7
1989						0.0	76.3	153.4
1990	SBA	Dec-12-1990	Mar-15-1992	94.8	9.0	9.0	91.6	70.8
1991						0.0	30.3	40.4
1992	SBA	Jul-01-1992	Jun-30-1993	163.8	16.0	16.0	18.3	38.1
1993						0.0	10.2	27.9
1994						0.0	7.4	20.5
1995						0.0	6.5	14.0
1996	**SBA**	**Mar-01-1996**	**Mar-31-1997**	**100.0**	**0.0**	**0.0**	**8.0**	**6.0**
1997	**SBA**	**Jun-20-1997**	**Mar-19-1999**	**125.0**	**114.2**	**0.0**	**6.0**	**0.0**
1998						114.2	0.0	114.2
1999	**SBA**	**Mar-29-1999**	**Mar-28-2000**	**70.0**	**0.0**	**0.0**	**0.0**	**114.2**
2000	**SBA**	**May-31-2000**	**Mar-31-2002**	**150.0**	**150.0**	**0.0**	**0.0**	**114.2**
2001						0.0	0.0	114.2
2002 3/	SBA/SRF	Apr-01-2002	Mar-31-2005	1,988.5	1,988.5	1,261.7	57.1	1,318.8
2003						364.2	57.1	1,625.9
2004						372.8	270.3	1,728.4
2005 4/	*SBA*	*Jun-08-2005*	*Jun-08-2008*	*766.3*	*766.3*	*231.8 5/*	*317.3*	*1,642.8*
2006						*343.3*	*434.3*	*1,551.8*
2007						*269.7*	*574.4*	*1,247.1*
2008						*61.3*	*332.3*	*976.1*

Source: Finance Department.

1/ Precautionary arrangements upon approval are marked in bold.
2/ As of end December.
3/ Amount agreed and undrawn balance exclude SDR 257.4 million not drawn under the SRF and SDR 139.8 million not drawn under the credit tranches. Uruguay's SRF was approved on June 25, 2002 and canceled on August 8, 2002; access under the SBA was reduced by SDR 139.8 million on August 27, 2004. The final review under the current arrangement was completed on February 23, 2005.
4/ Projected staff proposal shown in italics. Assumes access of SDR 766.3 million under a 3-year SBA beginning in June 2005. Repurchases are assumed to follow the obligations schedule.
5/ Includes a purchase of SDR 139.8 million in February, 2005 under the 2002 Stand-By Arrangement.

Table 3. Major Users of Fund Credit: GRA Credit Outstanding, March 2005

	In SDR Millions	In Percent of Total GRA Credit	In Percent of Quota	In Percent of GDP 1/ 2/
Brazil	15,356.2	30.5	505.8	3.8
Turkey 1/	13,187.1	26.2	1,368.0	6.7
Argentina	8,354.1	16.6	394.6	8.1
Indonesia	6,015.2	11.9	289.3	3.5
Uruguay	1,635.6	3.2	533.6	18.3

Sources: Finance Department, Board documents, and staff estimates.

1/ GNP data are used for Turkey.
2/ Data are for 2004. The annual average USD/SDR exchange rate of 1.48 is used.

Table 4. Uruguay: Public External Debt Outstanding, 1999-2004 1/

	1999	2000	2001	2002	2003	2004
	(In millions of U.S. dollars)					
Total public external debt	5,591	6,092	5,829	8,299	9,557	10,209
Official creditors	2,388	2,511	2,525	4,751	5,623	5,876
Multilaterals	1,920	2,108	2,218	4,494	5,419	5,714
of which IMF	157	149	144	1,793	2,416	2,684
Bilaterals	468	402	307	257	204	162
Private sector creditors	3,204	3,582	3,304	3,548	3,934	4,334
Financial	3,124	3,509	3,225	3,466	3,781	4,172
Commercial Banks	726	661	505	511	214	192
Others	2,398	2,848	2,719	2,955	3,567	3,980
Nonfinancial	80	73	79	82	153	162
	(In percent of total public external debt)					
Total public external debt	100.0	100.0	100.0	100.0	100.0	100.0
Official creditors	42.7	41.2	43.3	57.2	58.8	57.6
Multilaterals	34.3	34.6	38.1	54.2	56.7	56.0
of which IMF	2.8	2.4	2.5	21.6	25.3	26.3
Bilaterals	8.4	6.6	5.3	3.1	2.1	1.6
Private sector creditors	57.3	58.8	56.7	42.8	41.2	42.5
Financial	55.9	57.6	55.3	41.8	39.6	40.9
Commercial Banks	13.0	10.8	8.7	6.2	2.2	1.9
Others	42.9	46.8	46.7	35.6	37.3	39.0
Nonfinancial	1.4	1.2	1.4	1.0	1.6	1.6

Source: CBU, IFS and staff estimates.

1/ Gross debt data are reported. Public sector is defined as the non-financial public sector and the central bank.

Table 5. Fund Share in Debt of Large Borrowers, 2004

	Public External Debt	Total Public Debt	Public External Debt Service
Argentina	15	7	26
Brazil	22	6	28
Turkey	22	9	33
Uruguay	26	22	34

Source: Staff estimates.

Table 6. Uruguay: Selected Indicators of Capacity to Repay the Fund, 2004-2010
(in millions of SDRs unless otherwise indicated) 1/

	2004	2005	2006	2007	2008	2009	2010
Projected gross debt service to the Fund 2/	334.4	393.9	514.4	638.2	382.0	348.9	295.7
In percent of:							
GDP	3.7	3.7	4.3	5.0	2.8	2.4	1.9
Reserves	19.7	22.4	27.1	31.4	17.9	15.9	12.9
Exports 3/	13.3	14.9	18.4	20.6	11.2	9.6	7.5
Overall external debt service	28.8	26.6	29.6	36.1	26.0	23.3	19.3
Public external debt service	33.8	31.7	35.0	43.0	32.6	29.3	24.2
Projected net debt service to the Fund 2/	-38.4	162.2	171.1	368.5	320.7	348.9	295.7
In percent of: 4/							
GDP	0.4	1.5	1.4	2.9	2.4	2.4	1.9
Reserves	2.3	9.2	9.0	18.1	15.0	15.9	12.9
Exports 3/	1.5	6.2	6.1	11.9	9.4	9.6	7.5
Overall external debt service	3.3	11.0	9.9	20.9	21.9	23.3	19.3
Public external debt service	3.9	13.1	11.6	24.8	27.3	29.3	24.2
Memorandum items:							
GDP	8,957	10,769	11,837	12,727	13,445	14,276	15,166
Reserves	1,696	1,758	1,897	2,030	2,138	2,192	2,285
Exports 3/	2,505	2,636	2,797	3,100	3,399	3,630	3,922
Overall external debt service	1,160	1,481	1,736	1,767	1,467	1,496	1,529
Public external debt service	989	1,241	1,470	1,485	1,173	1,191	1,219
Change in Fund credit outstanding	102	-86	-91	-305	-271	-314	-274

Sources: Finance Department, Board documents and staff estimates.

1/ Projections are based on end-March 2005 exchange rate data.
2/ Based on the staff proposal which assumes access of SDR 766.3 million under a 3-year SBA beginning in June 2005. Repurchases are assumed to follow the obligations schedule. Projection of Fund charges is based on the fixed and constant rate calculated as the average rate of charge in April, 2005 of 3.47 percent.
3/ Exports of goods and non-factor services.
4/ Absolute amounts used for calculating the percentages.

Table 7. Uruguay: Impact on Fund Finances
(In millions of SDRs, and end of period, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008
Exposure						
Fund credit outstanding to Uruguay						
Baseline scenario--effective 1/	1,626	1,728	1,551	542	221	17
Baseline scenario--obligations 2/	n.a.	n.a.	1,551	1,117	542	221
Staff proposal--obligatons 3/	n.a.	n.a.	1,643	1,552	1,247	976
Fund credit outstanding to Uruguay (percent of total outstanding credit)	2.5	3.1	…	…	…	…
Fund credit outstanding to 5 largest debtors (percent of total outstanding credit)	86.2	85.9	…	…	…	…
Liquidity						
One-year Forward Commitment Capacity (FCC) 4/	54,238	71,950	…	…	…	…
Uruguay's impact on FCC 4/						
Baseline scenario--effective 1/	-2,008	-1,551	…	…	…	…
Baseline scenario--obligations 2/	n.a.	n.a.	…	…	…	…
Staff proposal--obligatons 3/	n.a.	n.a.	-1,883	-1,308	-976	-662
Prudential Measures						
Fund credit outstanding to Uruguay as a percent of current precautionary balances 5/						
Baseline scenario--effective 1/	25.6	23.9	21.4	7.5	3.1	0.2
Baseline scenario--obligations 2/	n.a.	n.a.	21.4	15.4	7.5	3.1
Staff proposal--obligatons 3/	n.a.	n.a.	22.7	21.5	17.2	13.5
Uruguay's annual charges as a percent of Fund's residual burden-sharing capacity 6/						
Baseline scenario--effective 1/	27.7	30.6	…	…	…	…
Baseline scenario--obligations 2/	n.a.	n.a.	…	…	…	…
Staff proposal--obligatons 3/	n.a.	n.a.	…	…	…	…
Memorandum items:						
Uruguay's debt to Fund as a percent of its total public external debt						
Baseline scenario--effective 1/	25.3	25.7	23.5	8.3	3.4	0.3
Baseline scenario--obligations 2/	n.a.	n.a.	23.5	17.0	8.4	3.5
Staff proposal--obligatons 3/	n.a.	n.a.	24.8	23.7	19.3	15.3
Uruguay's debt to Fund as a percent of its total public debt: baseline scenario--effective 1/	20.7	21.4	19.1	6.6	2.7	0.2
Uruguay's debt to multiraterals as a percent of its total public debt: baseline scenario--effective 1/	20.6	39.9	40.0	37.7	n.a.	n.a.
Fund's precautionary balances 5/	6,363	7,231	…	…	…	…
Fund's residual burden-sharing capacity 6/	177	210	…	…	…	…
Undrawn commitments to Uruguay						
Baseline scenario--effective 1/	652	140	…	…	…	…
Baseline scenario--obligations 2/	n.a.	n.a.	…	…	…	…
Staff proposal--obligatons 3/	n.a.	n.a.	674	331	61	0
Repurchases by Uruguay						
Baseline scenario--effective 1/	57	270	317	1,009	321	204
Baseline scenario--obligations 2/	n.a.	270	317	434	574	321
Staff proposal--obligatons 3/	n.a.	270	317	434	574	332
Annual charges 7/						
Baseline scenario--effective 1/	49	64	75	52	15	5
Baseline scenario--obligations 2/	n.a.	64	75	66	33	14
Staff proposal--obligatons 3/	n.a.	64	77	80	64	50

Source: Staff estimates.

1/ Assumes no new arrangement. Includes extensions of repurchase expectations between June and December 2005.

2/ Assumes no new arrangement. Assumes extensions of repurchase expectations from June 2005 onwards.

3/ Assumes access of SDR 766.3 million under a 3-year SBA beginning in June 2005. Repurchases are assumed to follow the obligations schedule.

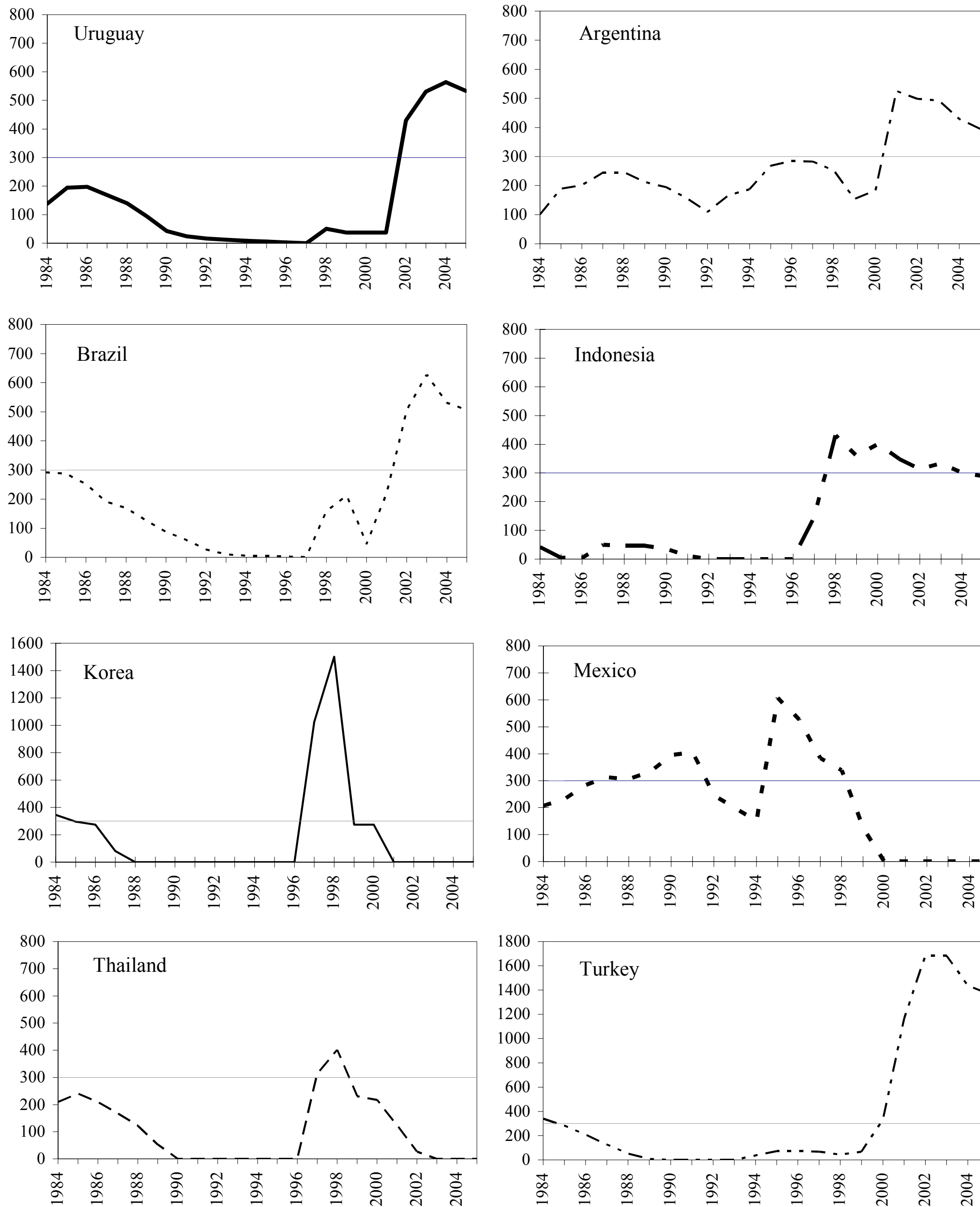
4/ The Forward Commitment Capacity is a measure of the resources available for new financial commitments in the coming year, equal to usable resources plus repurchases one-year forward minus the prudential balance. A single country's negative impact on the FCC is defined as the sum of Fund credit and undrawn commitments minus repurchases one-year forward falling due on obligations schedule.

5/ Figures for 2003 and 2004 represent end FY-2004 and FY-2005, respectively. Data reflect adjustments for the implementation of IAS 19.

6/ Burden-sharing capacity is calculated based on the floor for remuneration at 85 percent of the SDR interest rate. Residual burden-sharing capacity is equal to the total burden-sharing capacity minus the portion being currently utilized to offset deferred charges and to build SCA-1 balances.

7/ Projection of Fund charges is based on the fixed and constant rate calculated as the average rate of charge in April, 2005 of 3.47 percent.

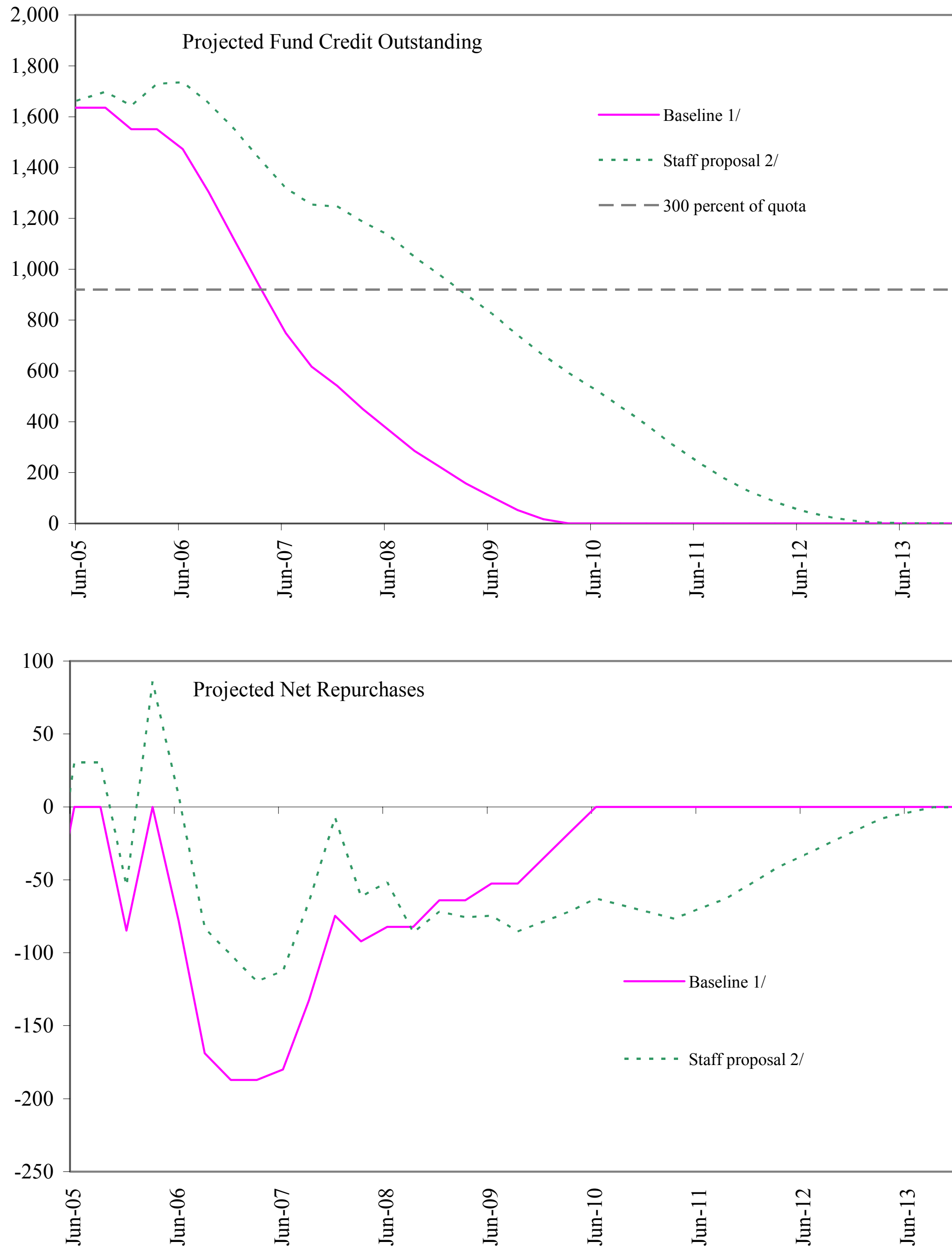
Figure 1. Fund Credit Outstanding in Exceptional Access Cases, 1984-2005 1/
(In percent of quota 2/)



Source: IFS.

1/ Based on end-year positions, except for 2005 where data are as of end-March.
2/ Quota increases took place in 1992 and 1999.

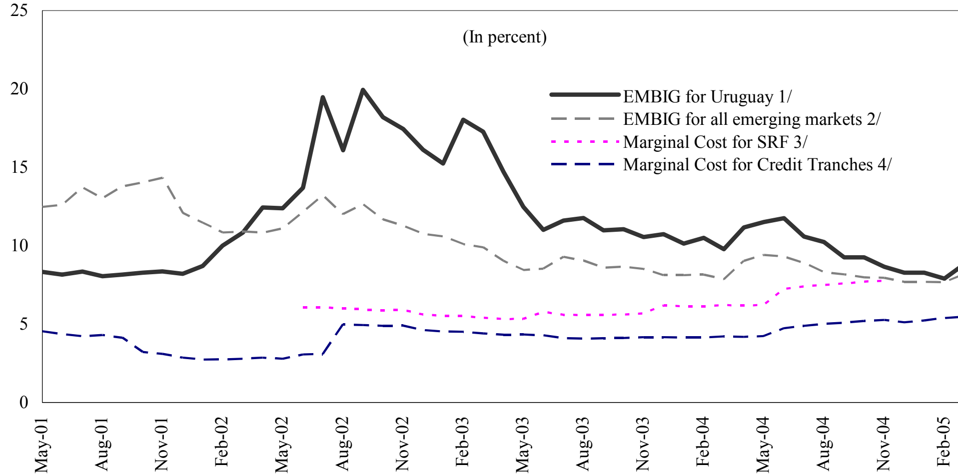
Figure 2. Uruguay: Fund Credit Outstanding, June 2005-December 2013
(In millions of SDRs)



Source: IFS, Finance Department and staff estimates.

1/ Projected baseline assumes repurchases to follow the obligations schedule.
2/ Staff proposal assumes access of SDR 766.3 million under a 3-year SBA beginning in June 2005. Repurchases are assumed to follow the obligations schedule.

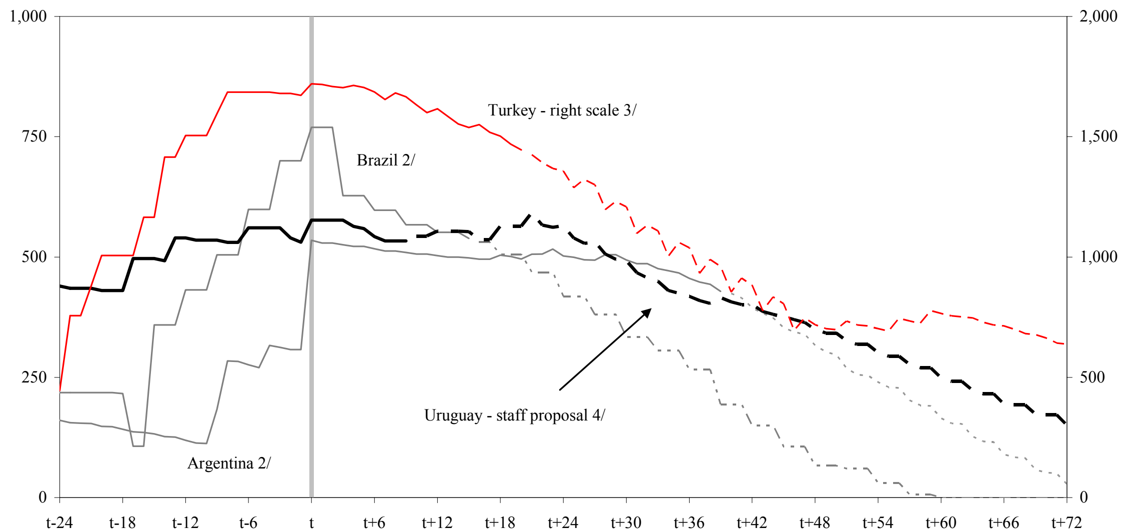
Figure 3. Uruguay: Secondary Market Yields and
Marginal Cost of Fund Credit, May 2001-March 2005



Source: J. P. Morgan, Finance Department, and staff estimates.

1/ Historical J. P. Morgan's EMBI Global (EMBIG) index, stripped of collateralized debt, is reported for the period available. For countries that defaulted on sovereign debt, EMBIG yield may not represent the cost of issuing new debt, as debt issued after a default often trades with a different discount.
2/ Composite EMBIG for all emerging market countries, stripped of collateralized debt.
3/ Defined as the actual rate at which outstanding SRF resources are being serviced. Reported only for periods with outstanding SRF resources.
4/ Defined as the highest level-based surcharge rate applicable plus the adjusted rate of charge. Access is calculated on the basis of non-SRF outstanding credit.

Figure 4. Fund Credit Outstanding in the GRA around Peak Borrowing 1/
(In percent of quota)



Source: IFS and IMF staff estimates.

1/ Peak borrowing is defined as the highest level of credit outstanding in percent of quota. Month t represents the month of the highest historical credit outstanding in percent of quota. For Argentina t is September 2001, for Brazil t is September 2003, for Turkey t is April 2003 and for Uruguay t is August 2004. Dashed lines indicate projections. For comparability, all projected repurchases are assumed to be on an obligations basis.
2/ Assumes no further purchases.
3/ Includes the SBA approved on May 11, 2005.
4/ Assumes access of SDR 766.3 million under a 3-year SBA beginning in June 2005.

INTERNATIONAL MONETARY FUND

URUGUAY

Request for Stand-By Arrangement

Supplementary Information

Prepared by the Western Hemisphere Department
(In collaboration with other Departments)

Approved by Markus Rodlauer and Juha Kähkönen

June 6, 2005

1. Since issuance of the staff report, additional information on recent developments and policy measures has become available. This information does not alter the thrust of the staff appraisal.

2. **Prior actions**. As explained in the staff report, there were four prior actions for Board consideration of the authorities' request for a new stand-by arrangement—three were fully met and, for the last, there was satisfactory progress leading staff to recommend going ahead.

- **NBC.** ***Appoint a Board of Directors with appropriate professional experience and an interim CEO with banking experience***. On May 2, 2005 new board members were appointed with the appropriate experience, and on May 24, 2005 the Board appointed an interim CEO with banking experience.

- **Tax administration**.

    - ***Formulate a plan to coordinate tax audits between the DGI, the BPS, and the Ministry of Labor***. A coordinating committee established for this purpose has set out a comprehensive plan to coordinate tax collections, including stepped-up audits.

    - ***Issue a decree to implement the DGI's modernization law***. The decree was issued on May 30, 2005.

    - ***Establish a large taxpayers unit (LTU) at the DGI***. The May 30 decree implementing the DGI modernization law also provides for establishment of the LTU. However, in accordance with the DGI modernization law, the decree only takes effect 30 days after issuance; thus, the prior action has not been fully met. Nevertheless, staff considers that the authorities have made satisfactory progress toward establishing an LTU. With the decree, the FAD TA mission on revenue

administration (June 8–22) can now work with the authorities on finalizing the LTU's organizational structure and function.

3. **Recent economic developments have been generally favorable**.

- Leading indicators point to growth consistent with program projections. Through April, exports were up 17 percent and imports up 36 percent (y/y). The 12-month rate of inflation declined in May to 4.2 percent.

- In light of appreciation pressures on the peso and the benign inflation outlook, on May 17 the central bank resumed purchases in the foreign exchange market (through end-May, it had purchased US$27 million), taking advantage of current conditions to bolster its international reserves.[1] The foreign exchange purchases were not sterilized.

- The fiscal program is on track. Data through April show tax revenue stronger than programmed, mainly reflecting better corporate income tax performance, and discretionary spending is well within the program.

- On May 26, Uruguay reopened the 12-year global bond issue of May 10 and placed an additional US$200 million with a yield of 8.875 percent, some 37.5 basis points below that obtained in the initial placement of US$300 million. This completed the government's 2005 external financing plan.

4. **The Ministry of Finance in mid-May presented to a congressional commission draft guidelines for the refinancing of distressed bank debts.**[2] The guidelines would apply to debts that were incurred prior to the 2002 crisis and past due as of December 2004. They would provide guidance on the terms of (discounted) settlement of the debts or their restructuring,[3] and be non-binding. The government's proposal is generally seen as a response to more aggressive proposals presented to the commission to grant relief to domestic debtors through legally-forced rescheduling of bank debt. In recent discussions with the authorities, staff expressed concern that the guidelines could be seen as a bailout and a step backward in the progress made to date in improving creditor discipline. The authorities assured staff that their proposal was a pre-emptive step to ensure continued market-based and

[1] The central bank bought some US$170 million from the market in the first quarter of 2005 (partially sterilized).

[2] The commission, created in April, will continue to hear proposals on this matter for the next month or so, and is expected to make a recommendation to the congress soon thereafter.

[3] For debt less than US$15,000, the guidelines allow for cash repayments at a principal discount of up to 50 percent or a rescheduling after paying interest due this year. For debts up to US$250,000, the guidelines allow for a principal discount of up to 20 percent for cash repayments or a rescheduling provided that 10 percent of the debt is paid upfront.

decentralized resolution of distressed debts. They explained that it was primarily aimed at guiding the system in helping relatively small debtors that were hard hit by the 2002 financial crisis, in a transparent and even-handed manner. They also noted that the proposed guidelines were broadly consistent with the existing internal debt resolution policies of BROU. The authorities agreed with staff that the upcoming reform of bankruptcy legislation will need to address the issue of resolution of distressed debts in a comprehensive and consistent fashion, and there was agreement that the guidelines would not impact the results of the debt sustainability analysis.

INTERNATIONAL MONETARY FUND

EXTERNAL RELATIONS DEPARTMENT

Press Release No. 05/136
FOR IMMEDIATE RELEASE
June 8, 2005

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US$ 1.13 billion Stand-By Arrangement for Uruguay

The Executive Board of the International Monetary Fund (IMF) today approved a 36-month, SDR 766.3 million (about US$ 1.13 billion) Stand-By Arrangement for Uruguay, aimed at supporting the country's economic stabilization through mid-2008 and helping to foster sustainable growth while reducing vulnerabilities related to high public debt. The approval enables the immediate release of SDR 30.7 million (about US$ 45.3 million) under the arrangement.

Following the Executive Board discussion on Uruguay, Mr. Agustín Carstens, Deputy Managing Director and Acting Chair, made the following statement:

"Uruguay's economic performance over the past three years has been very favorable. After stabilizing the economy from the severe financial crisis in 2002, the authorities' Fund-supported program achieved an impressive recovery of growth, in an environment of rising exports and international reserves, falling inflation, and sharply improving fiscal accounts. These favorable results reflect the steadfast pursuit of prudent fiscal and monetary policies, important structural reforms especially in the banking sector, and a generally supportive external environment. The smooth political transition to a new government following the 2004 elections also helped solidify market confidence in sustained domestic consensus on a core framework of stability and growth-oriented policies.

"While much has been achieved over the past three years, the task is now to sustain the recent recovery and build a lasting trend of rapid growth and improving social conditions. Although fiscal adjustment, prudent monetary policy, and banking reforms have reduced economic vulnerabilities, important weaknesses and risks remain—including a still large public debt, weaknesses in the financial sector, and obstacles to investment that hamper Uruguay's growth potential and its ability to compete in the global market place. There have also been delays with planned tax and pension system reforms, which—unless addressed—leave the fiscal accounts vulnerable to shocks and contingent costs.

"The authorities' economic strategy aims to address these challenges and create a sustained dynamic of rapid growth, declining public debt, and improving social conditions. Key to their strategy is the creation of a favorable environment for private investment, through the pursuit of

prudent fiscal and monetary policies and a comprehensive growth-oriented structural reform agenda. Decisive implementation of these envisaged measures will be crucial. At the same time, the strategy places increased emphasis on ensuring that the benefits of growth are more equally shared and on addressing the lingering social dislocations from the recent crisis.

"A key plank of the authorities' strategy is continued fiscal consolidation, supported by structural fiscal reforms, while making room for a temporary social emergency program to address urgent social needs. Monetary policy will be geared to achieving a steady reduction in inflation to the low single digits, while strengthening international reserves in the context of a flexible exchange rate system. As in the fiscal area, the agenda includes important institutional reforms to strengthen the framework and instruments of monetary policy. A broad range of growth-enhancing structural reforms, supported by the World Bank and the Inter-American Development Bank, aim to strengthen the environment for private investment and productive enterprise, with emphasis on improving access to financing, competition, infrastructure, and the regulatory framework," Mr. Carstens said.

Annex

Program Summary

The authorities' program for 2005–08 envisages real GDP growth to average around 4 percent a year, benefiting from the momentum of the recent recovery and two large foreign investment projects. Inflation is targeted to decline gradually, by 1 percentage point a year, to around 3½ percent by 2008, while exports are projected to increase by about 9 percent a year and net international reserves to increase by US$1.5 billion over the program period. A key program goal is to gradually re-establish Uruguay's access to international capital markets, instrumental to the country's longer-term growth prospects as well as the envisaged exit from IMF financial support.

The fiscal program is anchored on a medium-term primary surplus target of 4 percent of GDP, to bring down the public debt-to-GDP ratio to about 60 percent by 2008 and to about 50 percent by 2012. Key measures to achieve these goals include a comprehensive tax reform, an improved budgetary framework and firm spending control, timely adjustment of public tariffs, and reform of the specialized pension funds. The primary surplus in 2005–06 would be somewhat lower to accommodate a temporary social emergency program.

Monetary policy will continue to be based on base money targeting in the context of a flexible exchange rate regime, until conditions are in place to move to an inflation targeting framework. To prepare for this move, the program envisages a strengthening of the autonomy and financial position of the central bank.

Financial system reforms are to continue, building on the crisis resolution efforts of recent years with a view to creating the necessary infrastructure of financial intermediation in support of sustained private-sector led growth. Priorities include the continued reform of public banks (BROU and BHU); strengthening NBC, including by divesting the government's stake; further improving the supervisory framework; and overhauling the bank resolution framework to ensure rapid and efficient resolution of banking problems should they occur.

A wide range of growth-enhancing reforms constitute another core pillar of the program and are designed to stand beside prudent macroeconomic policies and supporting institutional reforms. Many of these reforms are being supported under World Bank and the Inter-American Development Bank lending programs, and aim at creating an environment conducive to private investment and productive enterprises. The reforms include developing capital markets, opening up sectors currently reserved for the state to private sector participation and competition, bolstering property and creditor rights, improving infrastructure, and strengthening Uruguay's investment climate.

Table 1. Uruguay: Selected Economic Indicators, 2002–08

	2002	2003	2004	Projection 2005	2006	2007	2008
			(percentage changes)				
Output and prices							
Real GDP	-11.0	2.5	12.3	6.0	4.0	3.5	3.0
Consumer prices (eop)	25.9	10.2	7.6	6.5	5.5	4.5	3.5
Exchange rate (Ur$/U.S.$, eop)	84.2	7.3	-2.8	...	...	...	...
GDP (in U.S. dollar billion)	12.1	11.2	13.3	16.4	18.0	19.4	20.5
Monetary indicators							
Currency issued	5.8	22.4	15.7	11.6	12.0	9.4	11.5
Credit to the private sector (constant exchange rate)	-13.7	-25.5	-20.1	8.6	14.1	12.5	15.3
			(percent of GDP)				
Public sector operations							
Revenue	31.1	31.1	30.0	30.2	29.4	29.3	29.1
Non-interest expenditure	31.1	28.4	26.3	26.7	25.6	25.3	25.1
Primary balance	0.0	2.7	3.8	3.5	3.7	4.0	4.0
Interest	4.7	6.0	6.0	5.2	5.0	4.8	4.8
Overall balance	-4.6	-3.2	-2.2	-1.7	-1.3	-0.8	-0.8
Public sector debt 1/	95.5	104.4	92.5	75.8	70.1	65.5	62.5
			(U.S. dollar million)				
External indicators							
Merchandise exports, f.o.b.	1,922	2,273	3,025	3,276	3,463	3,862	4,248
Merchandise imports, f.o.b.	1,874	2,092	2,990	3,713	4,429	4,144	4,430
Current account balance (in percent of GDP) 2/	3.1	-0.3	-0.8	-2.8	-5.3	-1.2	-0.7
External debt (in percent of GDP)	87.2	98.3	87.4	70.2	63.4	58.1	54.5
Gross official reserves	776	2,087	2,512	2,656	2,866	3,067	3,230
in percent of short-term debt and FX deposits	7.0	20.0	27.7	26.2	25.7	26.5	27.4
Net international reserves (program definition) 3/	-2,391	-2,508	-2,218	-1,938	-1,692	-1,106	-738
REER (percentage depreciation -, e.o.p.)	-20.3	-13.2	9.3	...	...	...	...

Sources: Data provided by the Uruguayan authorities; and IMF staff estimates.

1/ Includes nonfinancial public sector debt plus liabilities to the IMF.

2/ Includes imports of the forestry project Botnia, which are fully financed by FDI.

3/ Includes all liabilities to the Fund and to resident financial institutions.

**Statement by Hector Torres, Executive Director for Uruguay
and David Vogel, Advisor to Executive Director
June 8, 2005**

1. On behalf of the Uruguayan authorities, we would like to thank the Fund's Management and staff for their hard work and constant support since the new government was elected, allowing the country to apply, just nearly three months after the new administration was positioned, for a strong IMF-supported program. Meanwhile, we would like to reiterate the government's main objectives: to achieve higher and sustainable growth rates; to enhance the level and quality of employment; to significantly reduce poverty conditions; and to improve social equity.

2. Macroeconomic stability is a necessary condition to achieve our authorities' objectives; thus, they are fully committed to undertake sound macroeconomic policies. In the fiscal area, the government's program establishes important primary surpluses (3.5 percent of GDP in 2005, 3.7 percent in 2006, and 4 percent in 2007 and beyond) that are fully compatible with the Uruguayan authorities' high priority in ensuring debt sustainability. It is important to note that Uruguay's primary surplus targets have been set up in consistency with the efforts required by the interest burden and the objective to make the country's debt sustainable. The aforementioned fiscal primary surplus targets will allow the country to reduce substantially and systematically the overall fiscal deficit. Likewise, debt-to-GDP ratio will be reduced from 92 percent in 2004 to 76 percent this year, and will continue falling to 62 percent in 2008 and 50 percent in 2012, according to the Staff's Debt Sustainability Analysis presented in the current staff report. Beyond this, it is also important to note that, as stressed in the staff report, our authorities have agreed to save any revenue over performance under the program.

3. As previously mentioned, our authorities will follow strict expenditure policies, while reorienting expenditures, improving targeting, and undertaking comprehensive reforms of specialized pension funds. Furthermore, they are committed to avoid a procyclical fiscal policy, consequently recuperating in the medium-term the possibility of using fiscal policy to smooth economic fluctuations. Our authorities see the five-year budget law as an important opportunity to improve the efficiency of the public sector, reprioritize expenditure, and introduce proper incentives in public administration.

4. The Central Bank's autonomy will be increased as a key component of our authorities' plan to ensure its capacity to enforce prudent policies toward maintaining inflation rates in the targeted range -in a context of an appropriate exchange rate flexibility-, and progressing toward an inflation-targeting regime. Market's confidence in the Central Bank's capacity to keep inflation under control is reflected, among other things, by the fact that inflation expectations are in line with the Central Bank's envisaged targets. Likewise, the nominal exchange rate has shown an appreciating trend over the last year, as it has been a common behavior around many regions of the world –even though, as noted in the staff report, the peso in real effective terms still remains about 25 percent below its pre-crisis level.

5. Taking advantage of the current level of the nominal exchange rate, in a context in which the inflation has been at the bottom of the inflation target range, the Central Bank has been buying dollars to further strengthen its reserve position, thus allowing to meet the related quantitative performance criteria. Regarding the external current accounts, as noted in the staff report, Uruguay has shifted to a moderate deficit. While exports have continued showing a robust expansion (20 percent in the first quarter of 2005, compared to the same period of 2004), imports have increased at an even higher rate (42 percent), reflecting to a large extent a strong increase of imports of capital goods (70 percent).

6. Productive investment, which has historically been the Achilles' heel for the country, is critical in spurring Uruguay' growth. Given that currently the country has limited scope for increasing public investment, the government is aware that domestic and foreign private investment must have a predominant role in the next years. Taking into account Uruguay's comparative advantages in some sectors –among others, food industry, forestry, tourism, communications, information technology-, the government's policies will pursue the promotion of value-added production. Consequently, along with the necessary condition of macroeconomic stability, the government will implement pending structural reforms aimed at strengthening institutional frameworks affecting private investment. In order to attain that, our authorities firmly believe that Uruguay has an important platform, consisting of its long tradition of respecting property rights and making the rules of the game predictable.

7. Financial infrastructure and financing availability is key for investment. To this end, it is crucial to continue improving market confidence by, among other things, enhancing institutions in the banking supervision area. For instance, the authorities are further strengthening bank supervisory and prudential regulations, while continuing with the restructuring of public banks. Among the expected reforms of the financial sector is the establishment of a suitable bank resolution framework –including a refined deposit insurance scheme-, whose necessity was clearly demonstrated during the 2002 crisis. At the same time, improving governance structure, risk management, and credit policies at the public banks is critical for the stability of the system. Since widespread financial dollarization remains an important vulnerability, the authorities will make significant efforts to diminish it, not only through prudential regulations, but also by promoting the development of financial products and instruments in local currency. Our authorities are aware that de-dollarizing the economy involves cultural issues, thus it will take time to promote a sustainable change.

8. The tax system reform is a central component of our authorities' structural reform agenda. This reform will be oriented by efficiency as well as vertical and horizontal equity considerations, and it will be fully compatible with our authorities' objective of boosting private investment. As stressed in the Fund paper on Investment Climate[1], "while tax incentives may, at the margin, attract investment to certain industries (particularly, capital intensive sectors), a stable and transparent corporate tax regime is

[1] Investment Climate – Concept and Selected Issues for Fund Surveillance (IMF document).

more important for enhancing the level and stability of investment flows". Our authorities agree with this comment, and have proceeded to promote a simplification of the tax system, with lower yet more efficient and effective taxes. While preparing for the introduction of a comprehensive personal income tax for the first time[2], the Uruguayan authorities will make a profound review of the current tax regime's exemptions and subsidies, several of which probably do not have an economic rationality. The authorities are committed to introduce a comprehensive reform of the revenue administration, which they see as crucial to accompany the tax system reform.

9. Our authorities are fully committed to maintain an open trade regime, so as to fully integrate Uruguay in the global economy. The government's commitment to Mercosur is absolutely compatible with its intention to continue diversifying the country's export base and external markets. In this regard, our authorities see Mercosur as an open region; a launching platform rather than an ending point. Our authorities have a firm decision on carrying out other needed reforms to further improve the investment climate such as those related to regulatory and legal frameworks –for instance, by amending the current bankruptcy legislation. Clearly, while some activities need further deregulations to create a more competitive environment, others –particularly, those related to public utilities- need to have better regulations. In this regard, it is important to stress that our authorities see the role of state run public services as complements rather than alternatives to market-oriented policies. Our authorities are committed to improve governance at public enterprises, and to seek associations in joint ventures with private or public capital partners, thus preparing the public enterprises for competition with the private sector. Meanwhile, private initiative is a core engine in any economy, and small and medium enterprises are important instruments to reduce poverty, therefore simplifying business start-up procedures is an important issue for our authorities. [3]

10. As underscored in a recent issue of IMF's Finance & Development[4], "managing the tension between creating a favorable investment climate for firms and achieving other social goals is a major challenge for governments at all levels". In this regard, the Uruguayan government is absolutely committed to making its growth and social objectives fully compatible and synergetic. For instance, in May, the authorities launched a national agreement on employment, income and responsibilities (*Compromiso Nacional*

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[2] As Mr. Tanzi and Mr. Zee ("Tax Policy for Emerging Markets: Developing Countries", IMF WP/00/35) underline, personal income taxes and property taxes have been very little exploited in developing countries. Consequently, according to the authors, tax incidence studies of developing countries have found that tax systems rarely achieve effective progressitivity.

[3] Although there was some improvement over the last few years, "Doing Business" from the World Bank underscores that much remains to be done, particularly regarding the number of procedures to start a business and its cost, areas in which Uruguay shows relatively poor indicators. The IDB is supporting the authorities on a restructuring of business start-up procedures.

[4] Smith, Warrick, and Mary Hallward-Driemeier, "Understanding the Investment Climate", Finance & Development, March 2005.

para el Empleo, los Ingresos y las Responsabilidades)[5], for which some European models were considered, such as Ireland's, which is based on agreements among the government, employers and trade unions. Indeed, the aforementioned national agreement is oriented toward achieving common objectives to all economy's actors, and creates a framework of rights, obligations and responsibilities. This common framework will be expanding to include social and community issues. Therefore, consensus should now play a positive role in the decision-making process to enact the needed reforms and to make them long-lasting and less subject to reversals.

11. In the same direction, a two-year social emergency program is being carried out. This temporary program is being implemented in a transparent manner, providing appropriate incentives, aimed at reinserting into the economic and community activities people who were expelled from the system during the economic crisis. By providing, among other things, support in education, nutrition, and primary health, these people (particularly children) will be better prepared to reinsert into the system. Meanwhile, this program is regarded critical in building up ownership to complete the pending structural reforms. It is clear that reducing exclusion and inequity improves the capacity of a government to push ahead with changes without affecting stability. Hence, our authorities' efforts aimed at integrating people and objectives are also an important contribution to a better investment climate.

12. Our authorities would like to express their firm willingness to establish a well-articulated exit strategy from the Fund's financial support, which has been beneficial for the Uruguayan people to the extent that it allowed the country to overcome one of the most severe crisis in Uruguay's history. Clearly, Uruguay's new program, supported by the Fund, will continue to increase market confidence in the country, resulting in Uruguay's increasing access to the external financial markets. Indeed, the strong possibility to reach a new Stand-By Arrangement with the Fund has been key in allowing Uruguay to place in international markets US$ 300 million of 12-year bonds in early May, and US$ 200 million in bonds with the same maturity in late May. Finally, we would like to reiterate that our authorities are strongly committed in making Uruguay a successful case for the benefit of the Uruguayan people and also for the Fund.

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[5] On May 19, the Uruguayan government called employers and workers to join in this agreement aimed at having a national strategic project, which contributes to fulfill the above-referred objectives established by the administration. More details could be found in the Uruguayan Presidency's web site (www.presidencia.gub.uy/_Web/noticias/2005/05/2005051901.htm).