December 2006
IMF Country Report No. 06/425

Uruguay: 2006 Article IV Consultation, Fourth Review Under the Stand-By Arrangement and Request for Waiver of Nonobservance and Modification of Performance Criteria—Staff Report; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Uruguay

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2006 Article IV consultation with Uruguay, fourth review under the stand-by arrangement and request for a waiver of nonobservance and modification of performance criteria, the following documents have been released and are included in this package:

- the staff report for the combined 2006 Article IV Consultation, Fourth Review Under the Stand-By Arrangement and Request for Waiver of Nonobservance and Modification of Performance Criteria, prepared by a staff team of the IMF, following discussions that ended on May 17, 2006, 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 June 14, 2006. 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;

- a staff statement of June 28, 2006 updating information on recent economic developments;

- a Public Information Notice (PIN) and Press Release, summarizing the views of the Executive Board as expressed during its June 28, 2006, discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively; and

- a statement by the Executive Director for Uruguay.

The document listed below has been or will be separately released.

Selected Issues Paper

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.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

URUGUAY

Staff Report for the 2006 Article IV Consultation, Fourth Review Under the Stand-By Arrangement and Request for Waiver of Nonobservance and Modification of Performance Criteria

Prepared by Western Hemisphere Department
(In Consultation with Other Departments)

Approved by Ranjit Teja and Adrienne Cheasty

June 14, 2006

Last Article IV consultation. On July 11, 2003, Directors recommended (i) continued fiscal consolidation; (ii) maintaining a floating exchange rate regime; (iii) addressing balance sheet vulnerabilities; and (iv) creating room for private sector-led growth. An Ex Post Assessment was completed on March 18, 2005.

Developments. Economic recovery since the 2002 crisis has been strong. Export-led growth, prudent monetary policy in the context of a flexible exchange rate regime, and fiscal consolidation have contributed to a strengthened external position, low inflation and a sharp fall in public debt. While near-term risks have declined, significant vulnerabilities remain, related to high public debt and balance sheet dollarization.

Article IV issues. Discussions focused on policies to reduce macroeconomic vulnerabilities further, including by (i) sustaining low inflation and further building reserves within a flexible exchange rate regime; (ii) reducing financial sector vulnerabilities linked to high dollarization and large state banks; (iii) sustaining fiscal consolidation and reducing budget rigidities to lower public debt and improving the public debt structure; and (iv) trade diversification, labor market reforms, and improving the investment climate to reduce the risks to the growth outlook.

Fourth review issues. Preliminary data indicate that all performance criteria for this review have been met, except for approval of the police pension reform, for which a waiver and resetting to October is requested. Final data will be reported prior to the Board meeting. Approval dates for tax and financial sector reforms, which are performance criteria, are proposed to be modified within 2006 to reflect the congressional timetable. Also, it is proposed to revise the June monetary performance criteria to reflect the stronger NIR and to establish the end-September and end-December performance criteria.

Staff discussions. Discussions were held in Montevideo during May 3–17. The mission met with Finance Minister Astori, Central Bank President Cancela, Industry Minister Lepra, Labor Minister Bonomi, other senior officials, and private sector and labor representatives. The staff team comprised M. Piñón (Head), J. Canales-Kriljenko, S. Eble (all WHD), H. Finger (PDR), A. Hajdenberg (FAD), H. Kamil (ICM), G. Gelos (Resident Representative), S. Ramirez and S. Seelig (MFD). C. Pazarbasioglu (FSAP Head, ICM) and D. Vogel (OED) participated in some of the policy discussions.

Exchange system. 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 exchange restrictions on current international transactions. Uruguay has followed an independently floating exchange rate regime since July 29, 2002, but the authorities have frequently intervened to build reserves and reduce exchange rate volatility.

Stand-By Arrangement. In March, Uruguay repurchased in advance all Fund obligations falling due in 2006 (SDR 434.3 million) as a cash management operation. Outstanding obligations as of end-April 2006 were SDR 1,261 million (411 percent of quota), and SDR 588.5 million remain to be disbursed under the program.

Data. Uruguay subscribed to the SDDS in February 2004 and its statistical database is generally adequate for surveillance (Appendix V).

Contents Page

I. Background: *Assessing Progress and Identifying Vulnerabilities*................................4
A. Macroeconomic and Financial Trends..4
B. Underlying Vulnerabilities and Sensitivity Analysis......................................10
C. Medium-Term Outlook and Alternative Scenarios..13

II. Policy Discussion: *The Challenge of Reducing Vulnerabilities*.................................14
A. Monetary and Exchange Rate Policies under Volatile Capital Flows.............14
B. Sustainable Fiscal and Public Debt Framework 17
C. Financial Sector Vulnerabilities..20
D. Growth, Competitiveness, and Diversification...21

III. Fourth Review Discussions..22
A. Recent Developments 22
B. Discussions 24

IV. Staff Appraisal: *The Need to Stay the Course*..25

Boxes
1. Assessment of External Competitiveness 16
2. Measures Taken to Address Financial System Risks Arising from High Dollarization..17
3. Main Findings and Recommendations from the FSAP 19

Tables
1. Selected Economic and Social Indicators..28
2. Balance of Payments...30
3. Public Sector Operations...31
4. Summary Accounts of the Banking System 33
5. Financial Soundness Indicators...34
6. Vulnerability Indicators 35
7. Public Sector Financing Outlook, 2006 36
8. Performance Under the 2006 Economic Program 37
9. Schedule of Purchases Under the Stand-By Arrangement, 2005–08 39
10. Projected Payments to the Fund and Capacity to Repay 40

Figures
1. Fiscal Developments...8
2. Monetary Developments...9

Appendices

I. Public Sector Debt Sustainability Analysis and Balance Sheet Risks 41
II. Fund Relations 52
III. Relations with the World Bank 55
IV. Relations with the Inter-American Development Bank 57
V. Statistical Issues 59

Attachments

I. Supplementary Letter of Intent 62
II. Supplementary Technical Memorandum of Understanding 66

I. BACKGROUND: *ASSESSING PROGRESS AND IDENTIFYING VULNERABILITIES*

1. **Focus**. With the recovery from the 2002 crisis well advanced, discussions focused on policies to reduce remaining vulnerabilities and sustain growth. Even though near-term risks are relatively low in the current environment, strong policy implementation is needed to consolidate macrostability and confidence in the system, reduce further still important balance sheet vulnerabilities, including from high public debt and dollarization, and sustain growth over the medium term. The generally favorable domestic and external conditions, and continued political support for the program, provide an important opportunity.

A. Macroeconomic and Financial Trends

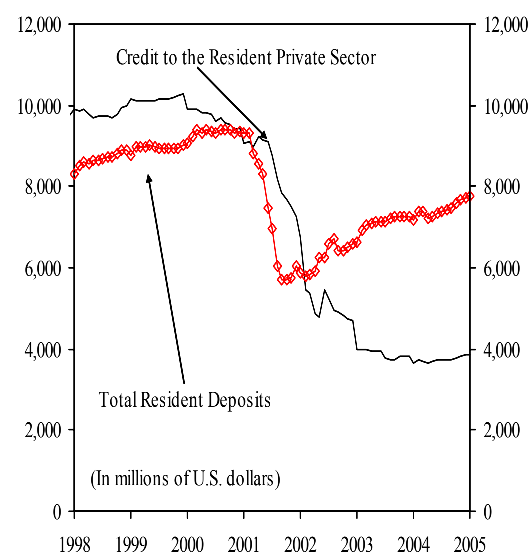
2. **Macroeconomic indicators**. Many of those have improved to better than pre-crisis levels.

- ***Economic recovery***. GDP has rebounded in the last two years (18 percent), reaching its 1998 pre-crisis peak, mainly led by exports and investment. Unemployment, while still high at 12 percent and mainly structural, has declined considerably with the reduced output gap, with labor participation rates now close to pre-recession levels. Real wages have started to recover, but are still some 13 percent below the 2001 levels.

- ***Exchange rate***. The peso has appreciated significantly since the sharp depreciation that followed its float in mid-2002. Still, it remains some 20 percent more depreciated in real effective terms compared with pre-crisis levels. In 2005, even as the central bank took advantage of strong capital inflows to rebuild foreign exchange reserves, the peso strengthened by 8½ percent vis-à-vis the U.S. dollar. BCU resistance to further peso appreciation led to a stable exchange rate in early 2006, but some flexibility has been restored since.

- ***Low inflation***. Inflation was quickly brought under control after spiking in 2002, aided by the peso appreciation, and since 2004 has been in single digits.

- ***Improved financial indicators***. Soundness indicators have improved markedly, including capital adequacy and loan performance. Credit has started to pick up slowly, but still amounts to only 50 percent of deposits (70 percent in 2001). Also, the share of sight deposits in total deposits is now well above that five years ago.



Uruguay: Banking System Indicators: 2001-2006
(in percent)

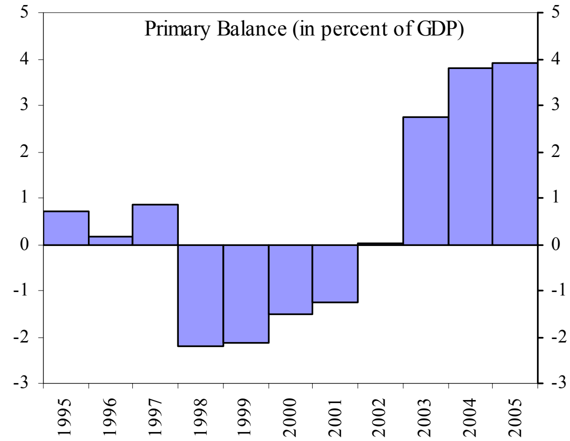
	2001	2002	2003	2004	2005	March 2006
Capital to assets						
Banking system	7.3	-8.8	6.2	8.0	8.0	8.2
(Excluding BHU)	7.2	-10.0	7.2	8.3	8.6	8.5
BROU	9.3	4.6	5.2	6.8	6.9	6.5
BHU	8.7	6.0	0.7	8.1	2.1	5.9
Private Banks	5.8	-22.8	8.5	9.3	9.5	9.7
Return on assets						
Banking system	-2.0	-29.8	-2.8	0.7	0.5	2.5
(Excluding BHU)	0.0	-25.3	-1.1	-0.1	0.7	1.2
BROU	0.2	-4.2	0.1	0.5	0.6	1.2
BHU	-15.6	-61.7	-16.8	6.8	-0.7	15.2
Private Banks	-0.2	-42.6	-2.0	-0.2	1.0	1.3
Nonperforming loans to total loans						
Banking system	16.1	38.6	13.6	9.2	8.4	8.0
(Excluding BHU)	12.4	37.2	9.4	3.8	2.7	2.3
BROU	35.8	34.5	10.7	2.7	2.6	2.7
BHU	46.5	60.0	61.5	65.7	66.9	68.7
Private Banks	4.9	39.0	7.3	3.9	1.7	1.9
Credit to deposits						
Banking system	60.4	65.9	42.0	38.7	38.5	35.9
(Excluding BHU)	58.8	62.8	38.8	36.0	35.6	32.9
BROU	56.2	48.2	34.8	30.6	29.3	26.7
BHU	67.9	167.4	145.5	123.1	119.1	123.2
Private Banks	59.3	71.6	40.1	38.6	38.5	37.3
Sight to total deposits						
Banking system	28.1	48.9	45.2	54.1	59.3	60.8
(Excluding BHU)	30.1	53.3	50.1	59.4	64.1	65.5
BROU	36.9	31.1	50.6	57.2	64.8	65.0
BHU	13.3	8.6	7.7	10.7	19.4	19.5
Private Banks	28.1	67.0	50.1	62.3	64.8	66.5

Source: Superintendency of Banks and Fund staff estimates.

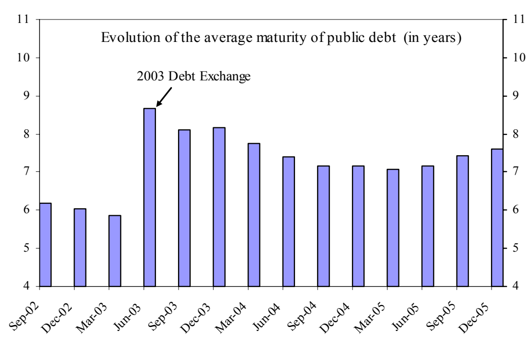
- ***Strengthened external position***. With buoyant export growth, the external current account ended with only a modest deficit in 2005, despite a steep rise in imports stemming partly from high oil prices and a pick-up in FDI. International reserves have reached US$3.4 billion, compared to US$3.1 billion before the crisis and a low of US$0.8 billion in 2002; and NIR has increased by over US$1.5 billion since.
- ***Declining public debt***. Strong growth, the improved fiscal position, lower interest costs, and currency appreciation have lowered the public debt-to-GDP ratio from 105 percent at end-2003 to 69 percent at end-2005.

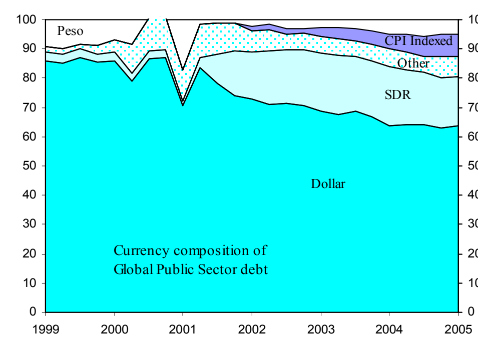
3. **Underlying factors**. These results have been driven by solid macro and structural policies, supported by favorable external conditions. Major policy achievements include:

- ***Substantial fiscal adjustment***. The primary balance has shifted from large deficits during 1998–2001, to surpluses rapidly approaching the 4 percent of GDP medium-term target. The adjustment fell mainly on expenditures, where wages, social security benefits and capital spending have significantly contracted in real terms (Figure 1). A five-year budget consistent with the medium-term primary surplus target of 4 percent of GDP was approved in 2005.



- ***Strengthened public debt management***. Following the end-May 2003 debt exchange, the debt structure has been gradually improved by lengthening maturities, and increasing the share of fixed rate and peso debt (mostly indexed to the CPI). Still, some 85 percent of public debt continues to be denominated in foreign currency. A debt management unit at the Ministry of Finance was recently established to prepare and implement a strategy to further reduce vulnerabilities.





- ***Monetary policy geared at maintaining low inflation in the context of a flexible exchange rate***. The adoption of a flexible exchange rate regime in mid-2002, after several years of a crawling band, has been a key accomplishment in allowing the economy to better adjust to shocks and in providing incentives for de-dollarization. Also, the new framework of preannounced one-year-ahead inflation target ranges, pursued by managing base money, has lowered inflation and inflationary expectations. Facing large private capital inflows, the authorities have intervened in the foreign exchange market to increase international reserves and slow down peso appreciation (Figure 2).

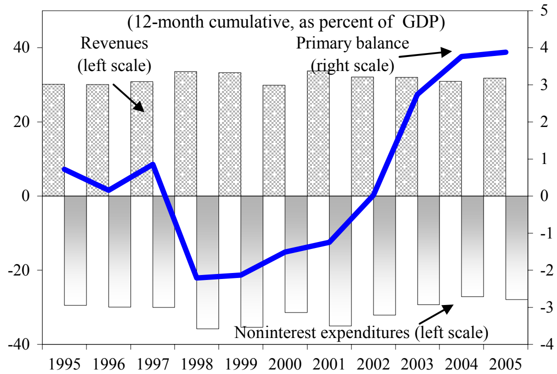
- ***Financial sector reforms***. Prudential norms were tightened to internalize risks from high financial dollarization and exposure to regional contagion, and to reduce credit risk. While the state bank BROU has improved some procedures, further progress with risk management and controls is still needed. The state mortgage bank BHU was transformed into a nondeposit taking institution and is being further restructured to restore its financial viability. NBC, the bank formed with performing assets of three of the failed banks was recently privatized. A bill being considered by Congress sets price stability as a main goal of the BCU and delinks the appointment of its board members from the political cycle; unifies financial supervision; and creates an agency outside the BCU to manage the deposit insurance fund and bank resolutions.

- ***Sustainable income policies***. To channel wage pressures, the new government reinstated wage councils, where agreements are reached at the industry level, with the government intervening in case of an impasse. The resulting real wage increases in 2005 of 4–5 percent have been broadly in line with productivity growth. Public sector wage rules were modified in the last five-year budget, linking increases to inflation and economy-wide productivity growth, and made conditional on attainment of the primary fiscal target.

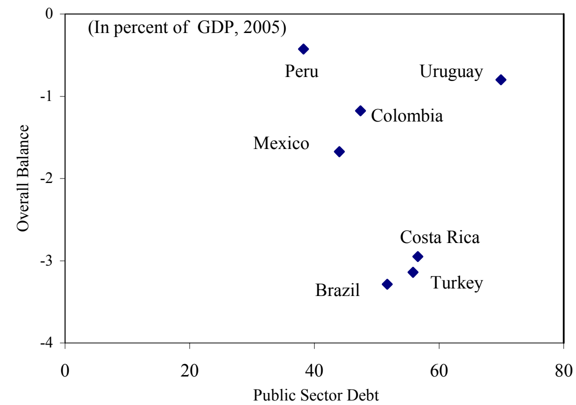
- ***Other reforms to lay the foundations for sustained growth are in train***. A far-reaching tax reform bill currently being debated in Congress, while revenue neutral, is expected to improve significantly the tax structure and introduce a personal income tax. A new competition bill is also being considered by Congress and a bankruptcy framework bill establishing Chapter-11 type procedures is to be submitted shortly.

Figure 1. Uruguay: Fiscal Developments: 1995-2005

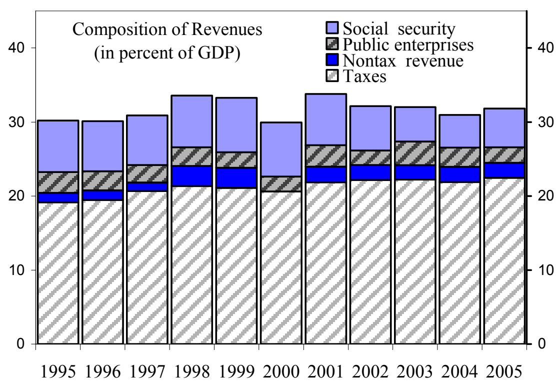
A major fiscal adjustment began in 2002...



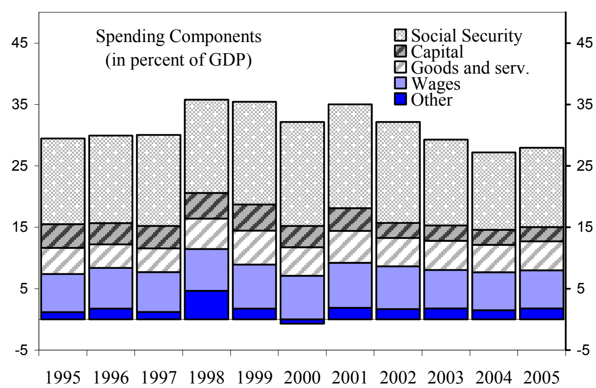
...and Uruguay's fiscal performance compares well to other countries with similar debt levels.



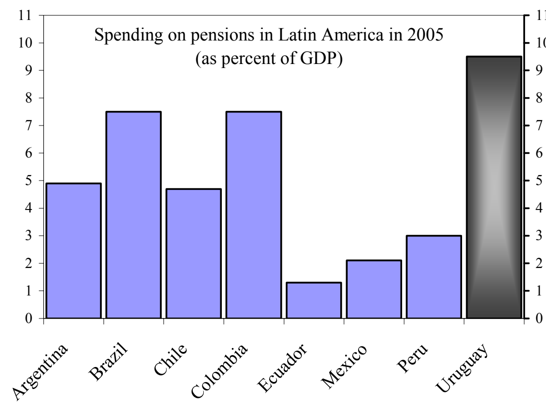
While revenues have remained broadly stable..



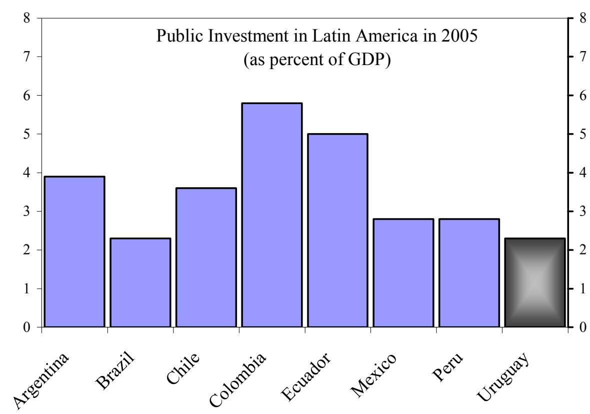
...expenditures have been greatly reduced.



Spending on pensions remains relatively high...

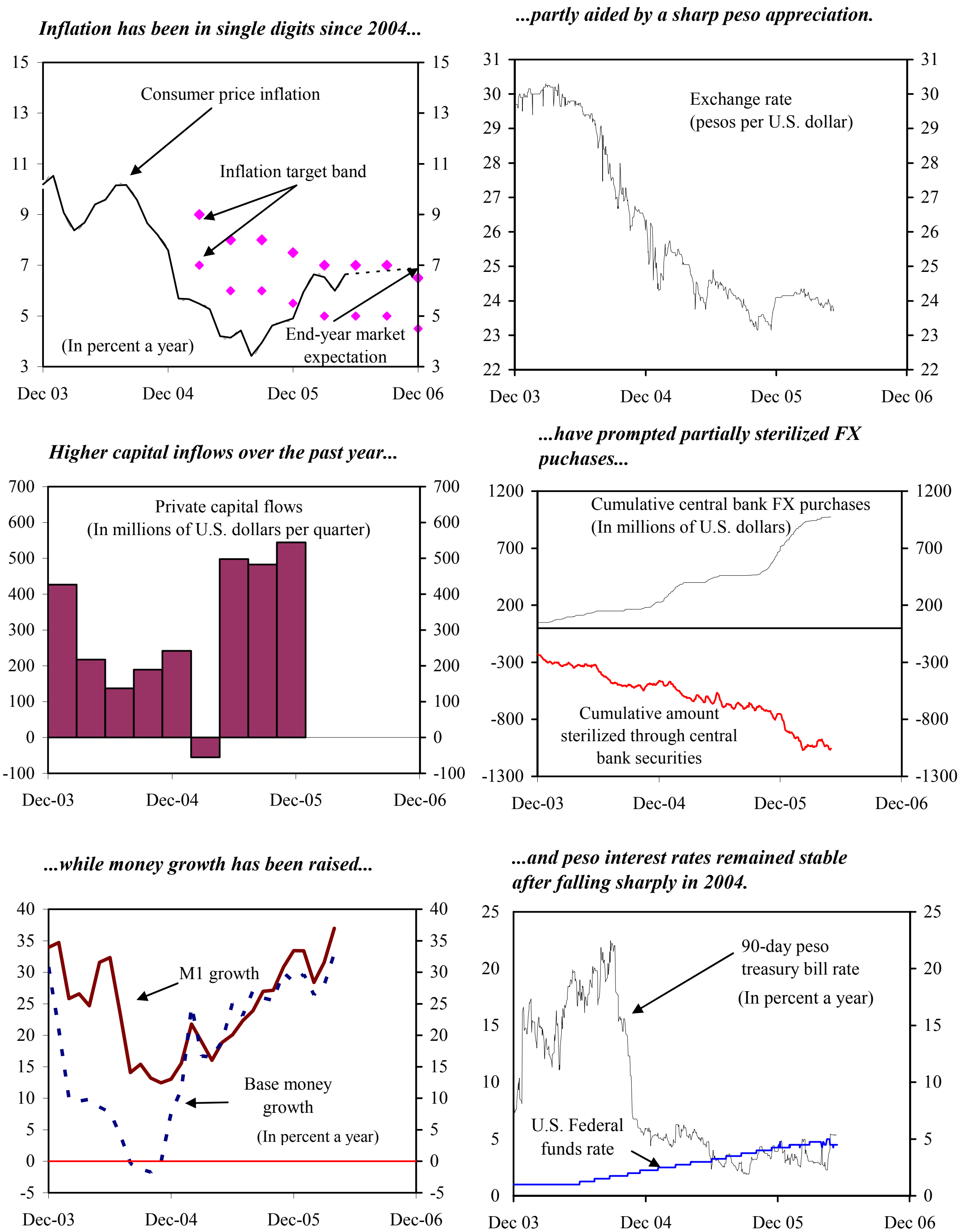


…and public investment relatively low.



Source: Ministry of Finance; and Fund staff estimates.

Figure 2. Uruguay Monetary Developments: December 2003-May 2006



Source: Central bank of Uruguay.

B. Underlying Vulnerabilities and Sensitivity Analysis

4. **Improvements**. The economy's capacity to weather shocks has increased since the crisis. In particular, risks have declined as a result of: (i) larger central bank reserves and commercial banks' liquidity; (ii) lower exposure to nonresident deposits; (iii) higher export market diversification; (iv) a strengthened banking system and supervision; (v) policies to improve the economy's capacity to adjust to shocks, notably a flexible exchange rate; and (vi) sound macro policies and structural reforms to set the debt on a downward trend and foster sustained growth.

5. **Remaining vulnerabilities**. These include:

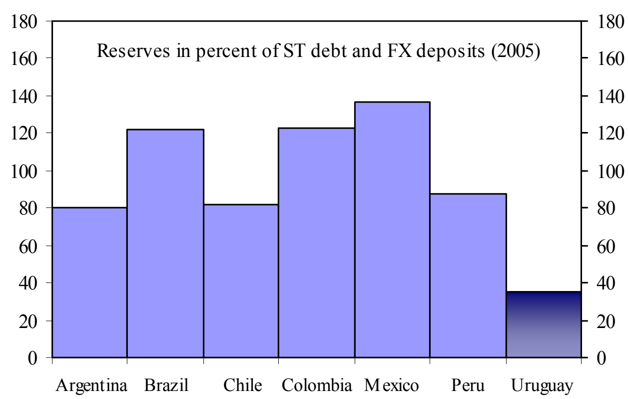
- ***Still low liquidity buffers for a dollarized economy***

  - **Central bank's coverage**. Reserves have increased to 33 percent of short-term debt and FX deposits, from 19 percent in 2001. However, compared with other economies in the region they remain low.

Buffers: Central Bank Reserves and Commercial Banks FX Liquidity
(in percent)

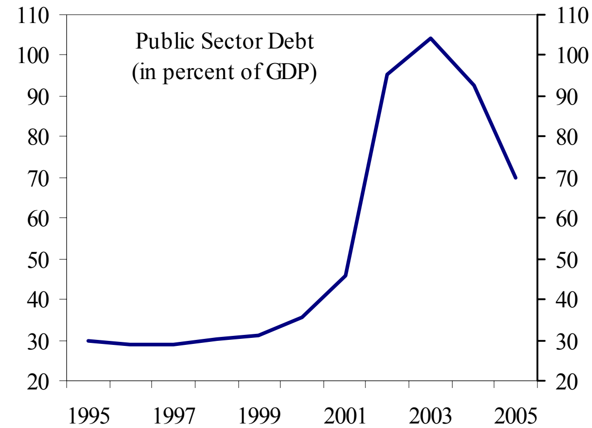
	2001	2005
I. Central bank reserve coverage of ST debt and FX deposits	**17**	**34**
II. System's coverage of ST and FX deposits	**43**	**70**
Coverage of deposits	53	90
Coverage of short-term debt	212	320
III. Commercial bank liquidity coverage of FX deposits	**48**	**73**
Required liquidity	**22**	**48**
Standard reserve and liquidity requirements	22	26
Additional liqudiity requirements at BROU and NBC	0	21
Excess liquidity	**26**	**26**
Commercial banks' short-term foreign assets coverage of		
Non-resident deposits	76	243
Sight deposits	115	86
Maximum deposit drop covered by banks' ST foreign assets	35	69
Nonresident deposits	76	100
Sight deposits	100	86
FX resident credit to deposits ratio	89	54

Source: Central Bank of Uruguay and Fund staff estimates.



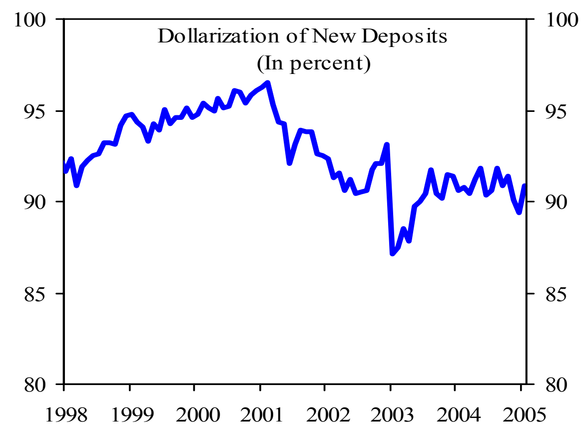
  - **System liquidity**. Central bank reserves and commercial banks' liquidity cover now about 70 percent of banks' deposits and external short-term debt, compared with 43 percent in 2001. More than twice the level of nonresident deposits is now covered by commercial bank liquidity, compared with about 80 percent in 2001. However, with the shift toward short-term deposits, coverage of short-term debt and sight deposits by commercial bank liquidity is well below pre-crisis levels. Moreover, high liquidity is also partially explained by the so far slower recovery in credit than in deposits.

- ***High public debt and bunching of maturities***. Public debt as a share of GDP has declined significantly, but it is still higher than before the crisis, with a high share in foreign currency (85 percent) and floating interest rates (40 percent), large gross financing needs (averaging 7½ percent of GDP during 2006–08) and lumpy amortization payments when the bonds of the 2003 debt exchange fall due (2011, 2022 and 2033).

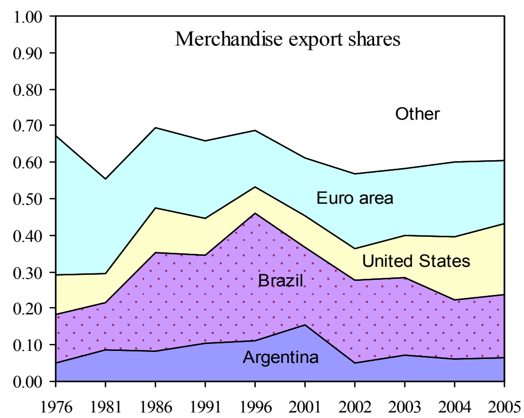


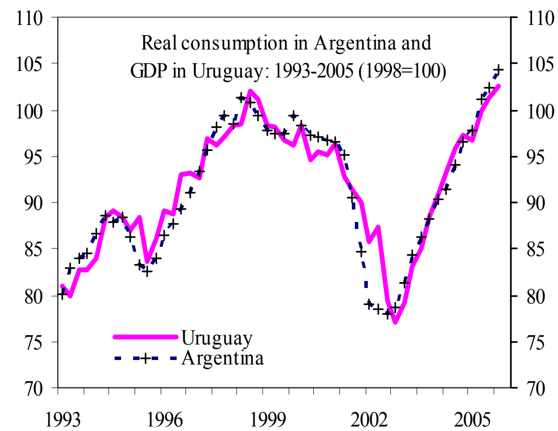
- ***High contingent financial sector liabilities***. Continued recovery on BROU's government-guaranteed assets important to minimize contingent fiscal costs of 5 percent of GDP. More generally, public bank charters offer full guarantees on deposits, representing over half of the financial system assets (20 percent of GDP), and the large presence of the government in the insurance and pension sectors poses also medium-term risks.

- ***High financial dollarization and large share of sight deposits***. Uruguay remains highly dollarized, with 90 percent of new resident deposits and 70 percent of bank loans in dollars, with important currency mismatches in the public and corporate sectors (with peso income and dollar debts). (See Selected Issues Paper—Balance Sheet Vulnerabilities). Also, the share of sight deposits is now even higher than before the crisis, likely explained by low interest rates on time deposits (linked to weak credit demand) and past experiences with reprogramming of time deposits in times of financial difficulties.



- ***Dependence***. Uruguay's real and financial linkages to Argentina have been remarkably tight. For example, Argentine consumption and Uruguayan GDP are strongly cointegrated, and about 80 percent of fluctuations in Uruguay in a two-year horizon can be explained by changes in consumption in Argentina. Nevertheless, Uruguay is making strides in reducing vulnerabilities from changes in the region, with nonresident deposits representing now a much lower share in the financial system and a substantial increase in trade outside the Mercosur region. (See Selected Issues Paper—Uruguay's Growth Story)





- ***Commodity price dependency***. The export composition is still highly commodity based (10 percent of GDP or half of exports) and the share of oil imports in the economy has risen to 6 percent of GDP.

6. **Sensitivity analysis**. This suggests that the economy, while having become more resilient in recent years, is still vulnerable:

Uruguay: Sensitivity Analysis of Financial Sector Indicators and Public Debt
(in percent)

I. Liquidity indicators	2005	II. Solvency indicators	2012
Banking system reserves to ST-debt and FX deposits	**70**	**Debt to GDP ratio (Baseline)**	**48**
Excluding Fund resources	52	Higher U.S. libor rates and spreads by 100 bps each	51
After a		REER depreciation of the peso by 10 percent	56
Drop of 20 percent in deposits	65	Weaker primary balance of 1 percent	55
Drop of 50 percent in sight deposits	56	Lower growth of 1 percent	53
One-year stop in public market financing (2007)	68		
Full withdrawal of non-resident deposits	64		
Increase in Credit/Deposit ratio to 2001 level	51		**2005**
Central bank reserves to ST-debt and FX deposits	**33**	**Capital asset ratio for banking system 1/**	**36**
Excluding Fund resources	12	Higher U.S. libor rates and spreads by 100 bps each	35
One-year stop in public market financing (2007)	28	REER depreciation of the peso by 30 percent	34

Source: Central Bank of Uruguay and Fund staff estimates.
1/ Based on estimations from Uruguay's Financial sector assessment.

- ***Effects on liquidity buffers***.

  - **Greater resilience**. Several tests show increased resilience: (i) a 20 percent drop in deposits or 50 percent in sight deposits would reduce banking system liquidity coverage of deposits and short-term debt to 56–65 percent (similar shocks would have reduced it from 43 percent to about 32 percent in 2001); (ii) a one-year loss of access to public external financing (2007) would reduce the system’s coverage by only 2 percentage points to 68 percent and by 5 percent in central bank’s coverage to 28 percent; and (iii) a full withdrawal of nonresident deposits would lead to a decline in the system's coverage to 64 percent, which would still be above pre-crisis levels.

- **Areas of vulnerability**. For instance, a large recovery in bank lending, leading to a return to the pre-crisis credit/deposit ratio, would reduce the liquidity coverage back to pre-crisis levels (50 percent). Also, sustained economic growth will be important to ensure the continued recovery of the financial sector, including by maintaining healthy loan portfolio and bank profitability.

- **Fund resources**. These still provide important support. While coverage of deposits and short-term debt by banks' liquidity and central bank reserves have increased significantly, excluding IMF resources, the coverage would be only 52 percent.

- ***Debt sustainability***. The debt-to-GDP ratios are particularly sensitive to the real exchange rate or a relaxation in fiscal policy—a 10 percent real depreciation or a sustained 1 percent lower primary balance would increase the debt by 6–7 percent of GDP by 2012.

- ***Capital adequacy***. The FSAP found that the capital-asset-ratios in the system would not be materially affected by a moderate depreciation or an interest rate increase. However, these shocks are likely to have a larger impact through credit risk, as about a third of all loans are extended to debtors with unstable foreign-currency incomes.

- ***Combined effects***. While the economy may be better prepared to deal with single and moderate shocks, in reality the effects of shocks are likely to be felt through more than one channel. Stress tests of the FSAP indicate that severe current or capital account shocks would reduce the capital of many financial institutions below minimum requirements and in the most extreme case lead to the insolvency of a few but not systemically important financial institutions.

C. Medium-Term Outlook and Alternative Scenarios

7. **Macroeconomic outlook**. Uruguay is expected to grow on average by 3–4 percent over the next years—above its historical rate of 2 percent—with inflation stabilizing below 4 percent. This is based on sustained policy implementation in the context of benign external conditions, with the world economy expanding, and Argentina and Brazil growing at or above potential rates, in an environment of international interest rates staying broadly at current levels, while the terms of trade would deteriorate slightly. Under these conditions, the primary surplus is envisaged to reach its 4 percent of GDP medium-term target in 2007, which will help reduce the public debt-to-GDP ratio to below 50 percent by end-2012. The current account deficit is projected to remain modest and only widen temporarily due to FDI-financed investment for two major pulp mill projects.

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

						Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Real GDP (percentage change)	-3.4	-11.0	2.2	11.8	6.6	4.6	4.2	2.8	3.4	3.0	3.0	3.0
CPI (eop, percentage change)	3.6	25.9	10.2	7.6	4.9	5.5	4.9	4.4	3.5	3.5	3.5	3.5
Primary balance	-1.2	0	2.7	3.8	3.9	3.7	4.0	4.0	4.0	4.0	4.0	4.0
Overall fiscal balance	-4.2	-4.6	-3.2	-2.2	-0.7	-0.9	-0.5	-0.4	-0.3	-0.3	-0.3	-0.3
Public sector debt	46	96	104	92	69	67	63	59	57	54	51	48
External current account balance	-2.7	3.2	-0.5	0.3	-0.5	-4.3	-3.2	-2.6	-1.5	-1.4	-1.4	-1.2
excluding: pulp mill projects	-2.7	3.2	-0.5	0.3	0.1	-1.2	-1.7	-1.5	-1.5	-1.4	-1.4	-1.2
Official reserves (millions of U.S. dollars)	3,099	772	2,087	2,512	3,438	3,963	4,113	4,263	4,416	4,545	4,737	4,897
As a % of ST debt + FX deposits	18.0	7.0	20.0	27.7	32.9	35.2	38.1	39.3	39.9	38.8	39.2	39.6
Memorandum items:												
Libor rate (US 6 months)	5.0	4.2	3.8	4.8	4.8	5.3	5.3	5.3	5.3	5.3	5.3	5.3
Spreads	284	1,400	900	600	387	300	300	300	300	300	300	300
Terms of trade	-0.4	3.5	2.2	-2.4	-6.3	-2.9	-1.1	-0.6	-0.6	0.3	-0.2	0.0
Growth in trading partners	1.2	0.7	2.8	5.0	4.0	4.1	3.6	3.6	3.5	3.5	3.5	3.5

Sources: Uruguayan authorities; and Fund staff estimates.

8. **Scenarios**. Changes in the external and domestic policy environment pose, however, considerable up and downside risks (Appendix I). Illustrative scenarios show that public debt by 2012 could be some 10–15 percent of GDP above baseline, assuming: (i) higher international interest rates in an environment of lower international liquidity; (ii) a sustained global slowdown of 1 percentage point and lower non-oil commodity prices; or (iii) a weakening in domestic fiscal policy by 1 percent of GDP. A positive shock related to stronger growth, however, would further reduce the debt ratio to 40 percent of GDP by 2012. While these scenarios would not affect materially the financial system, the FSAP presents more extreme scenarios with severe impact on financial institutions.

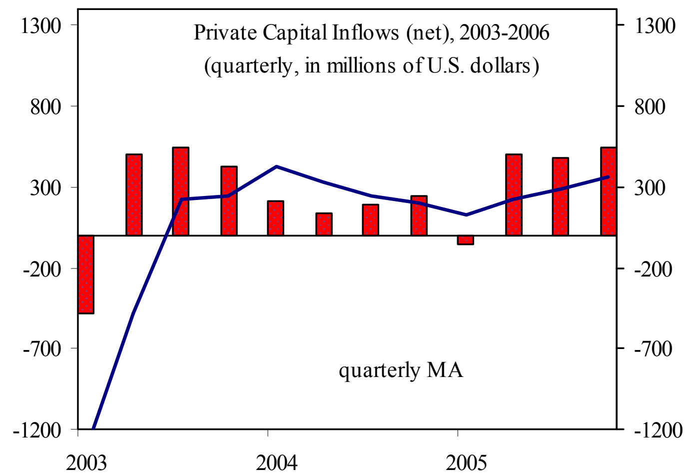
II. Policy Discussion: *The Challenge of Reducing Vulnerabilities*

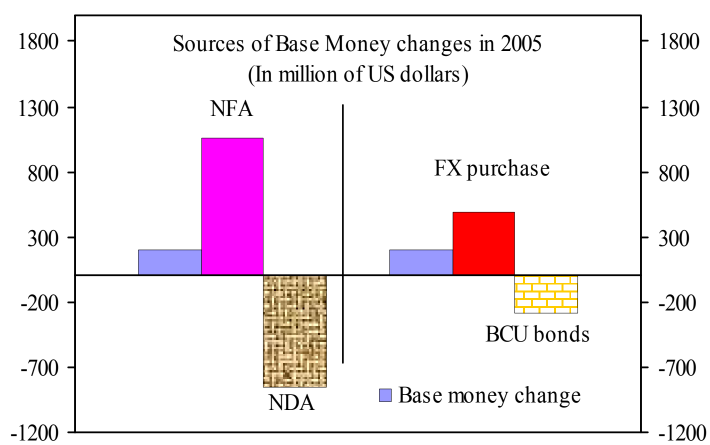
9. **Focus on vulnerabilities**. The authorities agreed to continue increasing buffers and strengthening Uruguay's underlying performance, noting that under current strong policies and expected continued favorable external conditions, vulnerabilities should decline considerably with time. They also highlighted that the political and institutional stability of Uruguay and its track record of sound policy implementation were important stabilizing factors.

A. Exchange Rate and Monetary Policies under Volatile Capital Flows

10. **Large capital inflows**. The authorities reiterated their commitment to a flexible exchange rate, while noting difficult policy trade-offs in light of large (about twice the size of base money in 2005) and uncertain capital inflows. In particular, they expressed concern about a possible loss of export competitiveness as a result of excessive appreciation. Against this backdrop, they had decided to step up foreign exchange purchases since late 2005. Staff

noted that while rebuilding reserves and resistance to appreciation pressures linked to short-term capital inflows may be appropriate, exchange rate flexibility should be maintained. Targeting the exchange rate should be avoided in an economy that is highly exposed to external shocks.





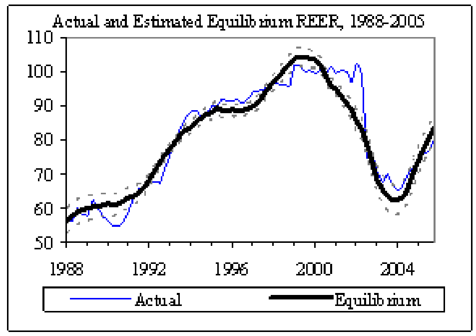
11. **Competitiveness**. The strong appreciation of the peso in the past year—while strengthening the debt sustainability outlook and supporting low inflation— has prompted some public concern over competitiveness. However, continued buoyancy of exports, econometric estimates of the equilibrium rate, and labor cost developments in the manufacturing sector indicate that Uruguay's exchange rate is not overvalued (Box 1). Staff and authorities agreed that targeting an exchange rate below its equilibrium level would eventually lead to higher inflation and that lasting improvements in competitiveness depended on moving ahead with productivity-enhancing structural reforms.

Box 1. Assessment of External Competitiveness[1]

Notwithstanding the significant appreciation of the REER since early 2004, several indicators suggest that Uruguay has remained competitive.

- **Exports**. Since the 2002 crisis, the current account has remained nearly balanced, with exports performing vigorously (17 percent volume growth in 2005). Moreover, inflows of foreign direct investment have increased markedly, pointing to Uruguay's attractiveness as a location for investment.

- **Real exchange rate**. The PPI, CPI and ULC-based REERs have remained substantially more depreciated than before the crisis, with some 11, 19 and 43 percent below their respective 2001 averages. The CPI-based REER appears to be near its long-run equilibrium, with the current rate within the 95 percent confidence interval of the estimated equilibrium level (estimate based on a long-term relationship between the REER, real GDP relative to trading partners, and net foreign assets). The analysis also suggests that the exchange rate was significantly more appreciated than its long-term equilibrium level before the 2002 devaluation.



- **Other competitiveness indicators.** The ratio of export unit values to unit labor costs, a proxy for profit margins in the tradable sector, has improved substantially, remaining more than 80 percent above its pre-crisis level. The ratio of prices for tradable to non-tradable goods, an indicator of competitiveness between the tradable and non-tradable sectors, has declined since the crisis, but remains 5 percent above pre-crisis levels.

1/ See Selected Issues Paper—Assessing Competitiveness in Uruguay.

12. **Inflation targeting**. There was agreement that monetary and exchange rate policies should remain focused on achieving the inflation objective, while moving to full-fledged inflation targeting over time. Achieving the inflation targets would further improve central bank credibility and over time help reduce financial dollarization. At this point, the authorities however did not feel ready to move to full-fledged inflation targeting, given remaining weaknesses in the financial system, high gross financing needs, and the still incomplete understanding of price formation. Nevertheless, they stressed that the proposed new central bank law and the planned central bank recapitalization would be important steps in this direction. Regarding monetary policy instruments, with high dollarization and remonetization, they have decreased emphasis on monetary aggregates and were monitoring an array of indicators, but were skeptical about the use of short-term peso interest rates in the immediate future, given the high degree of dollarization and the shallowness of the peso money market, and agreed that further development of local markets would be desirable.

13. **Policy transparency**. While the current framework has helped in lowering inflation, to consolidate central bank credibility it would be important that its actions be better understood by the market, including the mechanisms and rationale of foreign exchange

interventions and their link to the inflation objective. The authorities agreed that improving the monetary framework and its transparency was key, and that they would welcome Fund TA in this area later this year.

14. **Rebuilding foreign exchange**. The high degree of dollarization, the government's full deposit guarantee of state banks' deposits, and remaining weaknesses in the banking system make it important to continue building reserves. The central bank has recently increased significantly its reserve target for 2006, and intends to build reserves further over the medium term, as opportunities from capital inflows arise and remain consistent with the inflation objective. While rules-based preannounced purchases of the central bank would have clear advantages of transparency, the authorities observed that such a policy had put the central bank in a weak position in 2005 in a shallow market and reduced the effectiveness of intervention.

B. Financial Sector Vulnerabilities

15. **Dollarization**. The authorities agreed that high dollarization remained an important challenge for the financial system, with most potential borrowers lacking a stable dollar income stream. They explained that the immediate vulnerability from high dollarization had decreased as low credit demand had resulted in high foreign exchange liquidity of banks. In addition, prudential rules that discourage dollarization and internalize the risks of dollar lending have been issued, and the deposit insurance scheme and new tax reform provide incentives to reduce financial dollarization through differential premiums and tax rates (Box 2). Encouraging the market to develop hedging instruments to transfer currency risk will also be important.

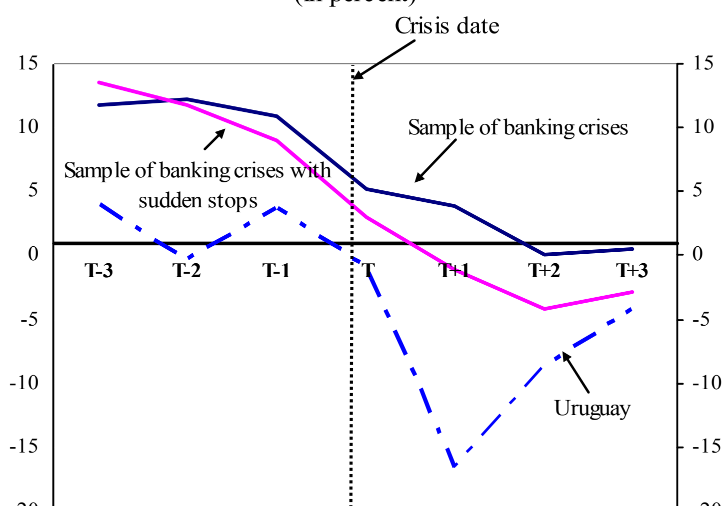
Box 2: Measures Taken to Address Financial System Risks Arising from High Dollarization

Objective	Measures Taken
Deposit insurance coverage	US$5,000 of dollar deposits and the equivalent of US$15,000 in peso deposits per depositor per bank.
Deposit insurance premium	0.2 percent for dollar and 0.1 percent for peso deposits.
Interest income	Tax on interest income of dollar time deposits 10 percent and 3 percent for peso time deposits.
Control liquidity risk arising from dollarization	Imposed higher reserve requirements on foreign exchange deposits (October 2003).
Control credit risk arising from dollarization	Imposed higher capital requirements for foreign currency credit; increased risk weight of FX loans to 125 percent (June 2006).
	Amended loan classification and provisioning rules to take into account the sensitivity of the capacity to repay to changing market conditions, including movements in the exchange rate (April 2006).
	Imposed strict criteria for classification of foreign currency consumption and housing loans (rated 3 if debt service higher than 15 percent and 30 percent of household income for FX loans and domestic currency loans, respectively) (April 2006).
Control foreign exchange risks	Imposed capital requirements for FX open position (modified in 2003).

16. **State banks**. A more competitive and modern financial system will be key to ensure more effective financial intermediation, and the current large state-presence in the insurance, pension and banking sector distorts competition and poses macroeconomic risks. The authorities argued that given Uruguayan society's preferences expressed in several referenda, they were not considering privatizing BROU. They however agreed to consider improvements in its governance, including making directors subject to fit-and-proper tests, but noted that significant improvements were already being made through better regulation and transparency.

17. **New lending**. Strong prudential policies and creditor discipline will be instrumental in ensuring sound financial intermediation, especially when lending starts picking up. Moreover, BHU loans and the small loans of BROU should be incorporated into the credit registry to improve credit culture, foreclosure and bankruptcy processes should be shortened to improve credit recoveries, and controls and risk management policies and practices of BROU further strengthened. The authorities explained that they had advanced in all these areas and that banks had extended new loans cautiously. Furthermore, coverage of the credit registry was being extended, and the new bankruptcy legislation would help in fostering sound financial intermediation. (See Selected Issues Paper—Post-Crisis Credit)

Real private credit growth after banking crises
(in percent)



Source: IDB and staff

Box 3: Main Findings and Recommendations from the FSAP

Main findings

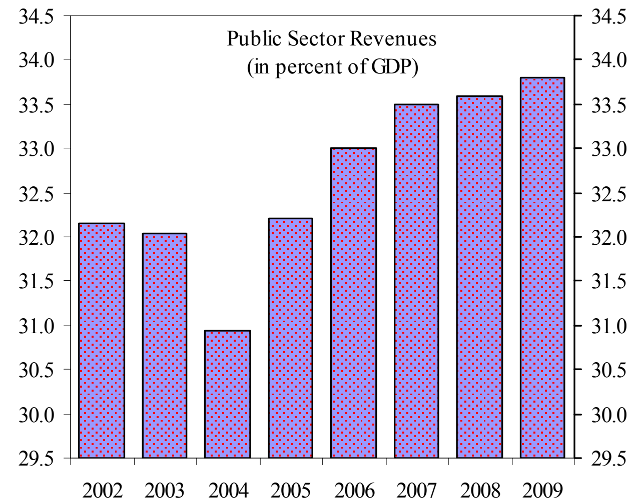
- **Financial soundness indicators—**have improved significantly and commercial banks are better prepared than in 2002 to withstand medium-sized shocks given their high liquidity and capital adequacy. The large liquidity at public bank BROU, accounting for half of system's deposits, reduces the fiscal exposure arising from the full deposit guarantee established in its charter.
- **Regulation and supervision of the financial system**— has improved significantly since the crisis (see Box 2 above). The bank resolution framework is also being strengthened.
- **Stress tests—**show that while the system appears prepared to handle moderate shocks, severe current or capital account shocks would lead to a significant deterioration of the capitalization of several financial institutions in Uruguay.
- **State banks—**insufficient resources and the predominance of public financial institutions presents informational, oversight, and governance challenges. The constitutional status of two public banks (at par with the central bank) remains an issue. While the supervisor can impose sanctions on these banks and their senior management, it has no influence on the appointment or removal of directors and management. Several Basel core principles have been rated materially noncompliant because the BCU cannot apply the full range of corrective actions. Predatory underpricing practices by some public financial institutions and government guarantees create unfair competition to private institutions.
- **Pension funds (AFAPs)—**the market is highly concentrated and government guarantees (including a minimum investment return in the public AFAP) pose potential risks. Investment regulations governing the AFAPs allow little asset risk diversification of affiliates' investments.
- **Payments and securities settlement systems—** are being upgraded, but their oversight and legal frameworks need to be strengthened.
- **AML**—formal cooperation and information exchange mechanisms with other overseas supervisors, particularly in neighboring countries, are not yet in place.

Main recommendations

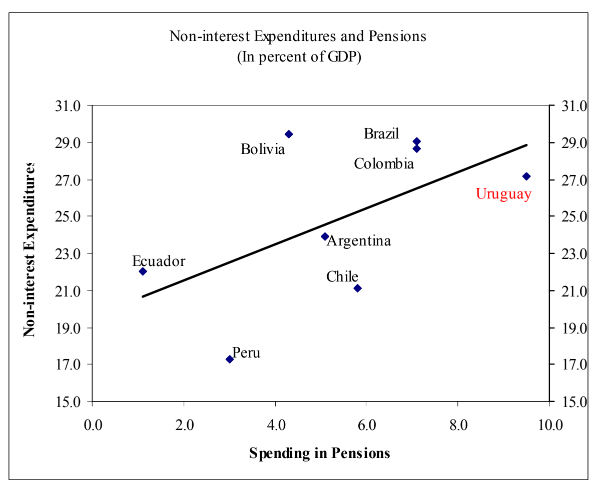
- **Contingent liabilities**. Conduct an independent analysis of the potential contingent liabilities that may arise from state-owned institutions in banking, insurance and pension fund sectors.
- **Supervision**. Increase resources for effective supervision, improve information systems and provide training to staff.
- **State banks**. Require directors and managers of public financial institutions to satisfy supervisory fit and proper requirements and to be subject to supervisory corrective actions.
- **Prudential policies**. Address the factors contributing to the weak credit culture by making the credit registry easier to use and speeding up incorporation of BHU loans and the small loans of BROU, strengthening the lax credit and debt relief practices of public banks, and shortening foreclosure and bankruptcy processes.
- **Pension funds**. Liberalize rules for AFAP investments in nongovernment obligations, including allowing limited, high-quality offshore investments. Eliminate the government-guaranteed minimum return in AFAP Republica.
- **Insurance system.** Any mortgage default insurance system would need to be evaluated carefully and ensure that underlying risks are priced accurately.
- **Payments system**. Form a small unit in charge of payments system oversight, separate from systems operations, and improve the legal framework in the areas of bankruptcy procedures, netting arrangements, and custody arrangements. Upgrade the RTGS payment system as planned.
- **AML**. Engage in cooperation and information exchange agreements with foreign supervisors.

C. Sustainable Fiscal and Public Debt Framework

18. **Fiscal policy framework**. Sustaining high primary surpluses of 4 percent of GDP will continue to be at the core of the authorities' fiscal strategy, but at times of high growth and strong capital inflows higher surpluses could be targeted, to lower the burden on monetary policy and further reduce debt. The authorities considered that they would meet their fiscal targets in 2006, as they had done in 2005, but also noted that the current targets already imposed considerable constraints. In their view, fostering long-term growth would also require allocating additional public resources to strengthen infrastructure and making room for other priority expenditures, including education. Further, while the ceilings in the recently passed net debt law would allow for a higher than currently targeted debt-to-GDP ratio, their fiscal strategy would continue to be guided by the budget framework.



19. **Strengthening revenue**. There was agreement that tax administration reforms were critical for attaining the ambitious revenue targets and sustaining fiscal performance into the medium term. The current practice of setting high tariffs for public utility services to generate fiscal revenues is inefficient, and should be replaced by a more rational tariff-setting mechanism. However, before tackling this issue, the plan is to consolidate the tax reform to minimize fiscal risks.



20. **Spending rigidities**. Reducing budget rigidities can increase the resilience of public finances to shocks. While the expenditure levels are comparable to other emerging markets, spending on wages and social security benefits (70 percent of non-interest expenditure) is high. The authorities explained that, with the general pension system already reformed in 1996, high spending reflected Uruguay's demographic structure, and not overly generous benefits. Moreover, the system's deficit is expected to decline gradually over the long term as the effects of the reform kick in. On civil service reform, the government is considering measures to improve the quality of services and reduce costs, which could over the longer term include changes to the remuneration schemes and functional restructuring, but the discussion is still in its early stages.

21. **Public debt structure**. There was agreement that implementing the government's debt strategy was critical to increase resilience to shocks, with the authorities taking advantage of favorable market conditions to advance financing plans and improve the debt structure, including by issuing debt in local currency and smoothing the amortization profile. They also plan to further develop the local bond market by extending maturities, which should help to further shift the currency composition from foreign to local currency. Staff encouraged the authorities to move more aggressively to improve the currency and maturity composition of debt to lock in the current generally favorable conditions.

D. Growth, Competitiveness, and Diversification

22. **Growth**. Sustaining growth into the medium term will be critical to allow the continued improvement in social conditions, while ensuring fiscal and debt sustainability, and providing the basis for a healthy financial system. In this regard, the government has prepared an ambitious reform agenda (see Box 2, Country Report No. 06/197), of which many elements, such as tax and financial sector reforms, are already advancing. Further, a new competition bill is being considered by Congress and a new bankruptcy framework bill introducing a Chapter 11-type of regime would be submitted soon.

23. **Openness and trade diversification**. The authorities reaffirmed their commitment to seek further trade expansion to achieve scale economies, while diversifying to reduce exposure to the region. They pointed to their active role in the WTO's Doha round, the bilateral trade agreement with Mexico since 2003 and increased trade relations with the EU, and that they would welcome an enlarged Mercosur. Also, they are exploring further ways to deepen economic ties with the US—consistent with Mercosur— beyond the recently signed Bilateral Investment Treaty.

24. **Investment climate**. Improving the business climate is key for attracting private investment to sustain growth. The recent work of the growth commission (*Compromiso Nacional*) had identified further measures, including establishing an investor relations office and reforming public procurement, which have been incorporated in the government's agenda.

25. **Labor market flexibility**. In recent months there has been some public concern about the increased number of occupations of factories by striking workers and proposed minimum wage increases. The authorities pointed out that labor regulations were not rigid in comparison to the region, but acknowledged that strong unions and negotiated agreements imposed constraints in some sectors, especially in the banking sector. The number of strikes had actually declined to a decade-low in 2005 and the wage councils had helped bring stability to labor relations, and the recently discussed increase in the minimum wage of 20 percent would keep it nonbinding except for very few sectors. The government is also considering to allow for firm-level negotiations within the current framework.

26. **Public-Private-Partnerships (PPPs)**. With fiscal constraints and limited scope for privatization, the authorities consider private participation in public infrastructure as important to close the large investment gap, expand capacity further, and improve the

efficiency of public enterprises. They do not intend to set an overall legal framework for PPPs at this point, but rather move ahead with a few projects, which would be well-selected, carefully designed, and their contingent fiscal costs minimized. (See Selected Issues Paper—Options to Increase Infrastructure Investment in Uruguay).

27. **Public Enterprises.** Reform of public enterprises is important to reduce the high public tariffs and improve service delivery. While privatization is not being considered, the authorities are studying various options, including increased association with the private sector, establishing better links between remunerations and productivity, and shifting some of the enterprises to private law over the medium term.

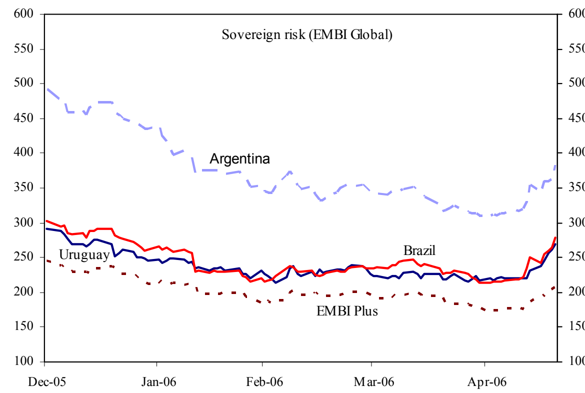
III. Fourth Review Discussions

A. Recent Developments

28. **Macroeconomic outcomes**. Results and policy developments have been mostly favorable.

- ***Growth.*** With continuous vigorous growth in early 2006, projections for the year have been revised upwards to 4½ from 4 percent,
- ***Inflation.*** The annual inflation rate increased from 6 percent in April to just above 6½ percent in May, reflecting the pass-through of higher oil prices. It is expected to return to within the target range by year-end (4½–6½ percent), although emerging price pressures (including a recent electricity tariff increase) pose an upside risk to this outlook.
- ***Fiscal performance.*** Preliminary data show a higher than programmed primary surplus in the first quarter (4.8 percent of GDP against 2.4 percent in the program, annualized), reflecting higher tax collection and social security contributions, which more than offset weaker performance by public enterprises; the outcome also reflects better local government performance and temporary delays in the social emergency program.
- ***Monetary policy***. The central bank exceeded the March indicative base money target by 7½ percent, and raised its 2006 M1 growth target from 12 percent in December 2005 to 28 percent, while leaving its one-year-ahead inflation target range unchanged from December (4½–6½ percent).
- ***Exchange rate policy***. Following periods of large central bank foreign exchange purchases, the exchange rate was constant during some periods in early 2006. Exchange rate flexibility has since resumed.

- ***Country risk***. With the recent tightening of international liquidity conditions, Uruguay's sovereign spreads and domestic interest rates increased in line with neighboring countries, but the exchange rate was largely unaffected.



- ***Program targets***. Available information suggests the authorities have met all the continuous and quantitative performance criteria for end-March 2006. They will provide final data ahead of the Board meeting.

29. **Structural reforms**. There has been important progress in the structural area.

- ***Tax reform law***. This is the key reform priority in the near term. The lower house is discussing the bill and congressional approval (end-October performance criterion) is now expected by mid-September (modification proposed to advance approval date).

- ***Revenue administration***. The social security agency (BPS) is on track to prepare a plan to strengthen its auditing and collection functions (end-June benchmark). The authorities have also identified the main elements of the customs reform, and the preparation of a detailed plan, including institutional and legal changes, is on track (end-August benchmark).

- ***Budget***. A government group is working on the institutional budget process and will be assisted by Fund TA in developing a reform plan (end-August benchmark).

- ***Specialized pension schemes***. Working groups have been established to prepare draft legislation for the military and banking employee pension reforms to be submitted to congress by end-November (performance criterion).

- ***Growth***. The government published its pro-growth reform agenda in March, and a timetable for the implementation of the measures was published with a slight delay in early June (end-March benchmark).

- ***Bank restructuring***. NBC was privatized in early June (end-June benchmark). BHU restructuring is progressing well (end-August performance criterion).

- ***Bankruptcy law***. The draft law was presented for public consultation and will be submitted to congress in time (end-June benchmark).

30. **Delays**. With the government giving priority to passage of the all important tax reform law, the congressional agenda is being rescheduled to defer consideration of pension and central bank reforms.

- ***Police pension reform law***. Approval (end-May performance criterion) is now expected by end-October (waiver requested). However, the delay will have no impact on the attainment of the 2006 fiscal targets.

- ***Financial sector law***. Approval of the law is being delayed (end-June performance criterion) to give priority to the tax reform, and is now expected by end-November (modification proposed).

B. Discussions

31. **Monetary policy stance**. The authorities view the recent pickup in inflation as transitory, owing to a drought-related increase in food prices and the recent pass-through of higher international oil prices, and were confident to attain the end-year target range. Also, the targeted additional base money increase of 16 percent (equivalent to US$180 million) would be fully met through foreign exchange purchases, consistent with the observed remonetization. However, given the increase in inflation and market expectations for 2006 above the target range, uncertainties about continued strength in money demand, a reduced output gap, and some money market rates negative in real terms, staff argued that the risks to the inflation outlook have increased. Against this background, it urged the authorities to initially target a slower base money growth until inflation has settled well within the year's end target range. The authorities explained that, while inflation is still within their quarterly target range (5–7 percent), they are monitoring developments closely and considering to tighten the stance even ahead of the next review.

32. **Reserve target**. The central bank has increased its reserve target for 2006 by US$410 million—and above original program projections for 2008—owing to larger than programmed foreign exchange purchases and the decision by the government to forgo foreign exchange available from forward operations maturing in 2006. The revised NIR accumulation target for 2005–06 of US$1.6 billion, compares with an original projection of US$1.1 billion during the three-year program.

33. **FSAP**. The authorities recognized that FSAP recommendations would further strengthen the financial sector and indicated that they would, after a thorough analysis, discuss incorporation of key recommendations into the program's conditionality at the next review. They also explained that the approval of the financial sector law, which is now expected by end-November, would address several of the issues raised by the FSAP. Staff stressed that strengthening the authority of the supervisor over public banks, within the constitutional constraints, was important to meet international supervisory standards.

34. **Fiscal targets**. Exceeding the 2006 fiscal targets would be desirable to further lower the high public debt, help control inflation, and moderate appreciation pressures.. On public enterprises performance, the authorities are committed to continue fully passing through international oil prices to protect revenue targets; drought-related shortfalls in the electricity company would be offset by better performance in the telecommunications company and the central government. Staff urged to monitor the situation closely and to execute spending cautiously to prevent slippages.

35. **Revenue administration**. It is important to advance with the revenue administration preparations for the tax reform. Initial steps in the authorities' action plan include delineating responsibilities between the DGI and the BPS to administer the personal income tax, appointing a high level working group to coordinate the actions of the collection agencies, drafting the regulations for the reform, and restructuring administration processes.

36. **Growth measures.** The SBA has already scheduled many important reforms of the recently published growth agenda, including bankruptcy legislation, tax reform, and bank restructuring. In addition, it is proposed to include establishing a private sector relations office by August 2006 and strengthening government procurement procedures by July 2007 as benchmarks in the program.

IV. STAFF APPRAISAL—*THE NEED TO STAY THE COURSE*

37. **Strong policies**. Uruguay's strong policies, supported by favorable external conditions, have contributed to the sharp recovery since the 2002 crisis. Four years of large primary fiscal surpluses, financial sector restructuring, and prudent debt management have contributed to a significant fall in debt ratios and improved debt structure, and a strengthened liquidity position of the financial system. Careful monetary policy within a flexible exchange rate regime brought inflation quickly down and has helped stabilize inflationary expectations in the low single digits. This has been accompanied by important structural reforms, including in the fiscal, financial sector, and business climate areas and has resulted in a strengthened market confidence in Uruguay's prospects.

38. **Remaining vulnerabilities**. The economy has generally become more resilient to shocks—macro policies are stronger; the flexible exchange rate allows the economy to better adjust to shocks; stricter prudential norms are in place; public banks have been or are being restructured; and key buffers, such as liquidity and reserve coverage, are higher. However, while rapidly declining, public debt remains high and largely dollarized, central bank reserves remain relatively low, and the financial system is still vulnerable. Thus, sustained strong policy implementation and advancing with structural reforms will be key. Current favorable global conditions provide a good opportunity to advance with this objective.

39. **Low inflation**. This is critical to further improve the credibility of the central bank and help reduce financial dollarization. Staff commends the central bank for keeping inflation in check and, while inflation risks have increased, supports the proposed modification of indicative targets for base money, given the authorities' commitment to adjust policies as necessary to meet the inflation objectives. Moving toward full-fledged inflation targeting could help institutionalize the commitment to low inflation, and the new central bank law increasing its autonomy will be a significant step in this direction. It will be important to enhance transparency of monetary policy, strengthen inflation forecasting of the central bank and develop new instruments to better communicate the stance of monetary policy. In this context, staff commends the authorities for their ongoing efforts to develop deeper markets in local currency. The newly established debt management unit should play a key role in these endeavors.

40. **Exchange rate flexibility**. The real exchange rate appears to remain at competitive levels, as evidenced by strong exports, a near current account balance, and a real effective exchange rate well below pre-crisis levels. Nevertheless, given the risk that large capital inflows may not be sustained, some resistance to appreciation may be appropriate, but interventions should avoid signaling the existence of an exchange rate target. The restoration of exchange rate flexibility after brief periods of rigidity in early 2006 is encouraging, and the authorities should also explore methods to make interventions more transparent and better understood by market participants.

41. **International reserves**. Reserves should be increased considerably over the medium term. While now well above pre-crisis levels, reserve coverage of short-term debt and dollar deposits is still low compared to other dollarized economies. Continuing capital inflows provide an opportunity to strengthen reserves in the near future, and the large increases now expected for 2006, beyond the initial program indicative targets, will be an important near-term step in this direction. However, large capital inflows also constitute a challenge for monetary policy to ensure that both the inflation objectives are met and exchange flexibility is maintained.

42. **State banks**. Continued reforms are essential to reduce risks associated with the public sector's large share in the banking sector, including because of full deposit guarantees. The ongoing restructuring of BHU should be completed as scheduled, and selection of managers in state banks should be subject to fit and proper criteria as set by the superintendency. Further, strong prudential policies and creditor discipline need to be in place once lending starts picking up. The recommendations of the FSAP provide useful guidance in these areas, and should be implemented.

43. **Fiscal sustainability**. Achieving high primary surpluses is necessary to bring about debt sustainability and further enhance the credibility of the overall policy framework. Stronger economic growth could provide an opportunity to overperform on fiscal targets, further reduce debt and help in reducing the burden on monetary policy in dealing with capital inflows. The revenue-neutral and efficiency-enhancing design of the tax reform needs to be protected. Swift progress in tax administration will be instrumental for successful implementation of the reform and attaining the ambitious revenue targets. Continuing to fully pass through in international oil prices will also be important. Public enterprise reform would also help reduce reliance on high tariffs. While large reductions in pension outlays are unlikely given Uruguayan demographics, the authorities could study options to improve the efficiency and reduce costs of the system. Also, a comprehensive civil service reform could result in important improvements in public services.

44. **Growth**. The risks to growth from current account shocks and possible loss of competitiveness also need to be addressed. Further trade liberalization and diversification of export markets should help reduce vulnerabilities from regional dependencies. Improving the investment climate, strengthening the bankruptcy framework and maintaining good labor relations and a competitive labor market will also be key. Finally, plans for PPPs provide a good opportunity for upgrading infrastructure but should be initially kept at a limited scale

and be handled cautiously, including by adequately sharing risks with the private sectors and properly recording of the transactions in the fiscal accounts.

45. **Next Article IV consultation**. It is proposed that it will be held on a 24-month cycle, in accordance with the provisions of the July 15, 2002 decision on consultation cycles for countries with Fund arrangements.

46. **Completion of the review**. In light of the strong performance under the program, and the positive outlook, staff recommends completion of the fourth review. Available information suggests that all performance criteria have been observed, except for the implementation of the police pension fund reform, because of changes in the congressional timetable, involving early consideration of the tax reform and the postponement of the police pension and the financial sector reforms. The authorities have expressed their continued commitment to implement these reforms, and in light of these corrective actions, staff supports the authorities' request for a waiver for the nonobservance of the end-May structural performance criterion and its resetting for end-October, and to change the tax and financial sector reforms test dates to mid-September and end-November, respectively.

Table 1. Uruguay: Selected Economic and Social Indicators

Population (estimate)	3.2	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	12.1	Secondary education	101.5
Poverty rate	29.8	Tertiary education	37.7
GDP per capita in 2005 (in US$)	5,208		
Human Development Index Rank	46 (out of 177 countries)		

					2006		Projections				
	2002	2003	2004	2005	Report 06/197	Proj.	2007	2008	2009	2010	2011
					(Percent change)						
					I. Output, prices, and employment						
Real GDP	-11.0	2.2	11.8	6.6	4.0	4.6	4.2	2.8	3.4	3.0	3.0
Contributions to real growth (percent) 1/											
Consumption	-15.2	-1.0	9.6	2.2	3.5	3.4	3.1	1.9	2.0	1.9	1.9
Investment	-5.0	2.7	2.7	1.4	4.9	6.0	-0.2	0.5	0.2	1.0	1.0
Net exports	9.1	0.9	-0.4	3.0	-4.3	-4.7	1.2	0.4	1.3	0.1	0.1
GDP (Ur$ billions)	261	315	379	411	448	452	489	522	560	599	640
GDP (US$ billions)	12.1	11.2	13.3	16.9	18.3	18.6	19.8	21.1	22.2	23.5	25.0
Investment	-11.7	32.1	24.9	9.0	40.3	52.7	2.7	6.8	9.2	6.0	6.0
Consumption	3.9	20.1	18.3	8.5	9.0	8.3	7.8	6.3	8.3	7.1	7.1
GDP deflator	18.7	18.4	7.5	1.7	5.5	5.1	3.8	4.0	3.7	3.9	3.7
CPI inflation (average)	14.0	19.4	9.2	4.7	6.0	6.1	4.3	4.4	3.5	3.5	3.5
CPI inflation (eop)	25.9	10.2	7.6	4.9	5.5	5.5	4.9	4.4	3.5	3.5	3.5
Exchange rate change (Ur$/US$)(average)	62.1	30.4	1.5	-14.8	...	...	...	...	...	...	...
Exchange rate change (Ur$/US$) (eop)	84.2	7.3	-9.9	-8.3	...	...	...	...	...	...	...
Average public sector wage (end-of-period)	0.5	7.9	9.7	10.2	10.5	10.5	9.6	8.6	5.5	5.5	5.5
Unemployment (in percent)	17.0	16.9	13.1	12.1	...	...	...	...	...	...	...
					II. Monetary indicators						
Base Money (average)	17.7	19.3	7.7	28.5	4.6	27.7	8.6	7.5	...	...	...
Base Money (eop) 2/	22.1	24.9	11.1	34.1	2.2	22.7	8.6	7.5	...	...	...
Currency issued	5.8	22.4	15.7	22.0	-0.2	21.8	8.6	7.5	...	...	...
M-1	1.7	34.6	13.4	29.4	7.0	28.0	8.6	7.5	...	...	...
M-2	-5.1	17.4	12.8	22.3	6.9	23.0	8.6	7.5	...	...	...
M-3	15.8	21.7	-2.0	0.1	1.7	7.7	6.1	6.3	...	...	...
Credit to the private sector (constant exch. rate) 3/	-17.6	-23.9	-11.2	2.7	9.9	9.9	10.8	6.9	...	...	...
					(Percent of GDP, unless otherwise indicated)						
					III. Public sector operations						
Revenue	32.1	32.0	30.9	31.8	33.0	32.7	33.6	33.6	33.8	33.8	33.8
Non-interest expenditure (incl. discrepancy)	32.1	29.3	27.2	27.9	29.3	29.0	29.5	29.6	29.8	29.8	29.8
Primary balance	0.0	2.7	3.8	3.9	3.7	3.7	4.0	4.0	4.0	4.0	4.0
Interest	4.7	6.0	6.0	4.6	4.8	4.6	4.6	4.5	4.3	4.3	4.3
Overall balance	-4.6	-3.2	-2.2	-0.7	-1.1	-0.9	-0.5	-0.4	-0.3	-0.3	-0.3
Public sector debt 4/	96	104	92	69	65	66	63	59	57	54	51
Public debt service (as a percent of GDP)	13	14	19	16	…	17	12	10	10	11	12

Table 1. Uruguay: Selected Economic and Social Indicators (concluded)

	2002	2003	2004	2005	2006 Report 06/197	2006 Proj.	Proj. 2007	2008	2009	2010	2011
IV. Savings and investment											
Gross domestic investment	11.5	12.6	13.3	13.2	18.9	18.3	17.4	17.3	16.9	17.4	18.0
Gross national savings	14.7	12.1	13.6	12.6	13.3	14.0	14.2	14.7	15.4	16.0	16.6
Foreign savings	-3.2	0.5	-0.3	0.5	5.6	4.3	3.2	2.6	1.5	1.4	1.4
V. External indicators											
Merchandise exports, fob (US$ millions)	1,922	2,281	3,145	3,758	3,760	4,140	4,487	4,857	5,113	5,435	5,766
Merchandise imports, fob (US$ millions)	1,874	2,098	2,992	3,826	4,767	4,936	5,069	5,358	5,449	5,807	6,190
Merchandise terms of trade (percentage change)	4.3	2.9	-3.1	-9.7	-3.0	-4.6	-2.3	-1.4	-1.3	-0.2	-0.9
Current account balance	3.2	-0.5	0.3	-0.5	-5.6	-4.3	-3.2	-2.6	-1.5	-1.4	-1.4
Of which: excluding cellulose projects	3.2	-0.5	0.3	0.1	-2.1	-1.2	-1.7	-1.5	-1.5	-1.4	-1.4
Foreign direct investment	1.5	3.6	2.4	3.6	6.2	6.9	4.6	3.9	2.6	2.7	2.7
Overall balance of payments (US$ millions)	-2,328	1,380	454	951	426	525	150	150	153	129	192
External debt 5/	87.5	98.2	87.4	67.8	61.2	61.9	57.4	52.7	49.2	45.3	41.9
Of which: external public debt	68.9	85.3	76.9	60.4	54.7	55.2	51.1	46.8	43.6	40.0	37.0
External debt service (percent of exports of goods and services)	55.0	52.3	44.8	47.0	60.3	54.8	41.9	34.5	31.9	33.8	32.8
Gross official reserves (US$ millions) 6/	772	2,087	2,512	3,438	3,865	3,963	4,113	4,263	4,416	4,545	4,737
In months of imports of goods and services	3.7	9.2	8.0	8.7	8.1	8.0	8.0	7.8	7.9	7.6	7.5
In percent of short-term debt	25.1	86.8	158.0	153.5	137.5	139.7	197.9	234.2	252.5	218.0	220.2
In percent of short-term debt plus bank non-resident deposits	14.3	45.1	61.6	75.7	74.2	75.7	89.8	96.5	99.3	93.0	93.8
In percent of short-term debt plus FX deposits	7.0	20.0	27.7	32.9	34.4	35.2	38.1	39.3	39.9	38.8	39.2
REER (percentage depreciation -, e.o.p.)	-20.3	-13.2	9.3	11.9	...	...	...	...	...	...	...

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

1/ 2005 and 2006 numbers are large driven by the large scale FDI project in the forestry sector.
2/ Program definition (end of period data).
3/ Part of the sharp drop in 2003 is due to the removal of the three liquidated banks from the database in May 2003.
4/ Covers debt of the NFPS and the central bank (excluding monetary policy instruments and free reserves).
5/ Excludes nonresident deposits.
6/ Includes reserve buildup through reserve requirements of resident financial institutions.

Table 2. Uruguay: Balance of Payments

(In millions of US$, unless otherwise stated)

	2002	2003	2004	Prel. 2005	2006 Report 06/197	2006 Proj.	Proj. 2007	Proj. 2008	Proj. 2009
				1. Balance of Payments					
Current account	**382**	**-56**	**43**	**-88**	**-1,063**	**-798**	**-627**	**-556**	**-324**
Trade balance	48	183	153	-69	-1,007	-796	-582	-501	-336
Exports, f.o.b.	1,922	2,281	3,145	3,758	3,760	4,140	4,487	4,857	5,113
Imports, f.o.b.	1,874	2,098	2,992	3,826	4,767	4,936	5,069	5,358	5,449
Services	153	167	365	439	385	474	459	451	534
Exports, f.o.b.	771	803	1,151	1,344	1,316	1,450	1,534	1,637	1,804
Imports, f.o.b.	618	636	786	905	931	976	1,076	1,186	1,270
Income (net)	109	-489	-588	-578	-543	-602	-636	-646	-670
Transfers (net)	72	83	113	120	102	126	132	140	147
Financial and capital account	**-2,234**	**1,039**	**67**	**855**	**1,489**	**1,323**	**777**	**706**	**477**
Foreign direct investment	180	401	315	605	1,174	1,276	918	815	586
Portfolio investment	415	-541	-422	768	558	603	-31	142	255
Government securities	171	-5	240	560	687	701	3	168	255
Issues	710	613	504	1,008	1,101	1,118	122	247	298
Amortization 1/	539	618	263	447	415	417	118	79	43
Banks	244	-537	-663	207	-129	-99	-34	-26	0
Other capital flows (net)	-2,828	1,179	174	-518	-242	-555	-110	-252	-364
Loans	1,290	375	-133	-241	-618	-713	-162	-403	-449
Of which: WB, IDB, commercial (net)	633	237	-37	17	-433	-502	229	-11	0
Disbursements	792	472	479	386	307	240	567	379	412
Amortization	159	235	517	370	741	743	339	390	412
Of which: IMF (net)	883	422	152	-176	-135	-135	-391	-392	-449
Disbursements	1,989	502	552	304	536	538	389	89	0
Amortization	1,105	80	400	480	670	673	779	480	449
Deposits, net	-1,693	267	180	-428	0	0	0	0	0
Other flows, net	-2,426	537	128	151	376	157	52	151	85
Errors and omissions	-476	397	345	184	0	0	0	0	0
Overall balance	-2,328	1,380	454	951	426	525	150	150	153
Reserve assets (- increase)	**2,328**	**-1,380**	**-454**	**-951**	**-426**	**-525**	**-150**	**-150**	**-153**
				2. Reserve Adequacy and External Indicators					
Gross official reserves (stock)	**772**	**2,087**	**2,512**	**3,438**	**3,865**	**3,963**	**4,113**	**4,263**	**4,416**
In months of imports of goods and services	3.7	9.2	8.0	8.7	8.1	8.0	8.0	7.8	7.9
In percent of short-term debt excluding nonresidential deposits	25.1	86.8	158.0	153.5	137.5	139.7	197.9	234.2	252.5
In percent of short-term debt including nonresidential deposits	14.3	45.1	61.6	75.7	74.2	75.7	89.8	96.5	99.3
Net international reserves (stock) 2/	**-1,088**	**-763**	**-2,218**	**-1,166**	**-843**	**-257**	**-152**	**340**	**941**
				(As percent of GDP)					
Exports	15.9	20.3	23.7	22.3	19.9	22.3	22.7	23.0	23.1
Imports	15.5	18.7	22.6	22.7	25.2	26.6	25.6	25.4	24.6
Current account	3.2	-0.5	0.3	-0.5	-5.6	-4.3	-3.2	-2.6	-1.5
Underlying current account 3/	3.2	-0.5	0.3	0.1	-2.1	-1.2	-1.7	-1.5	-1.5
Financial and capital account	-18.5	9.3	0.5	5.1	7.9	7.1	3.9	3.3	2.2
Of which: foreign direct investment (net)	1.5	3.6	2.4	3.6	6.2	6.9	4.6	3.9	2.6
Of which: government securities (net)	1.4	0.0	1.8	3.3	3.6	3.8	0.0	0.8	1.1
Of which: IMF (net)	7.3	6.0	0.8	-1.0	-0.7	-0.7	-2.0	-1.9	-2.0
Overall balance	-19.3	12.3	3.4	5.6	2.3	2.8	0.8	0.7	0.7
Changes in GIR	19.3	-12.3	-3.4	-5.6	-2.3	-2.8	-0.8	-0.7	-0.7
External debt	87.5	98.2	87.4	67.8	61.2	61.9	57.4	52.7	49.2
Short-term debt (residual maturity)	25.5	21.4	12.0	13.3	14.9	15.3	10.5	8.6	7.9
External public debt	68.9	85.3	76.9	60.4	54.7	55.2	51.1	46.8	43.6
External debt + NR deposits	106.8	118.1	106.1	81.4	73.8	74.8	70.0	65.1	61.4
				(As percent of annual exports of goods and services)					
Total external debt	392.8	357.1	269.9	224.3	227.8	205.8	188.4	171.1	157.8
Total external debt (including nonresidential deposits)	479.2	429.3	327.8	269.3	275.0	248.7	229.9	211.1	196.9
Debt service	55.0	52.3	44.8	47.0	60.3	54.8	41.9	34.5	31.9
Of which: interest payments	24.5	19.2	16.7	16.8	20.5	18.5	18.1	16.8	16.0
				(Annual percent changes)					
Exports	-10.2	18.7	37.9	19.5	7.9	10.2	8.4	8.2	5.3
Imports	-35.7	12.0	42.6	27.9	25.5	29.0	2.7	5.7	1.7
Export prices in US$ (year-on-year percent change) 3/	-7.7	7.4	6.4	5.2	1.1	2.6	0.0	-0.8	-0.4
Import prices in US$ (year-on-year percent change) 3/	-10.8	5.1	9.1	12.2	2.4	5.7	1.1	-0.3	0.1
Terms of trade 3/	3.5	2.2	-2.4	-6.3	-1.3	-2.9	-1.1	-0.6	-0.6
Export volume 3/	-2.1	9.4	28.7	16.2	8.6	8.6	7.0	7.2	7.2
Import volume 3/	-26.9	6.2	29.1	9.4	8.2	9.8	8.6	8.0	6.8

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

1/ Includes secondary market transactions between residents and non-residents.
2/ Includes all liabilities to the Fund and liabilities to residents; follows respective TMU definitions.
3/ Excluding imports related to the construction of planned pulp mill projects (Botnia and ENCE).

Table 3. Uruguay: Public Sector Operations
(In millions of pesos)

					2006				Proj.		
					Q1 3/						
	2002	2003	2004	2005	Prog.	Est.	Report 06/197	Proj.	2007	2008	2009
Revenue	**83,891**	**101,081**	**117,367**	**130,818**	**35,828**	**38,119**	**146,919**	**147,808**	**164,033**	**175,549**	**189,602**
Taxes	57,832	70,096	83,002	92,280	24,981	27,533	101,723	103,586	114,490	122,146	131,202
VAT and excise taxes	29,708	37,667	47,200	53,124	14,717	14,967	60,468	60,794	66,350	70,828	75,837
On income and profits	14,302	15,621	17,683	20,148	5,051	5,231	21,340	22,600	27,037	30,048	32,692
On foreign trade	2,730	3,780	4,958	5,195	1,186	1,316	5,111	5,490	4,247	3,857	4,150
On property and other	11,091	13,028	13,161	13,813	4,025	6,019	14,804	14,702	16,856	17,413	18,524
Social security contributions 1/	15,589	14,696	16,657	21,526	5,890	6,227	23,288	24,072	26,042	27,841	29,847
Nontax revenue	5,274	6,200	7,831	8,399	2,157	2,302	9,856	9,698	10,466	11,131	11,876
Current surplus of public enterprises	5,196	10,090	9,876	8,614	2,801	2,057	12,052	10,452	13,035	14,432	16,676
Noninterest expenditure	**83,819**	**92,431**	**103,082**	**114,858**	**33,178**	**32,709**	**130,247**	**130,906**	**144,308**	**154,588**	**167,140**
Current 4/	77,405	84,623	93,780	105,276	28,963	27,887	117,130	117,789	127,715	136,959	147,911
Wages	18,158	19,701	23,409	25,499	6,760	6,748	28,641	28,641	32,263	35,196	38,579
Goods and services	12,057	15,031	17,015	19,386	5,904	5,233	22,620	22,620	23,648	24,883	26,950
Of which: SEP	0	0	0	780	780	579	2,553	2,553	1,555	0	0
Social security benefits 1/	42,818	44,218	47,702	53,057	14,223	14,338	57,666	58,226	62,990	67,341	72,194
Other 1/	4,371	5,673	5,654	7,333	2,076	1,568	8,203	8,303	8,814	9,539	10,187
Capital (Government and enterprises) 4/	6,413	7,808	9,303	9,582	4,215	4,822	13,117	13,117	16,593	17,630	19,230
Primary balance	**72**	**8,651**	**14,284**	**15,960**	**2,651**	**5,376**	**16,672**	**16,902**	**19,724**	**20,961**	**22,462**
Interest	12,163	18,881	22,666	18,753	5,726	5,112	21,455	20,984	22,276	23,285	24,293
Overall balance	**-12,091**	**-10,231**	**-8,382**	**-2,793**	**-3,076**	**264**	**-4,783**	**-4,082**	**-2,552**	**-2,324**	**-1,831**

Table 3. Uruguay: Public Sector Operations (continued)
(In percent of GDP)

					2006						
					Q1 3/				Proj.		
	2002	2003	2004	2005	Prog.	Est.	Report 06/197	Proj.	2007	2008	2009
Revenue	**32.1**	**32.0**	**30.9**	**31.8**	**32.2**	**34.2**	**33.0**	**32.7**	**33.6**	**33.6**	**33.8**
Taxes	22.2	22.2	21.9	22.5	22.4	24.7	22.9	22.9	23.4	23.4	23.4
VAT and excise taxes	11.4	11.9	12.4	12.9	13.2	13.4	13.6	13.5	13.6	13.6	13.5
On income and profits	5.5	5.0	4.7	4.9	4.5	4.7	4.8	5.0	5.5	5.8	5.8
On foreign trade	1.0	1.2	1.3	1.3	1.1	1.2	1.1	1.2	0.9	0.7	0.7
On property and other	4.3	4.1	3.5	3.4	3.6	5.4	3.4	3.3	3.4	3.3	3.3
Social security contributions 1/	6.0	4.7	4.4	5.2	5.3	5.6	5.2	5.3	5.3	5.3	5.3
Nontax revenue	2.0	2.0	2.1	2.0	1.9	2.1	2.2	2.1	2.1	2.1	2.1
Current surplus of public enterprises	2.0	3.2	2.6	2.1	2.5	1.8	2.7	2.3	2.7	2.8	3.0
Noninterest expenditure	**32.1**	**29.3**	**27.2**	**27.9**	**29.8**	**29.4**	**29.3**	**29.0**	**29.5**	**29.6**	**29.8**
Current	29.7	26.8	24.7	25.6	26.0	25.0	26.3	26.1	26.1	26.2	26.4
Wages	7.0	6.2	6.2	6.2	6.1	6.1	6.4	6.3	6.6	6.7	6.9
Goods and services	4.6	4.8	4.5	4.7	5.3	4.7	5.1	5.0	4.8	4.8	4.8
Of which: SEP	0.0	0.0	0.0	0.2	0.7	0.5	0.6	0.6	0.3	0.0	0.0
Social security benefits 1/	16.4	14.0	12.6	12.9	12.8	12.9	12.9	12.9	12.9	12.9	12.9
Other 1/	1.7	1.8	1.5	1.8	1.9	1.4	1.9	1.8	1.8	1.8	1.8
Capital (Government and enterprises)	2.5	2.5	2.5	2.3	3.8	4.3	2.9	2.9	3.4	3.4	3.4
Primary balance	**0.0**	**2.7**	**3.8**	**3.9**	**2.4**	**4.8**	**3.7**	**3.7**	**4.0**	**4.0**	**4.0**
Interest	4.7	6.0	6.0	4.6	5.1	4.6	4.8	4.6	4.6	4.5	4.3
Overall balance	**-4.6**	**-3.2**	**-2.2**	**-0.7**	**-2.8**	**0.2**	**-1.1**	**-0.9**	**-0.5**	**-0.4**	**-0.3**
Memorandum items:											
Augmented balance 2 /	**-56,106**	**-10,231**	**-1,229**	**-2,793**	**-4,020**	**-680**	**-5,759**	**-14,649**	**-2,552**	**-2,324**	**-1,831**
In percent of GDP	-21.5	-3.2	-0.3	-0.7	-3.6	-0.6	-1.3	-3.2	-0.5	-0.4	-0.3
GDP (billions of pesos)	**261**	**315**	**379**	**411**	**...**	**...**	**445**	**452**	**489**	**522**	**560**

Sources: Ministry of Finance; and Fund staff estimates.

1/ This line was amended at the time of the second review to incorporate contributions collected by the BPS transferred to the AFAPs previously excluded.

2/ In 2002 this 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 are credited in 2004. In 2005 includes US$40 million for the financing of the deposit insurance scheme. In 2006 includes US$20 million for financing of the deposit insurance scheme and US$407 million for the net value of the recapitalization of the BHU.

3/ For quarters, amounts as percentage of one-fourth of annual GDP.

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

	2002	2003	2004	2005	2006 Report 06/197	2006 Proj.
1. Banco Central del Uruguay						
Net foreign assets	-689	-52	-51	1,307	1,382	1,942
Net international reserves 2/	-1,014	-321	-164	1,135	1,176	1,728
Gross international reserves 2/	772	2,087	2,512	3,438	3,491	3,963
Reserve liabilities 2/	-1,786	-2,407	-2,675	-2,304	-2,315	-2,235
Other net foreign assets	325	269	113	172	206	214
Net domestic assets	1,123	532	652	-287	-505	-867
Net credit to the public sector	1,541	2,464	2,626	1,969	1,755	1,741
Net credit to the financial system	-340	-2,112	-1,905	-1,975	-2,054	-1,981
Credit to the private sector	80	71	62	65	66	65
Securities issued by the BCU	-34	-243	-563	-904	-1,079	-1,361
Other	-124	352	431	558	808	669
Peso monetary liabilities	434	480	600	1,020	877	1,075
Memorandum items: 3/						
Monetary base (average) 4/	...	...	594	763	880	1,074
Monetary base (end of period) 4/			594	784	866	1,061
NIR program definition	...	...	-2,218	-1,166	-843	-257
NDA program definition	...	...	2,811	1,950	1,709	1,317
NIR flows	...	...	...	1,052	243	829
NDA flows	...	...	...	-852	-241	-632
2. Public and Private Banks 5/						
Net foreign assets	551	1,213	1,887	2,030	2,090	2,128
Net domestic assets	5,254	5,331	5,090	5,397	5,839	5,712
Net credit to the public sector 1/	399	219	437	0	-124	-124
Net credit to the financial system	947	2,612	2,256	2,602	2,756	2,925
Credit to the private sector	6,319	4,726	4,307	4,533	4,996	4,699
Other	-2,411	-2,226	-1,909	-1,738	-1,788	-1,788
Liabilities to the private sector (residents)	5,805	6,544	6,977	7,426	7,930	7,840
Public banks	3,140	3,409	3,670	3,842	4,070	4,058
Local currency	339	394	520	682	727	807
Foreign currency	2,801	3,016	3,149	3,160	3,343	3,251
Private banks	2,666	3,135	3,307	3,584	3,860	3,782
Local currency	357	349	405	574	583	680
Foreign currency	2,309	2,785	2,902	3,010	3,276	3,101
3. Banking System						
Net foreign assets	-138	1,161	1,835	3,337	3,524	4,070
Net domestic assets	6,288	5,788	5,738	4,952	4,999	4,875
Credit to the public sector	1,940	2,684	3,063	1,968	1,631	1,617
Credit to the rest of financial system	-218	-173	-165	470	419	975
Credit to the private sector	6,398	4,797	4,369	4,598	5,061	4,764
Other	-1,831	-1,519	-1,529	-2,084	-2,112	-2,481
Broad money (M3)	6,150	6,949	7,573	8,288	8,524	8,945
Memorandum items:			(Percentage chage)			
Base money (average)	18	19	8	28	5	28
Base money (eop)	22	25	11	34	2	23
Currency issued	6	22	16	22	0	22
M-1	2	35	13	29	7	28
M-1 (authorities' definition) 6/	5	34	13	33	7	28
M-2	-5	17	13	22	7	23
M-3	16	22	-2	0	2	8

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. Program figures for 2005 are at exchange rates prevailing in December 2004, while those for 2006 at those prevailing in September 2005.

2/ Includes all outstanding liabilities to the IMF, but excludes liabilities to resident financial institutions. The monetary table in Country Report 06/197 omitted from gross reserves US$374 million in government deposits at special accounts at the central bank.

3/ Program figures for 2005 are estimated at December 2004 exchange rates, while those for 2006 are estimated at September 2005 exchange rates.

4/ Monetary base excludes from peso monetary liabilities the net government and BPS deposits with BROU, which are subject to 100 percent requirements.

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

6/ Includes government and nonbank financial institution deposits at the central bank.

Table 5. Uruguay: Financial Soundness Indicators 1/

	2001	2002	2003	2004	Jun-05	2005
Capital adequacy indicators						
Capital/assets (percent)	7.3	-8.8	6.2	8.0	8.9	8.0
Asset quality indicators						
Nonperforming loans to total loans (percent)	16.1	38.6	13.6	9.2	8.9	8.4
Loan provisions to nonperforming loans (percent)	49.9	55.0	66.1	59.3	57.4	53.4
Loan provisions to total loans (percent)	8.0	21.2	9.0	5.4	5.1	4.5
Credit growth (net of provisions, percent)	21.5	7.1	-6.6	-10.7	-3.8	4.7
Net credit to the nonfinancial sector to total assets (percent)	42.0	46.1	25.4	27.3	26.0	25.7
Profitability indicators						
ROA	-2.0	-29.8	-2.8	0.7	0.9	0.5
ROE	-27.4	...	-44.7	9.2	10.3	6.5
Financial margin to gross income	-2.6	0.0	-1.4	5.3	2.1	4.3
Noninterest expenses to gross income	-3.9	-0.6	-4.8	14.2	4.9	13.3
Personnel expenses to noninterest expenses	32.6	14.7	16.2	17.7	22.4	16.4
Spread between lending and deposit rates (domestic currency, percent)	27.0	55.8	29.3	17.5	10.8	...
Spread between lending and deposit rates (foreign currency, percent)	6.3	7.6	7.9	6.3	5.1	...
Liquidity indicators						
Liquid assets to total assets (percent)	7.8	7.9	11.3	10.5	11.9	...
Liquid assets to total deposits (percent)	8.9	7.6	12.5	12.0	13.7	...
Foreign currency assets to foreign currency deposits (percent)	8.1	7.0	12.5	11.6	12.1	...
Domestic currency assets to domestic currency deposits (percent)	16.3	14.5	12.1	14.3	22.1	...
Net loans to the private sector/total deposits (percent)	47.8	29.1	28.5	31.1	29.8	...
Foreign currency loans to foreign currency deposits (percent)	40.2	25.1	25.5	28.2	28.1	...
Domestic currency loans to domestic currency deposits (percent)	115.8	79.1	51.1	48.2	38.6	...
Sensitivity-to-risk indicators						
Average maturity (years)						
Private banks						
Assets	1.7	1.3	1.2	1.1	1.2	...
Liabilities	1.0	1.7	1.0	0.7	0.6	...
Public banks						
Assets	1.3	1.5	1.6	1.9	1.8	...
Liabilities	0.5	1.3	0.9	0.3	0.3	...
Cooperative banks						
Assets	1.9	2.0	1.3	1.3	1.6	...
Liabilities	1.3	1.2	0.8	0.7	1.1	...
Net open position (percentage of net worth)						
BROU, BHU, private banks and cooperatives	-95.7	232.5	-48.2	-8.6	-8.4	...
BROU, private banks, and cooperatives	2.1	-12.8	3.4	5.0	4.8	...
Public banks	-2.6	-3.5	-2.5	-0.9	-0.8	...
Private banks	0.4	1.1	0.7	0.6	0.6	...
Cooperative banks	0.1	0.2	0.9	1.0	0.5	...

Source: Banco Central del Uruguay; and International Monetary Fund.

1/ Includes private and public banks (BROU and BHU) and cooperatives.

Table 6. Uruguay: Vulnerability Indicators

	2002	2003	2004	Est. 2005	Proj. 2006
(Percent change, unless otherwise indicated)					
Financial sector indicators					
Broad money	15.8	21.7	-2.0	0.1	7.7
Credit to the private sector (const. exch. rate)	-17.6	-23.9	-11.2	2.7	9.9
Share of nonperforming loans in total loans (in percent) 1/	37.2	9.4	3.8	2.7	2.3
Provisions to nonperforming loans 1/	58.3	91.4	106.8	118.8	121.0
Capital to asset ratio (in percent) 1/	-10.0	7.2	8.3	8.6	8.5
Return on assets 1/	-25.3	-1.1	-0.1	0.7	1.2
Interbank interest rates (percent, end-of-period)	45.0	2.5	1.3	1.0	...
FX deposits held by residents (in percent of total deposits)	88.3	88.8	87.6	83.7	82.0
FX loans to residents (in percent of total loans)	80.4	77.6	73.3	70.0	70.0
Public debt indicators					
Public sector gross debt (PSGD, in percent of GDP)	95.5	104.5	92.5	69.4	66.5
Of which: Exposed to rollover risk (in percent of total PSGD)	17.2	12.1	13.5	16.0	...
Exposed to exchange rate risk (in percent of total PSGD)	96.0	94.3	90.2	87.0	...
Exposed to interest rate risk (in percent of total PSGD)	57.0	45.5	44.6	40.0	...
External indicators					
Merchandise exports	-10.2	18.7	37.9	19.5	10.2
Merchandise imports	-35.7	12.0	42.6	27.9	29.0
Merchandise terms of trade	4.3	2.9	-3.1	-9.7	-4.6
REER appreciation (+)	-20.3	-13.2	9.3	11.9	...
(Percent of GDP, unless otherwise indicated)					
Current account balance	3.2	-0.5	0.3	-0.5	-4.3
Capital and financial account balance	-18.5	9.3	0.5	5.1	7.1
Of which : Net foreign direct investment	1.5	3.6	2.4	3.6	6.9
Government securities	1.4	0.0	1.8	3.3	3.8
Other net inflows	-21.4	5.7	-3.7	-1.8	-3.5
Total gross external debt (ED) in percent of GDP	87.5	98.2	87.4	67.8	61.9
Of which: Short-term ED (original maturity, in percent of total ED)	12.5	6.7	7.6	7.9	5.4
ED to foreign official sector (in percent of total ED)	44.9	51.1	50.7	48.3	42.5
External interest payments (in percent of exports of GNFS)	24.5	19.2	16.7	16.8	18.5
External amortization payments (in percent of exports of GNFS)	30.5	33.1	28.2	30.2	36.3
(U.S. million, unless otherwise indicated)					
Central Bank reserve liabilities 1/	1,786	2,407	2,675	2,304	2,235
Short-term foreign assets of the banking system	3,140	4,989	5,637	6,880	7,503
Short-term foreign liabilities of the banking system 2/	4,916	4,597	4,389	4,504	4,476
Gross official reserves	772	2,087	2,512	3,438	3,963
In months of imports GNFS	3.7	9.2	8.0	8.7	8.0
In percent of short-term external debt excl. nonres FX deposits	25.1	86.8	158.0	153.5	139.7
In percent of short-term external debt plus bank NR deposits	14.3	45.1	61.6	75.7	75.7
In percent of short-term debt plus FX deposits	7.0	20.0	27.7	32.9	35.2
In percent of broad money	12.2	28.7	34.3	37.9	38.0
In percent of base money	175.4	427.3	418.1	386.3	372.9
Banking system foreign assets as percent of short-term external debt plus all FX deposits 3/ 4/	46.6	56.9	68.1	74.5	71.5
Financial market indicators					
Foreign currency debt rating (Moody's) 5/	B3	B3	B3	B3	…
Foreign currency debt rating (S&P) 5/	B-	B-	B	B+	…
EMBI secondary market spread (bps, end of period) 5/	1,228	624	388	298	279
Exchange rate (per U.S. dollar, period average)	21.6	28.2	28.6	24.4	…
Exchange rate (per U.S. dollar, end-of-period)	27.2	29.3	26.4	24.1	…

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

1/ Excludes BHU. March 2006 figures.
2/ Includes all use of Fund credit.
3/ By remaining maturity.
4/ Excludes nonreserve assets from the BCU.
5/ As of June 7, 2006.

Table 7. Uruguay: Public Sector Financing Outlook, 2006 1/
(In millions of U.S. dollars)

	Actual	Projections			
	Q1	Q2	Q3	Q4	Year
Public sector gross borrowing requirements	**1,211**	**323**	**272**	**728**	**2,534**
Of which : IMF repurchases	675	0	0	0	675
Of which : World Bank/IDB 2/	555	79	42	67	743
Of which : Bond amortizations	233	49	60	401	744
Gross financing	**1,211**	**323**	**272**	**728**	**2,534**
Of which : IMF disbursements	168	124	124	124	541
Of which : World Bank/IDB 2/	29	43	29	139	240
Of which : Bond placements	1,125	119	123	516	1,883
10 year maturity international issuances	1,010	0	9	402	1,421
Of which : Prefinancing for 2007	...	...	...	...	400
UI bonds	59	101	114	114	388
Letras	56	18	0	0	74
Of which : Short-term debt	0	0	0	0	0
Banking system credit	13	26	-10	-84	-55
Bilaterals and others	-124	10	6	32	-75
Memorandum items:					
Fund credit outstanding	...	...	...	...	2,184
(as a share of quota)	...	...	...	...	495
Net World Bank/IDB 2/	-526	-36	-13	73	-502
Net bond placements	892	70	63	115	1139

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

1/ Excludes the assumption of net liabilities (non-cash) from BHU in the third quarter of 2006 of US$407 million.
2/ Includes official debt.

Table 8. Uruguay: Performance under the 2006 Economic Program 1/

Area	Structural Conditionality	Date	Status
A. 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	Observed.
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	Observed.
Tax reform	Submit to congress a comprehensive tax reform as described in paragraph 7 of the MEFP.	February 28, 2006	Not observed. Done with slight delay.
Tax reform	Begin to implement the comprehensive tax reform.	October 31, 2006	Modification requested to move to September 15, 2006.
Central Bank	Submit simultaneously three laws to congress to: (i) give appropriate autonomy to the central bank (as described in paragraph 12 of the MEFP); (ii) strengthen the regulation of the financial system (as described in paragraph 13 of the MEFP); and (iii) provide a suitable bank resolution framework (as described in paragraph 14 of the MEFP).	December 31, 2005	Not observed. 2/
Central Bank	Begin to implement the financial sector reform law	June 30, 2006	Modification requested to move to November 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	Observed.
BHU	Adopt action plan to address the financial situation of BHU consistent with minimizing systemic risks and contingent fiscal costs.	December 31, 2005	Observed.
BHU	Move nonperforming loans into a fideicomiso and adequately capitalize BHU as specified in paragraph 11 of the TMU.	August 31, 2006	
BHU	Transform BHU into an institution with a viable business plan and a strong regulatory framework as specified in paragraph 12 of the TMU.	November 30, 2006	
Pensions	Begin to implement reform of the pension fund for the police.	May 31, 2006	Not observed. Reset for end-October.
Pensions	Submit to Congress reform of the pension fund for the military and bank employees as described in paragraph 12 of the SMEFP.	November 30, 2006	
Pensions	Begin to implement the reform of the pension fund for the military and bank employees as described in paragraph 12 of the SMEFP.	May 31, 2007	
B. Structural benchmarks			
Fiscal	Establish quarterly revenue collection targets (floors) at the social security bank (BPS).	June 30, 2005	Observed.
Debt management	Create a debt management unit at the Ministry of Finance.	December 31, 2005	Observed.
Tax administration	Sign a memorandum of understanding between the Ministry of Finance and the DGI agreeing on quantitative targets and indicators for 2006 on tax collections, audit coverage, tax services, and information systems.	December 31, 2005	Observed.
Tax administration	Formulate a plan to strengthen the auditing and enforced collection functions of the BPS.	June 30, 2006	
Tax administration	Finalize the design of a comprehensive reform plan for the customs agency (including establishing collection targets consistent with the program).	August 31, 2006	
Debt management	Create a debt management unit at the Ministry of Finance.	December 31, 2005	Observed.
Budget	Prepare recommendations, with a timetable, to improve legislation, coverage, classification, formulation, controls, and transparency of the budget process.	August 31, 2006	
Growth	Publish agenda of growth-enhancing reforms (including timetable for implementation) prepared by the business environment commission.	March 31, 2006	Not observed. Done with sight delay.
Growth	Submit to Congress bankruptcy law (to include Chapter-11 type corporate restructuring).	June 30, 2006	
Financial sector	Adopt a detailed schedule for the implementation of the BHU action plan.	February 28, 2006	Observed.
Financial sector	Sell shares of NBC in amounts that yield managerial control to the private sector.	June 30, 2006	Observed.
Central Bank	Adopt plan to strengthen the central bank finances (outright capitalization or interest payment on government paper).	September 30, 2006	Modification requested to move to November 30, 2006.

PC= performance criterion; IT=Indicative target.
Sources: Ministry of Economy and Finance; and Central Bank of Uruguay.

Table 8: Uruguay: Performance under the 2006 Economic Program (concluded) 1/

	2005 Stock	2006 Targets			
		Mar. 31			
	Sept. 30	Target	Adj. Target	Prel.	**Margin (+)**
A. Quantitative performance criteria					
		(In millions of Uruguayan pesos)			
1. Combined public sector primary balance (floor) 3/	n.a.	2,651	2,651	5,376	**2,725**
2. General government noninterest expenditure (ceiling) 3/	n.a.	13,409	13,409	12,147	**1,262**
3. Net domestic assets of the BCU (ceiling) 3/ 4/	51,525	-3,136	-7,264	-14,820	**7,556**
		(In millions of U.S. dollars)			
4. Net international reserves of the BCU (floor) 3/ 4/	-1,546	250	423	779	**357**
5. Nonfinancial public sector gross debt (ceiling) 5/	12,309	12,882	13,110	12,327	**783**
6. Accumulation of external payment arrears of the public sector (on a continuous basis) 3/	0	0	0	0	**0**
B. Indicative targets					
		(In millions of Uruguayan pesos)			
7. Combined public sector overall balance (floor) 3/	n.a.	-3,076	-3,076	264	**3,340**
8. Combined public sector primary balance (extended) (floor) 3/	n.a.	2,651	2,651	5,783	**3,132**
9. Monetary base (ceiling) 3/ 4/	16,146	3,140	3,140	4,558	**-1,418**

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/ Nonobservance due to authorities' decision to keep the financial sector supervisory authority within the BCU.
3/ Cumulative changes from the previous calendar year.
4/ 2006 targets are cumulative from end-September 2005.
5/ All maturities.

Table 9. Uruguay: Schedule of Purchases Under the Stand-By Arrangement, 2005–08

	Amount of Purchase		
Availability Date	**SDR**	**Percent Quota**	**Conditions**
June 8, 2005	30.65	10.0	Program approval
September 28, 2005	30.65	10.0	Completion of first review and observance of structural PCs and end-June quantitative PCs
January 18, 2006	30.65	10.0	Completion of second review and observance of structural PCs and end-December quantitative PCs
March 27, 2006	85.82	28.0	Completion of third review and observance of structural PCs and end-December quantitative PCs
June 28, 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 10. Uruguay: Projected Payments to the Fund and Capacity to Repay

	2003	2004	2005	2006	2007	2008	2009	2010	2011
					(In SDR million)				
Fund disbursements (existing and prospective)									
Principal disbursements	364.2	372.8	201.1	373.9	269.7	61.3	0.0	0.0	0.0
Existing	364.2	372.8	201.1	116.5	0.0	0.0	0.0	0.0	0.0
Prospective	0.0	0.0	0.0	257.5	269.7	61.3	0.0	0.0	0.0
Fund repurchases and charges (existing and prospective)									
Principal (repurchases) 1/	57.1	270.3	317.3	467.9	540.9	332.3	310.4	274.2	265.1
On existing purchases	57.1	270.3	317.3	467.9	540.9	332.3	278.2	94.9	14.6
On prospective purchases	0.0	0.0	0.0	0.0	0.0	0.0	32.2	179.3	250.6
Charges and interest	49.0	64.0	77.9	83.4	82.4	66.2	47.5	30.2	15.9
On existing purchases	49.0	64.0	77.9	78.2	56.7	30.4	15.3	4.6	1.2
On prospective purchases	0.0	0.0	0.0	5.2	25.6	35.9	32.2	25.5	14.7
Total payments to Fund 1/	106.1	334.4	395.2	551.2	623.2	398.5	357.9	304.3	281.0
In millions of U.S. dollars	148.6	495.2	584.0	792.5	898.0	575.9	518.2	441.3	408.1
In percent of exports of goods and NFS	4.8	11.5	11.4	14.2	14.9	8.9	7.5	6.0	5.2
In percent of GDP	1.3	3.7	3.5	4.3	4.5	2.7	2.3	1.9	1.6
In percent of quota	34.6	109.1	128.9	179.8	203.3	130.0	116.8	99.3	91.4
In percent of overall external debt service	9.2	25.7	24.4	25.9	35.6	25.7	23.5	17.7	15.9
In percent of gross reserves	7.1	19.7	17.0	20.0	21.8	13.5	11.7	9.7	8.6
Fund credit outstanding					(End-of-period)				
In millions of SDRs	1,625.9	1,728.4	1,612.2	1,518.2	1,247.1	976.1	665.7	391.6	126.4
In millions of U.S. dollars	2,385.9	2,662.3	2,307.3	2,184.1	1,799.4	1,412.0	964.6	568.1	183.7
In percent of exports of goods and NFS	77.4	62.0	45.2	39.1	29.9	21.7	13.9	7.7	2.3
In percent of GDP	21.3	20.1	13.7	11.7	9.1	6.7	4.4	2.4	0.7
In percent of quota	530.5	563.9	526.0	495.3	406.9	318.5	217.2	127.8	41.1
In percent of public sector external debt	25.0	26.1	22.6	21.3	17.8	14.3	10.0	6.0	2.0
In percent of overall external debt	21.7	23.0	20.2	19.0	15.9	12.7	8.8	5.3	1.8
In percent of gross reserves	114.3	106.0	67.1	55.1	43.7	33.1	21.8	12.5	3.9
Memorandum items:					(In millions of U.S. dollars unless otherwise noted)				
Exports of goods and NFS	3,084	4,296	5,102	5,590	6,021	6,494	6,917	7,379	7,849
Quota (millions of SDRs)	306.5	306.5	306.5	306.5	306.5	306.5	306.5	306.5	307.5
GDP	11,211	13,268	16,878	18,591	19,777	21,071	22,174	23,517	24,964
U.S. dollar per SDR, e.o.p.	1.5	1.5	1.4	1.4	1.4	1.4	1.4	1.5	1.5
U.S. dollar per SDR, average	1.4	1.5	1.5	1.4	1.4	1.4	1.4	1.5	1.5
Public sector debt	11,705	12,272	11,720	12,365	12,442	12,516	12,551	12,591	12,640
Public sector external debt 2/	9,557	10,206	10,200	10,264	10,105	9,870	9,676	9,416	9,231
Overall external debt service	1,614	1,926	2,397	3,063	2,523	2,238	2,207	2,498	2,574
Overall external debt	11,012	11,594	11,441	11,505	11,346	11,111	10,917	10,657	10,472
Gross foreign reserves	2,087	2,512	3,438	3,963	4,113	4,263	4,416	4,545	4,737

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

1/ Projections on obligations basis.
2/ Excluding public commercial banks.

URUGUAY: PUBLIC SECTOR DEBT SUSTAINABILITY ANALYSIS AND BALANCE SHEET RISKS

1. **Uruguay's public debt outlook has strengthened significantly from that one right after the 2002 crisis.** At that time, the debt-to-GDP ratio was over 105 percent of GDP, projected to decline gradually to 75 percent by 2012. After the 2003 debt exchange, the outlook strengthened further, with the projected debt-to-GDP ratio down to 63 percent by 2012. Since then, the debt-to-GDP ratio has declined by some 30 percentage points, to an estimated 69 percent by end-2005, and it is now envisaged to decline to 48 percent by 2012. The improved outlook reflects mainly stronger than previously envisaged growth, recovery of the real exchange rate, and lower interest rates.

2. **Although the structure of Uruguay's public debt has improved, it remains highly vulnerable to interest rate, exchange rate, and rollover risks.** Of the total debt, almost 90 percent is exposed to exchange rate risk (mainly the U.S. dollar and SDR rates) and about 40 percent to interest rate risk. Contractual short-term debt has fallen significantly to about 2 percent of total debt, but residual short-term debt remains large (16 percent of total debt). While projected debt-service has declined further since the approval of the current program in June 2005, reflecting lower interest costs and refinancing at longer maturities, it remains high (16 percent of GDP in 2006, declining to 12 percent of GDP by 2011).

3. **Other balance sheet vulnerabilities persist, albeit significantly reduced, which could pose risks to the public sector debt sustainability outlook.** In the 2002 crisis, a large share of the increase in public debt was attributable to emergency assistance provided to public banks, which faced sharp deposit withdrawals and an increase in nonperforming loans. Today, corporations remain still largely liability dollarized, with foreign currency debt representing 65 percent of total liabilities, on average, at end-2005. Also, in the financial system dollarization and short-term deposits remain high, exposing banks to risks from peso depreciation, international interest rate increases, and foreign exchange liquidity withdrawals. However, with high liquidity and capital, banks can withstand important market and foreign exchange liquidity shocks better. For instance, as buffers against (i) *deposit runs*, banks hold 75 percent of FX deposits in liquid FX assets; (ii) *interest rate risks*, banks set short maturities on FX loans and charge high interest rate spreads; and (iii) *peso depreciation*, banks hold more foreign currency assets than foreign currency liabilities (2½ times), factoring in that 30 percent of the dollar loans are extended to individuals without a stable dollar income stream.

3. **Under baseline assumptions, Uruguay's public sector debt should decline considerably over the medium term (Table 1).** The baseline scenario assumes a primary fiscal surplus of 4 percent of GDP, sustained GDP growth of 3 percent a year, a gradual recovery of the real value of the peso vis-à-vis the U.S. dollar to 85 percent of its pre-crisis level (from 80 percent at end-2005), and sovereign spreads remaining broadly at current levels (assuming that less favorable market conditions would be offset by the lower country risk from a declining debt ratio) over the medium term. Assuming net costs of BHU restructuring of

US$0.4 billion[1] with no further contingent liabilities from bank restructuring coming due, and no possible debt reduction from privatization proceeds, public debt would decline to just below 50 percent of GDP by 2012. With nominal debt staying broadly at the 2005 level, this reduction would be mainly achieved through strong growth and real appreciation of the peso.

4. **Public debt remains on a declining path in the no-policy change scenario, but when key economic variables are set at their historical averages it jumps up significantly (Table 2)**. This is because by 2005, the primary balance had already moved close to its medium-term target of 4 percent of GDP (from a deficit of 1.1 percent of GDP in 2001 to a surplus of 3.9 percent of GDP). However, when key variables are set at their historical levels (primary fiscal balance and growth), the debt-to-GDP ratio would increase by 20 percent relative to baseline.

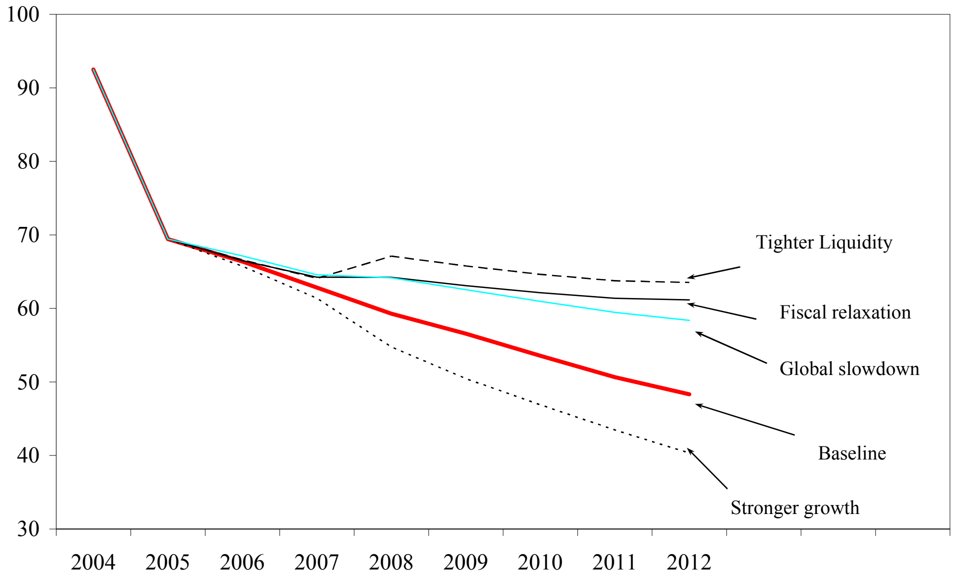
5. **Standardized bound tests show that Uruguay is vulnerable to several shocks, but particularly exposed to exchange rate risk (Figure 1)**. Assuming half a standard-deviation shocks to interest rates or growth rates, the public debt-to-GDP ratio would stay at 63–75 percent by 2011 compared to 48 percent in the baseline scenario. However, a similar shock to the primary balance would leave the public debt-to-GDP ratio at 56 percent by 2011, as the medium-term primary balance would still remain above 3 percent of GDP. If all three shocks with a ¼ standard deviation were to take place at the same time, the debt-to-GDP ratio would end up at 65 percent by 2011. However, if the exchange rate were to depreciate by 30 percent, the debt-to-GDP ratio would jump up to almost 100 percent and only decline to about 82 percent by 2011, raising debt sustainability concerns.

Tailored scenarios

6. **Tailored scenarios are used to assess Uruguay's overall vulnerabilities to macroeconomic shocks**. The figures below present illustrative scenarios of external, fiscal and growth shocks to Uruguay's debt outlook.

[1] This assumes that gross debt of some US$1 billion would be partly offset by the estimated net worth of BHU's assets of some US$640 million. This assumes that about 60 percent of BHU's loan portfolio (after current provisioning) can be recovered and that cash payment on leases and proceeds from the sale of properties would increase by about half, as a result of improved management. If asset recovery would be only 30 percent, the debt-to-GDP ratio would be some 1.2 percent higher relative to baseline by 2012.

Uruguay: Public Debt—Tailored Scenarios
(in percent of GDP)



7. **Under all these macroecononomic scenarios, the financial system soundness indicators are expected to weaken, but overall system stability would not be affected.** All scenarios were stress tested using the FSAP methodology. The findings suggest that while banks' profitability and loan portfolios would weaken somewhat, under the current high liquidity and capital adequacy ratios, overall financial system stability would not be put at risk. This however assumes that depositor confidence would be maintained.

- **Tighter international liquidity**. This scenario assumes a reduction in global liquidity (but not a sudden stop) and a sharper-than-currently-envisaged increase in U.S. interest rates (by 200 basis points) which would increase Uruguay's spread by some 100 basis points.[2] The resulting higher financing costs are assumed to lead to slower growth (by ½ percent relative to the baseline) and a permanent relaxation of the primary balance of ¼ percent of GDP. With lower capital inflows and lower growth the real exchange rate is assumed to be 10 percent more depreciated than under to baseline. Under this scenario, t*he public debt-to-GDP ratio by 2012 would increase to some 15 percent higher than in the baseline.*

- **Slowdown in global growth and lower non-oil commodity prices**. It is assumed that global growth would slow by 1 percent relative to baseline for the years 2006–12, causing a one-off drop in non-oil commodity prices of 10 percent.[3] This would lead to a

[2] Dailami et al. (2005) conclude that a 200 basis point increase in short-term U.S. interest rates increases emerging market spreads by 64 basis points with debt-to-GDP ratios above 94 percent.

[3] Uruguay's exports are mainly in beef, which have been subject to price swings of 30 percent within two years.

decline in Uruguay's exports. It is assumed that domestic growth would slow by 1 percent relative to baseline and in response the primary fiscal balance would weaken by ¼ percent of GDP. To maintain external balance, the REER would depreciate by some 5 percent relative to baseline. *The public debt-to-GDP ratio however would stay at 58 percent by 2012, 10 percent above baseline.*

- **A relaxation of fiscal discipline**. This scenario assumes that higher domestic spending pressures would weaken the fiscal position, implying a primary surplus of 1 percent of GDP (compared to 4 percent of GDP in the baseline). While this may raise near-term growth somewhat, the scenario assumes growth in line with baseline, as higher financing needs and country risk would reduce medium-term growth prospects. Interest rate spreads are assumed to increase by 200 basis points, and the REER to depreciate by 5 percent relative to baseline, reflecting lower capital inflows. *As a result, the debt-to-GDP ratio in 2012 would be at 61 percent, 12 percentage points above baseline projections.*

- **A strengthening of the overall growth outlook**. This scenario assumes that the government accelerates the implementation of a comprehensive structural reform agenda, leading to substantial increases in private investment and an increase of potential growth by 1 percentage point, to 4 percent. This in turn is assumed to reduce country spreads by 50 basis points and to contribute to a further appreciation of the real exchange rate by some 5 percent relative to baseline. *As a result, the debt-to-GDP ratio would decline to 40 percent by 2012.*

Table 1. Uruguay: Public Sector Debt Sustainability 1/

						Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
						A. Assumptions						
Real GDP growth (percent)	-3.4	-11.0	2.2	11.8	6.6	4.6	4.2	2.8	3.4	3.0	3.0	3.0
Interest rate spread (bps)	284	1400	900	600	387	300	300	300	300	300	300	300
Real U.S. dollar exchange rate (avg.) (change in percent)	-13.7	-11.0	-22.1	-0.2	10.4	5.9	2.3	1.0	0.1	0.6	0.6	0.1
Primary balance: Consolidated public sector	**-1.2**	**0.0**	**2.7**	**3.8**	**3.9**	**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	4.1	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**	**-0.7**	**-0.9**	**-0.5**	**-0.4**	**-0.3**	**-0.3**	**-0.3**	**-0.3**
Non-financial public sector	-3.8	-4.3	-2.9	-1.2	-0.6	-0.6	-0.2	-0.2	0.0	0.0	-0.1	-0.1
BCU 2/	-0.3	-0.3	-0.4	-1.0	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
						B. Debt Dynamics (in percent of GDP)						
Gross non-financial public sector debt	**46**	**96**	**104**	**92**	**69**	**67**	**63**	**59**	**57**	**54**	**51**	**48**
Of which:												
Contribution from REER (cum since 2004)	...	...	...	...	0	4	5	6	5	5	6	5
Contribution from Growth (cum since 2004)	...	...	...	...	0	3	6	9	12	16	19	22
						C. Cash Flow (in millions of U.S. dollars)						
Gross borrowing needs 3/	**1,210**	**3,209**	**1,251**	**2,504**	**2,588**	**2,941**	**1,699**	**1,357**	**1,480**	**1,776**	**2,077**	**1,370**
Augmented public sector deficit	707	2,524	324	161	95	555	41	43	8	18	27	26
Public sector deficit	707	526	324	161	95	118	31	34	-2	9	20	20
Bank assistance 3/	0	1,998	0	0	0	437	10	10	10	8	7	6
Buildup in free reserves at the central bank	-7	-364	6	631	633	81	100	100	100	100	100	100
Amortization	510	1,049	921	1,711	1,859	2,305	1,558	1,214	1,373	1,659	1,950	1,245
Long-term bonds and inflation-indexed bonds	403	349	221	29	289	634	129	186	184	488	836	348
Letras (2 years)	...	...	...	...	422	110	280	74	250	250	250	250
Peso bonds (short-term)	0	209	209	637	127	45	0	50	50	50	50	50
Commercial bank loans	0	214	217	307	89	69	99	114	128	149	90	94
Supplier credits	0	0	0	0	42	30	31	33	28	31	28	24
IDB/WB and other official debt	97	205	234	339	411	743	240	276	284	294	313	312
IMF	10	72	40	400	480	675	779	480	449	396	383	166
Gross Financing 3/	**1,209**	**3,209**	**1,251**	**2,504**	**2588**	**2,941**	**1,699**	**1,357**	**1,480**	**1,776**	**2,077**	**1,370**
Long-term bonds (external)	1,292	143	405	371	1,091	1,421	162	307	491	783	1,086	393
Inflation-indexed instruments	...	...	...	...	318	388	250	250	250	250	250	250
Letras (2 years)	...	...	...	...	310	74	250	250	250	250	250	250
Peso bonds (short-term)	-15	677	637	544	92	0	50	50	50	50	50	50
Commercial bank	33	-16	-475	365	19	-55	99	114	128	149	90	94
Use of deposits	26	-21	-543	200	-103	124	0	0	0	0	0	0
Loans	7	5	68	165	122	69	99	114	128	149	90	94
IDB/WB and other official debt	198	789	461	366	370	240	468	265	284	263	323	309
IMF	0	1,603	484	552	297	541	389	89	0	0	0	0
Central bank credit (net) (net of IMF disbursments)	0	0	0	0	0	0	0	0	0	0	0	0
Other inflows (net) 4/	-299	13	-261	307	91	332	31	33	28	31	28	24
Residual financing needs	**0**	**0**	**0**	**0**	**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	15.7	17.0	12.3	10.2	10.5	11.4	12.2	9.1
Average interest rate (in percent)	12.6	5.5	5.7	6.6	6.5	7.1	7.1	7.5	7.6	8.1	8.6	9.0
Memorandum items:												
GDP (millions of dollars)	18,561	12,089	11,211	13,268	16,878	18,591	19,777	21,071	22,174	23,517	24,964	26,274
Nominal debt (millions of dollars)	8,538	11,551	11,705	12,272	11,720	12,365	12,442	12,516	12,551	12,591	12,640	12,689
Commerical bond placements (net) (millions of dollars)	889	-207	184	342	1,008	1,139	253	546	557	545	500	295
World Bank/IDB (net)	...	...	...	...	49	-467	240	-3	6	-24	17	2
Rollover of Fund obligations (in percent)	...	...	...	...	62	80	50	18	0	0	0	0
Fund credit outstanding (millions of dollars)	145	1,754	2,386	2,662	2,307	2,184	1,799	1,412	965	568	184	17
Fund credit outstanding (in percent of GDP)	0.8	14.5	21.3	20.1	13.7	11.7	9.1	6.7	4.4	2.4	0.7	0.1
Fund credit outstanding (as a share of quota)	0.5	5.5	530.5	563.9	526.0	495.3	406.9	318.5	217.2	127.8	41.3	3.8

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

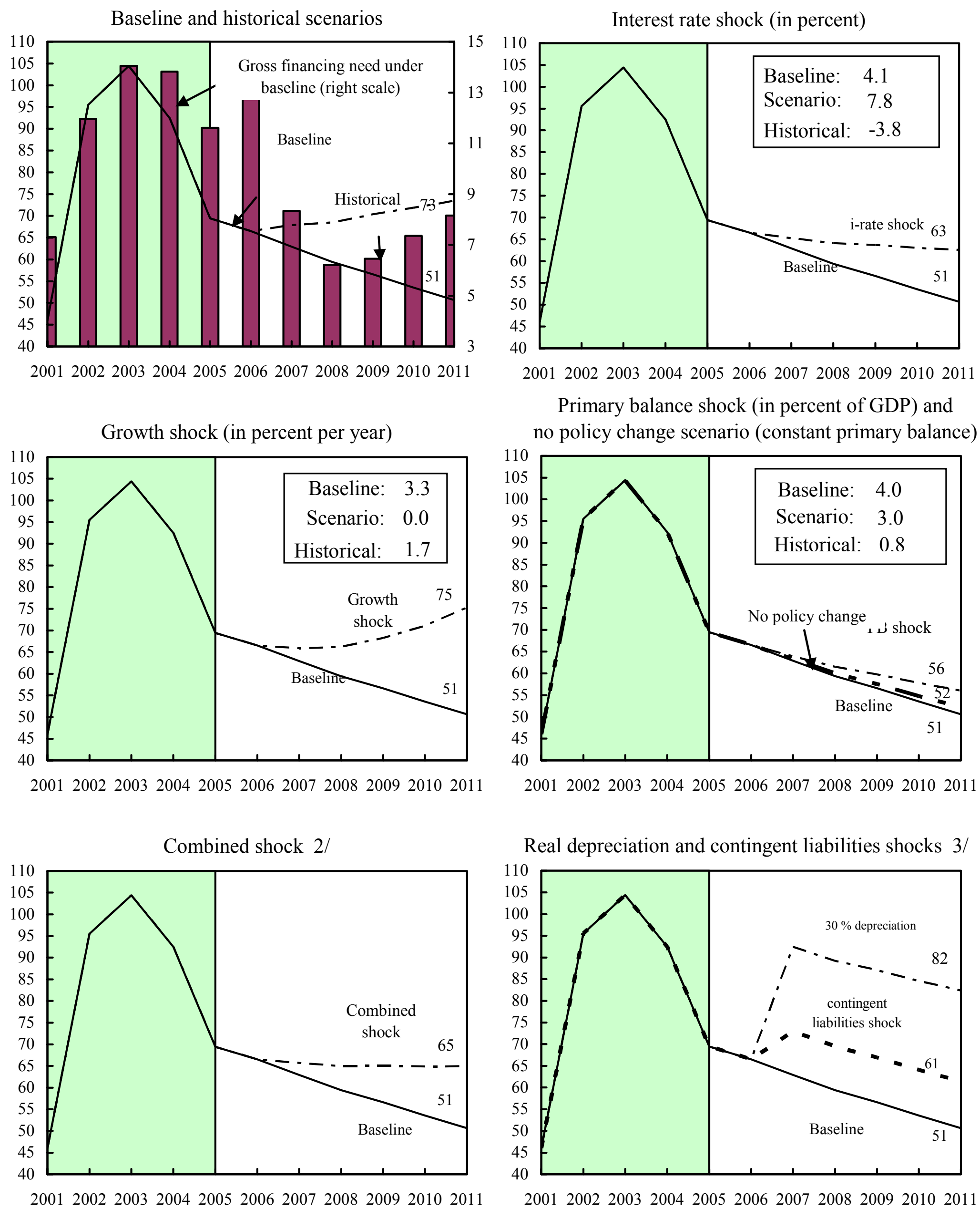
1/ Net of free reserves and monetary policy instruments.
2/ This does not reflect the planned strengthening of the BCU finances (SB for November 2006) yet.
The overall fiscal position will not be affected as interest costs of the central bank would be shifted to the government.
3/ Includes in 2006 the funding of the deposit insurance scheme of US$20 million and assumption of the BHU liabilities of US$407 million (net),
of which US$895 million are in form of non-cash liabilities and US$488 in form of financial assets (assumed recovery rate of 60 percent).
4/ In 2006: assumption of BHU financial obligations and cancellation of BHU deposits.

Table 2. Uruguay: Public Sector Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual				Est.	Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Debt-stabilizing primary balance 1/
Baseline: Public sector debt 2/	46.0	95.5	104.4	92.5	69.4	**66.5**	**62.9**	**59.4**	**56.6**	**53.5**	**50.6**	**1.2**
Of which : foreign-currency denominated	43.2	76.6	94.7	83.4	62.6	60.0	56.7	53.6	51.1	48.3	45.7	
Change in public sector debt	7.5	49.5	8.9	-11.9	-23.0	-2.9	-3.6	-3.5	-2.8	-3.1	-2.9	
Identified debt-creating flows (4+7+12)	10.3	57.5	-8.3	-14.0	-18.5	-5.3	-4.6	-3.6	-3.7	-3.4	-3.1	
Primary deficit	1.2	-0.1	-2.7	-3.8	-3.9	-3.7	-4.0	-4.0	-4.0	-4.0	-4.0	
Revenue and grants	33.2	31.1	31.1	30.1	30.6	29.3	29.3	29.1	29.1	29.1	29.1	
Primary (noninterest) expenditure	34.4	31.1	28.4	26.3	26.7	25.6	25.3	25.1	25.1	25.1	25.1	
Automatic debt dynamics 3/	9.2	40.7	-5.6	-10.3	-14.6	-1.6	-0.6	0.4	0.3	0.6	0.9	
Contribution from interest rate/growth differential 4/	2.3	2.2	-10.7	-11.6	-2.5	-1.6	-0.6	0.4	0.3	0.6	0.9	
Of which contribution from real interest rate	1.0	-2.6	-8.9	-1.3	3.1	1.2	2.0	2.0	2.2	2.2	2.4	
Of which contribution from real GDP growth	1.3	4.8	-1.7	-10.3	-5.6	-2.9	-2.6	-1.7	-1.9	-1.6	-1.5	
Contribution from exchange rate depreciation 5/	6.9	38.5	5.1	1.3	-12.1	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	16.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
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	
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	
Other (specify, e.g. bank recapitalization)	0.0	16.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 6/	-2.8	-8.0	17.1	2.1	-4.6	2.4	1.0	0.1	0.9	0.3	0.2	
Public sector debt-to-revenue ratio 2/	138.5	306.9	336.2	307.6	226.9	227.0	214.7	204.1	194.5	184.0	174.0	
Gross financing need 7/	7.3	12.0	14.0	13.8	11.6	13.6	8.3	6.2	6.5	7.4	8.2	
in billions of U.S. dollars	1.4	1.4	1.6	1.8	2.0	2.5	1.6	1.3	1.4	1.7	2.0	
Debt service	...	...	...	17.6	15.5	17.3	12.3	10.2	10.5	11.4	12.2	
Scenario with key variables at their historical averages 8/						**66.5**	**67.9**	**68.5**	**70.4**	**71.8**	**73.5**	**2.6**
Scenario with no policy change (constant primary balance) in 2005-2010						**66.5**	**63.2**	**60.0**	**57.5**	**54.8**	**52.2**	**1.2**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	-3.4	-11.0	2.2	11.8	6.6	4.6	4.2	2.8	3.4	3.0	3.0	
Average nominal interest rate on public debt (in percent) 9/	7.8	10.7	7.5	6.8	5.4	7.3	7.3	7.6	7.7	8.1	8.7	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.5	-8.0	-10.9	-0.6	3.8	2.2	3.4	3.6	4.0	4.3	4.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-15.3	-45.7	-6.8	-1.5	17.4	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	5.3	18.7	18.4	7.5	1.7	5.1	3.8	4.0	3.7	3.9	3.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	9.4	-19.6	-6.6	3.5	8.2	0.3	3.0	2.0	3.4	3.0	3.0	
Primary deficit	1.2	-0.1	-2.7	-3.8	-3.9	-3.7	-4.0	-4.0	-4.0	-4.0	-4.0	

1/ 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.
2/ Framework covers the public sector (net of free reserves and monetary policy instruments).
3/ 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).
4/ The real interest rate contribution is derived from the denominator in footnote 3/ as r - p (1+g) and the real growth contribution as -g.
5/ The exchange rate contribution is derived from the numerator in footnote 3/ as ae(1+r).
6/ For projections, this line includes exchange rate changes.
7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
8/ The key variables include real GDP growth and primary balance in percent of GDP.
9/ Derived as nominal interest expenditure divided by previous period debt stock.

Figure 1. Uruguay: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data.Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 3. Uruguay: External Debt Sustainability Framework, 2001-2011
(In percent of GDP, unless otherwise indicated)

	Actual				Est.	Projections						
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	48.1	87.5	98.2	87.4	67.8	**61.9**	**57.4**	**52.7**	**49.2**	**45.3**	**41.9**	**-1.3**
2 Change in external debt	3.9	39.4	10.7	-10.8	-19.6	-5.9	-4.5	-4.6	-3.5	-3.9	-3.4	
3 Identified external debt-creating flows (4+8+9)	10.7	21.1	3.8	-17.4	-21.8	-5.4	-3.9	-2.8	-2.9	-2.8	-2.6	
4 Current account deficit, excluding interest payments	0.2	-7.8	-2.6	-5.4	-4.1	-0.7	-1.8	-2.0	-3.0	-2.9	-2.7	
5 Deficit in balance of goods and services	2.4	-1.7	-3.1	-3.9	-2.2	1.7	0.6	0.2	-0.9	-1.0	-0.9	
6 Exports	17.6	22.3	27.5	32.4	30.2	30.1	30.4	30.8	31.2	31.4	31.4	
7 Imports	20.1	20.6	24.4	28.5	28.0	31.8	31.1	31.1	30.3	30.4	30.5	
8 Net non-debt creating capital inflows (negative)	-1.7	-1.5	-3.6	-2.4	-3.6	-6.9	-4.6	-3.9	-2.6	-2.7	-2.7	
9 A1. Key variables are at their historical averages in 2007-11 3/	12.2	30.4	9.9	-9.6	-14.1	2.2	2.5	3.1	2.8	2.9	2.8	
10 Contribution from nominal interest rate	3.0	4.6	3.1	5.1	4.6	5.0	5.0	4.7	4.5	4.3	4.1	
11 Contribution from real GDP growth	1.8	8.2	-2.1	-9.9	-4.5	-2.8	-2.4	-1.5	-1.7	-1.4	-1.3	
12 Contribution from price and exchange rate changes 2/	7.4	17.6	8.9	-4.9	-14.2	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	-6.8	18.2	6.9	6.6	2.2	-0.5	-0.6	-1.9	-0.6	-1.2	-0.8	
External debt-to-exports ratio (in percent)	272.8	392.8	357.1	269.9	224.3	205.8	188.4	171.1	157.8	144.4	133.4	
Gross external financing need (in billions of US dollars) 4/	3.5	3.8	3.0	2.1	2.5	3.5	2.5	2.0	1.7	2.0	2.1	
B5. One time 30 percent nominal depreciation in 2007	19.0	31.3	26.4	16.1	14.7	19.0	12.5	9.4	7.7	8.4	8.5	
Scenario with key variables at their historical averages 5/						**61.9**	**63.3**	**64.3**	**65.6**	**67.0**	**68.9**	**3.2**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	-3.4	-11.0	2.2	11.8	6.6	4.6	4.2	2.8	3.4	3.0	3.0	
GDP deflator in US dollars (change in percent)	-14.3	-26.8	-9.2	5.2	19.4	5.3	2.1	3.6	1.8	3.0	3.1	
Nominal external interest rate (in percent)	5.6	6.2	3.2	6.1	6.8	8.2	8.6	8.7	8.9	9.3	9.7	
Growth of exports (US dollar terms, in percent)	-10.5	-17.8	14.5	39.3	18.8	9.6	7.7	7.8	6.5	6.7	6.4	
Growth of imports (US dollar terms, in percent)	-11.2	-33.1	9.7	38.2	25.2	25.0	3.9	6.5	2.7	6.5	6.5	
Current account balance, excluding interest payments	-0.2	7.8	2.6	5.4	4.1	0.7	1.8	2.0	3.0	2.9	2.7	
Net non-debt creating capital inflows	1.7	1.5	3.6	2.4	3.6	6.9	4.6	3.9	2.6	2.7	2.7	

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 deflat

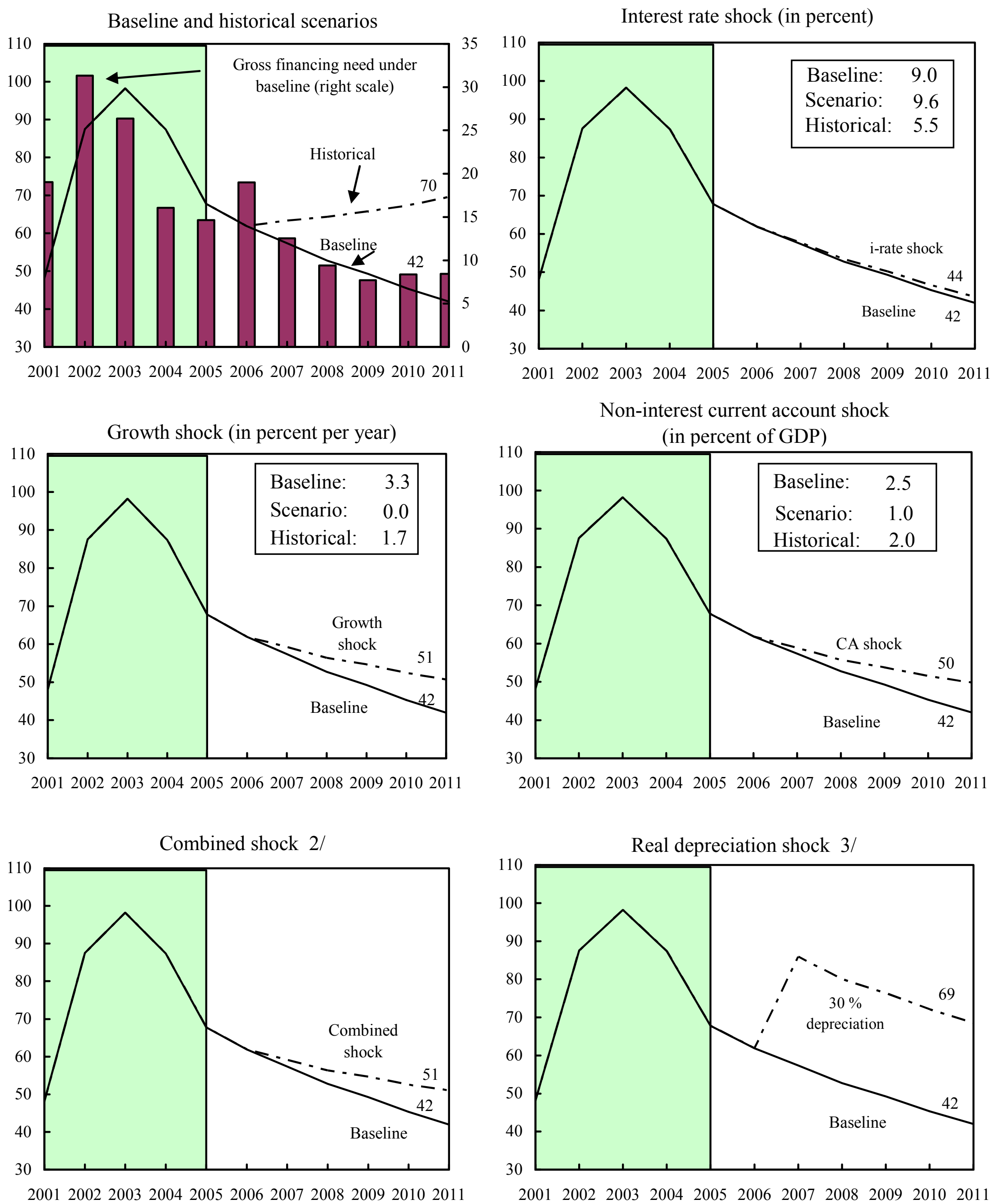
3/ For projection, line includes the impact of price and exchange rate changes.

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.

Figure 2. Uruguay: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2007.

Table 4. Uruguay: Public Sector Debt Sustainability Framework—Gross Public Sector Financing Need, 2001–2011

(In percent of GDP, unless otherwise indicated)

	Actual				Est.	Projections					
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
I. Baseline Projections											
Gross financing need 1/	7.3	12.0	14.0	13.8	11.6	13.6	8.3	6.2	6.5	7.4	8.2
in billions of U.S. dollars	1.4	1.4	1.6	1.8	2.0	2.5	1.6	1.3	1.4	1.7	2.0
II. Stress Tests											
Gross financing need 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						13.6	12.4	10.8	12.0	14.2	16.4
A2. No policy change (constant primary balance) in 2006-10						13.6	8.7	6.6	6.9	7.9	8.8
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						13.6	11.0	9.1	9.8	11.4	13.0
B2. Real GDP growth is at baseline minus one-half standard deviations						13.6	9.7	8.9	10.9	14.1	17.9
B3. Primary balance is at baseline minus one-half standard deviations						13.6	9.5	7.5	8.0	9.2	10.4
B4. Combination of B1-B3 using 1/4 standard deviation shocks						13.6	10.5	8.7	9.5	11.2	13.0
B5. One time 30 percent real depreciation in 2006 4/						13.6	12.0	11.2	11.9	13.8	15.6
B6. 10 percent of GDP increase in other debt-creating flows in 2006						13.6	9.6	7.9	8.3	9.5	10.7
Gross financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						2.5	2.4	2.2	2.5	3.1	3.8
A2. No policy change (constant primary balance) in 2006-10						2.5	1.7	1.4	1.5	1.9	2.2
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						2.5	2.2	1.9	2.2	2.7	3.2
B2. Real GDP growth is at baseline minus one-half standard deviations						2.5	1.9	1.8	2.2	2.9	3.8
B3. Primary balance is at baseline minus one-half standard deviations						2.5	1.9	1.6	1.8	2.2	2.6
B4. Combination of B1-B3 using 1/4 standard deviation shocks						2.5	2.0	1.8	2.0	2.5	3.0
B5. One time 30 percent real depreciation in 2006 4/						2.5	1.6	1.6	1.8	2.2	2.6
B6. 10 percent of GDP increase in other debt-creating flows in 2006						2.5	1.9	1.7	1.8	2.2	2.7

1/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period. Excludes assumption of BHU liabilities for 2006.

2/ Gross financing under the stress test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long-term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.

3/ The key variables include real GDP growth and primary balance in percent of GDP.

4/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 5. Uruguay: External Sustainability Framework--Gross External Financing Need, 2001-2011

	Actual				Est.	Projections					
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
I. Baseline Projections											
Gross external financing need in billions of U.S. dollars 1/	3.5	3.8	3.0	2.1	2.5	3.5	2.5	2.0	1.7	2.0	2.1
in percent of GDP	19.0	31.3	26.4	16.1	14.7	19.0	12.5	9.4	7.7	8.4	8.5
II. Stress Tests											
Gross external financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2007-11 3/						3.5	2.1	1.8	1.7	2.1	2.3
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						3.5	2.6	2.1	1.8	2.1	2.3
B2. Real GDP growth is at baseline minus one-half standard deviations						3.5	2.5	2.0	1.8	2.1	2.3
B3. Non-interest current account is at baseline minus one-half standard deviations						3.5	2.8	2.4	2.2	2.6	2.9
B4. Combination of B1-B3 using 1/4 standard deviation shocks						3.5	2.7	2.2	2.0	2.4	2.7
B5. One time 30 percent nominal depreciation in 2007						3.5	2.6	2.2	2.0	2.3	2.6
Gross external financing need in percent of GDP 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2007-11 3/						19.0	11.7	9.7	9.9	12.0	13.3
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						19.0	12.9	9.8	8.2	8.9	9.1
B2. Real GDP growth is at baseline minus one-half standard deviations						19.0	13.0	10.2	8.8	10.1	10.7
B3. Non-interest current account is at baseline minus one-half standard deviations						19.0	14.2	11.3	9.9	11.1	11.7
B4. Combination of B1-B4 using 1/4 standard deviation shocks						19.0	13.8	10.9	9.6	10.9	11.5
B5. One time 30 percent nominal depreciation in 2007						19.0	19.6	15.2	13.4	14.8	15.3

1/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.
2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.
3/ 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.

FUND RELATIONS

(As of April 30, 2006)

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	1,567.26	511.34
Reserve position	0.0	0.0

III. **SDR Department**:

	In millions of SDRs	Percent of Allocation
Net cumulative allocation	49.98	100.0
Holdings	24.07	48.16

IV. **Outstanding Purchases and Loans**:

	In millions of SDRs	In percent of quota
Stand-By Arrangements	1,260.76	411.34

V. **Financial Arrangements**:

			SDR Millions	
Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
Stand-By	6/08/05	6/07/08	766.25	177.77
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

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	0.00	540.86	332.27	278.20	94.87
Charges/interest	57.77	58.10	31.15	15.71	4.72
Total	57.77	598.96	363.42	293.91	99.58

VII. **Projected Payments to Fund (Expectation basis):** (SDR millions; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	0.00	873.13	278.20	94.87	14.56
Charges/interest	57.77	50.97	15.98	4.71	1.25
Total	57.77	924.10	294.18	99.58	15.81

II. NONFINANCIAL RELATIONS

VII. **Safeguards Assessment:** The authorities have already implemented many of the recommendations from the safeguards assessment conducted under the current SBA, completed in September 2005. In particular, (i) Uruguay's total obligations to the Fund are now included in the BCU's financial statements; (ii) data submitted to the Fund is periodically reviewed for consistency with the Technical Memorandum of Understanding; and (iii) the criteria for the selection and appointment of the BCU's external audit firm have been amended in line with the safeguards recommendation

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

[1] Except for 2006, 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.

June 12, 2006, buying and selling interbank rates for the U.S. dollar, the intervention currency, were Ur$23.80 and Ur$23.87, respectively. Uruguay's exchange system is free of restrictions on payments and transfers for current international transactions. The exchange restriction associated with the reprogramming of time deposits at BROU and BHU during the 2002 crisis was removed ahead of schedule in April 2005.

IX. **Article IV Consultation:** The 2003 Article IV consultation was concluded by the Executive Board on July 11 (Country Report No. 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 (Country Report No. 05/202).

XI. **FSAP participation and ROSCs**: The FSAP exercise was conducted over two missions (October 2005 and January 2006), completing an earlier exercise that was started in November 2001, but was subsequently suspended on account of the financial crisis in 2002. 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.

XII. **Technical Assistance**: Technical assistance on tax, customs, and social security administration was provided by FAD in March 2006, June 2005, and July 2003, on tax policy in October 2005 and May 2003, and on public financial management in March 2005. In April 2003, STA provided technical assistance on adequate recording of loans funded by the FSBS. MFD has been providing substantial and continuous technical assistance since 2002 in the resolution of intervened banks, the restructuring of the public bank BROU, and recently on BHU, and in July 2005 jointly with ICM on debt management.

XIII. **Resident Representative**: Mr. Gaston Gelos.

RELATIONS WITH THE WORLD BANK GROUP
(As of June 9, 2006)

The World Bank Board of Executive Directors approved a new Country Assistance Strategy (CAS) on June 9, 2005. The 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 in the new CAS is 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 were approved by the Board on June 9, 2005 together with the CAS.

The previous Country CAS was approved 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 million of SAL I and US$50 million of SSAL I) were released in October 2004.

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 and, with the immediate crisis over and the beginning of a new CAS period, the outstanding second and third tranches of this operation have been cancelled at the Government's request. The social reform agenda continues to be supported by a new development policy loan (DPL1), approved by the Board of Executive Directors together with the CAS on June 9, 2005. The DPL1 in an amount of US$75 million supports 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 has been fully disbursed.

The current investment portfolio comprises eight projects totaling US$389.5 million in commitments, with an undisbursed amount of US$136.0 million as of June 9, 2006. The performance of the investment portfolio has improved significantly in CY04 and CY05, with disbursements for investment operations aggregating to US$43.8 million and US$58.6 million respectively. 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)	Disbursed	Undisbursed
I. IBRD Operations (as of June 9, 2006)			
Agriculture	48.5	17.8	30.7
Central Government and Administration	151.5	51.5	100.0
Telecommunication	6.0	1.6	4.4
Education	42.0	15.9	26.1
Power	125.0	120.1	4.9
Transportation	141.0	75.8	65.2
Water Supply	27.0	22.0	5.4
Total	**541.0**	**305.0**	**236.0**

II. IFC Operations (as of December 31, 2005)

	Loans	**Equity**	**Quasi**	**Participation**
Held	18.86	0.21	10.00	0.0
Disbursed	18.86	0.19	10.00	0.0

III. IBRD Loan Transactions (calendar year)

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Disbursements	38.7	50.4	143.9	66.3	134.2	64.7	233.5	97.4	143.8	134.0
Repayments	69.9	67.9	64.1	63.2	57.9	72.5	75.3	78.2	80.2	103.6
Net Lending	**-31.2**	**-17.5**	**79.8**	**3.1**	**76.3**	**-7.8**	**158.2**	**19.2**	**63.6**	**30.4**

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(As of May 22, 2006)

The Inter-American Development Board of Executive Directors approved a new Country Strategy for Uruguay on March 15, 2006. The Bank's Country Strategy supports the Government's policy, which seeks to consolidate growth and improve the population's social welfare. In support of this longer-term goal, the Strategy focuses on the following priority areas: (i) improving 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 social inclusion.

The implementation of the Bank's strategy proposes a likely lending scenario of about US$950 million for the five-year period 2005–09, which together with a normal execution of the loan portfolio, mainly investment projects, will allow for the net lending flows to remain relatively neutral. The lending program for 2005–06 and a tentative program for the later years—2007-09—was agreed with the new authorities during the Bank's Programming Mission on August 22, 2005. This program includes lending to support the Government in the key policy areas of competitiveness, the social sectors, and public sector management. To this end, during 2005 a loan for a program to support the productivity and development of new livestock products, for US$15.8 million, was approved in July; a social sector loan for US$250 million was approved in August, to support the development and implementation of Government's social policy aimed at reducing poverty, improving the human resource base among the poor, and strengthening the sector's institutional framework; and a loan to support the public debt management unit for US$2.45 million was approved in November. An investment project to improve cluster competitiveness for US$9 million as well as a sectoral program to improve competitiveness for US$100 million are under preparation and are expected to be approved in 2006 and early 2007 respectively. Within the public sector management area, a three-year programmatic loan, to support improvements in tax administration and public sector management, is under preparation, with expected approval in 2006; the estimated financing for the first year amounts to US$50 million while for the next two years the amount is to be determined. The lending program also includes investment projects with new operations planned in the area of microfinance, to support transport infrastructure, sanitation in Montevideo and social programs such as a neighborhood improvement programs.

As of May 22, 2006 the Bank's current portfolio in Uruguay includes loans for the financing of 15 investment projects; and two policy based operations, for strengthening the banking sector and for the social sectors. The lending portfolio, which is largely aligned to the administration's priorities and consistent with the Bank's Country Strategy, amounts to US$1,185.8 million, of which US$509.7 million are pending disbursement. Portfolio performance in the recent past 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. An important challenge ahead in terms of portfolio management, for both the Bank and the authorities, will be to ensure that the projects increase the pace of project execution while setting the stage for a normal implementation of the new projects within the context of the approved five-year Budget Law. As part of their debt management strategy, the authorities paid in February, US$100 million due and in March, pre paid the remaining US$300 million due in August 2006 and 2007, corresponding to the Social Protection and Sustainability Program, that was approved in August 2002.

Financial Relations with the Inter-American Development Bank

(In millions of U.S. dollars)

Total outstanding loans: US$1,821[1]

Loan transactions:

	1999	2000	2001	2002	2003	2004	2005[2]	2006[3]
Disbursements	358.5	162.9	214.2	558.6	367.2	53.1	242.3	178.1
Amortization	57.0	59.4	60.7	73.1	103.7	113.3	220.0	519.9
Net Loan Flows	**301.5**	**103.5**	**153.5**	**485.5**	**263.6**	**-60.2**	**22.3**	**-341.8**

Source: Inter-American Development Bank.

[1] As of April 30, 2006
[2] As of March 31, 2006
[3] IDB staff projections

URUGUAY: STATISTICAL ISSUES

Uruguay's economic and financial database is generally adequate for the assessment and monitoring of macroeconomic policies. Uruguay subscribed to the SDDS in February 2004, and meets the SDDS specifications. However, Uruguay uses the flexibility option for timeliness of central and general government operations, and the analytical accounts of the banking sector.

Real sector statistics

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 the production and expenditure approaches, as well as quarterly constant price GDP estimates by the production and expenditure approaches. Gross national income, gross disposable income and gross savings are also available annually. A STA multisector mission in November 1999 recommended a range of improvements including completing revision of data and methods that had already been initiated, 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 base of the wholesale price index has been updated to 2001. Coverage of the CPI is limited to the capital city.

Government finance statistics

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. 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. The information reported for publication in the *Government Finance Statistics Yearbook* covers transactions on revenue and expense for the consolidated central government, and the general government's operations on financial assets and liabilities, both in terms of flows (financing) and stocks (debt). However, data on revenue and expense for local governments have not been reported since 1994.

Monetary and financial statistics

Monetary and financial statistics are prepared in accordance with the IMF's *Monetary and Financial Statistics Manual (2000).* Authorities have yet to report monetary data using the standardized reporting forms (SRF).

In April 2003, an STA mission visited Montevideo to assist the authorities in 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.

External sector statistics

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)*. 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.

Uruguay started disseminating the international reserves and foreign currency liquidity data template on the Central Bank's website in October 2003 and on the Fund's external website in August 2005. Monthly information on the data template has been disseminated since August 2003 on the Central Bank's website and January 2005 on the Fund's external website. The Central Bank also disseminates quarterly external debt statistics on its website, although not in the compact format envisaged by SDDS.

URUGUAY: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of May 22, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	5/22/2006	5/22/2006	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	5/21/2006	5/22/2006	D	D	D
Reserve/Base Money	4/5/2006	4/11/2006	D	D	M
Broad Money	Mar. 2006	4/11/2006	M	M	M
Central Bank Balance Sheet	Mar. 2006	4/11/2006	M	M	M
Consolidated Balance Sheet of the Banking System	Jan. 2006	4/11/2006	M	M	M
Interest Rates[2]	4/10/2006	4/11/2006	D	D	D
Consumer Price Index	April 2006	May 2006	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Mar. 2005	6/30/2005	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Mar. 2005	6/30/2005	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar. 2005	6/30/2005	Q	Q	Q
External Current Account Balance	Q4/05	March 2006	Q	Q	Q
Exports and Imports of Goods and Services	Q4/05	March 2006	Q	Q	Q
GDP/GNP	2005	April 2006	Q	Q	Q
Gross External Debt	Q4/05	March 2006	Q	Q	Q

[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); and not available (NA).

June 13, 2006

Dear Mr. de Rato:

1. ***Progress***. Performance under our program continues to exceed expectations. While we are raising our 2006 growth projection from 4 to 4½ percent, we continue to expect that inflation this year will remain within our target range of 4½–6½ percent. Policy implementation is going well, with solid revenue and prudent expenditure policy resulting in a strong fiscal outturn for the first quarter; buoyant exports and capital inflows allowing the central bank to strengthen its foreign exchange reserves beyond program targets; and strong capital market access further improving the public debt structure. In March, we advanced payments of all 2006 repurchases to the Fund.

2. ***Performance***. Preliminary data suggest that all continuous and end-March 2006 quantitative performance criteria were met, some with wide margins; final data will be available prior to the Board meeting. We have also made significant progress in the implementation of our ambitious structural reform agenda, including with the recent sale of Nuevo Banco Comercial and the preparation of a new bankruptcy law, which is about to be submitted to Congress (both benchmarks for end-June). Also, the timetable for the implementation of the recommendations of the growth commission has recently been published (end-March benchmark). Contrary to our earlier expectations, Congress decided to consider the tax reform prior to the police pension and financial sector reforms. Thus, we now expect its approval earlier than previously programmed, while the approval of the police pension reform (end-May performance criterion) and financial sector reform (end-June performance criterion) will be delayed to the second half of 2006.

3. ***Issues for this review***. We remain committed to the policies and objectives as presented in our Letter of Intent and Supplementary Memorandum of Economic and Financial Policies dated March 13, 2006, and would like to draw your attention to the following points:

- **Fiscal policy**. We are confident to achieve our 2006 primary surplus target of 3.7 percent of GDP. We have identified investment in telecommunication and highways, as two new projects under the program's fiscal targets adjustor of ¼ percent of GDP.

- **Monetary policy**. We remain committed to the 4½–6½ percent inflation target range for 2006, in the context of a flexible exchange rate arrangement. With indications of a continued strength in money demand, we have raised our indicative base money growth target for December 2006 to 28 percent. However, we will monitor inflation closely and stand ready to tighten, as necessary. We will reassess the appropriateness of our money targets at the time of the next review.

- **International reserves**. With a stronger than previously expected balance of payments, we have increased our end-2006 reserve accumulation target by US$410 million. In addition, we will further increase this target later in the year to the extent that this can be accommodated within the base money target and without compromising the inflation objective.

- **Structural reforms**. Although the agenda for structural reforms is a busy one, we are determined to make additional progress in the period ahead. In particular,

    - **FSAP**. We remain committed to continue reducing financial sector vulnerabilities, including by further enhancing financial sector supervision. After we have had a chance to study in detail the recommendations of the Financial Sector Assessment Program, we hope to discuss new measures in the context of the next review.

    - **Growth agenda**. Many of the recommendations of the Growth Commission are already in the program. As additional measures, we plan to establish a private sector relations office at the Ministry of Finance and to reform government procurement procedures.

4. ***Waivers and new conditionality***. In light of continued strong performance and in support of the program objectives, we request: (i) a waiver of nonobservance of the performance criterion on police pension reform and its resetting for end-October 2006; (ii) modification of the performance criterion on the tax reform, moving the implementation date to September 15, 2006 and of the performance criterion on financial sector legislation, moving the implementation date to end-November 2006; and (iii) modification of the end-June monetary performance criteria and targets and setting the ones for end-September and end-December 2006; and (iv) two new benchmarks in the growth area. The next reviews will be completed by August and November 2006, covering overall program performance and observance of the associated conditionality (Tables 1 and 2).

5. ***Request for purchase***. In requesting the completion of the Fourth Review under the stand-by arrangement and purchase of SDR 85.82 million, we note that we remain committed to maintaining a close policy dialogue with the Fund and stand ready to take additional measures as appropriate to ensure the achievement of the program's objectives. Should the external position turn out significantly stronger than we currently anticipate, we will consider making advanced repurchases or treating the arrangement as precautionary in the future.

Sincerely yours,

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

Attachment:
Supplementary Technical Memorandum of Understanding

Table 1: Quantitative Performance Criteria and Indicative Targets for the 2006-08 Program 1/

	2005 Stock	2006 Targets							2007 IT	2008 IT
	Sept. 30	Mar. 31				Jun. 30	Sept. 30	Dec. 31	Dec. 31	Dec. 31
		Target	Target (adj.)	Prel.	**Margin (+)**					
A. Quantitative performance criteria										
		(In millions of Uruguayan pesos)								
1. Combined public sector primary balance (floor) 2/	n.a.	2,651	2,651	5,376	**2,725**	5,196	10,434	16,473	19,311	20,748
2. General government noninterest expenditure (ceiling) 2/	n.a.	13,409	13,409	12,147	**1,262**	27,050	39,870	53,558	57,735	63,095
3. Net domestic assets of the BCU (ceiling) 3/	51,525	-3,136	-7,264	-14,820	**7,556**	-6,029	-12,278	-14,378	-10,308	-7,502
		(In millions of U.S. dollars)								
4. Net international reserves of the BCU (floor) 3/	-1,546	250	423	779	**357**	469	732	962	493	393
5. Nonfinancial public sector gross debt (ceiling) 4/	12,309	12,882	13,110	12,327	**783**	13,074	13,082	12,995	13,150	13,286
6. Accumulation of external payment arrears of the public sector (on a continuous basis) 2/	0	0	0	0	**0**	0	0	0	0	0
B. Indicative targets										
		(In millions of Uruguayan pesos)								
7. Combined public sector overall balance (floor) 2/	n.a.	-3,076	-3,076	264	**3,340**	-5,394	-5,935	-4,512	-2,966	-2,537
8. Combined public sector primary balance (extended) (floor) 2/	n.a.	2,651	2,651	5,783	**3,132**	5,196	10,434	16,473	19,311	20,748
9. Monetary base (ceiling) 3/	16,146	3,140	3,140	4,558	**-1,418**	5,118	6,075	9,526	2,106	1,923

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 the previous calendar year.
3/ 2006 targets are cumulative from end-September 2005.
4/ All maturities.

Table 2. Uruguay: Structural Conditionality under the 2006-08 Program

Area	Structural Conditionality	Date	Status
A. Structural performance criteria (Country Report No. 06/197)			
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	Observed.
Tax reform	Submit to congress a comprehensive tax reform as described in paragraph 7 of the MEFP.	February 28, 2006	Not observed. Implemented with small delay.
Tax reform	Begin to implement the comprehensive tax reform as described in paragraph 7 of the MEFP. 1/	September 15, 2006	
Central Bank	Begin to implement the laws that: (i) give appropriate autonomy to the central bank (as described in paragraph 12 of the MEFP); (ii) strengthen the regulation of the financial system (as described in paragraph 13 of the MEFP and modified as specified in paragraph 15 of the December SMEFP); and (iii) provide a suitable bank resolution framework (as described in paragraph 14 of the MEFP). 1/	November 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	Observed.
BHU	Move nonperforming loans into a *fideicomiso* and adequately capitalize BHU as specified in paragraph 11 of the TMU of March 13, 2006.	August 31, 2006	
BHU	Transform BHU into an institution with a viable business plan and a strong regulatory framework as specified in paragraph 12 of the TMU of March 13, 2006.	November 30, 2006	
Pensions	Begin to implement reform of the pension fund for the police.	May 31, 2006	Not observed; reset for end-October 2006.
Pensions	Submit to Congress reform of the pension fund for the military and bank employees as described in paragraph 12 of the SMEFP of December 27, 2005.	November 30, 2006	
Pensions	Begin to implement the reform of the pension fund for the military and bank employees as described in paragraph 12 of the SMEFP of December 27, 2005.	May 31, 2007	
B. New structural performance criteria			
Pensions	Begin to implement reform of the pension fund for the police.	October 31, 2006	
C. Structural benchmarks (Country Report No. 06/197))			
Tax administration	Formulate a plan to strengthen the auditing and enforced collection functions of the BPS.	June 30, 2006	
Tax administration	Finalize the design of a comprehensive reform plan for the customs agency (including establishing collection targets consistent with the program).	August 31, 2006	
Budget	Prepare recommendations, with a timetable, to improve legislation, coverage, classification, formulation, controls, and transparency of the budget process.	August 31, 2006	
Growth	Publish agenda of growth-enhancing reforms (including timetable for implementation) prepared by the business environment commission.	March 31, 2006	Not observed. Implemented with slight delay.
Growth	Submit to Congress bankruptcy law (to include Chapter-11 type corporate restructuring).	June 30, 2006	
Financial sector	Adopt a detailed schedule for the implementation of the BHU action plan.	February 28, 2006	Observed.
Financial sector	Sell shares of NBC in amounts that yield managerial control to the private sector.	June 30, 2006	Observed.
Central Bank	Adopt plan to strengthen the central bank finances (outright capitalization or interest payment on government paper). 1/	November 30, 2006	
D. New structural benchmarks			
Growth	Establish a private sector relations office at the MEF.	August 31, 2006	
Growth	Adoption of a detailed plan to strengthen government procurement procedures.	July 31, 2007	

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

1/ Modification of dates requested.

SUPPLEMENTARY TECHNICAL MEMORANDUM OF UNDERSTANDING

This supplements the Technical Memorandum of Understanding (TMU) of March 13, 2006, and will apply to the performance criteria and indicative targets for end-June, end-September, and end-December 2006 test dates.

1. Projects to be covered under the adjustor to the fiscal targets of up to US$50 million or Ur$1,200 million for capital expenditure during July 2006–June 2007 as specified in paragraphs 1–4 and 8 of the TMU of March 13, 2006 compromise (i) dredging operations in the port of Montevideo; (ii) railroad construction; (iii) investment on upgrading digital communication; and (iv) partial rehabilitation of route 1.

2. The NFPS debt ceiling as specified in paragraph 8 of the TMU of March 13, 2006 will be adjusted (i) upward (downward) by revisions made to the actual nonfinancial public sector gross debt stock at end-September 2005; (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$133 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/litigation to the former shareholders of Banco Comercial; (v) upward by a maximum of US$82 million for debt issued to finance below-the-line operations of public enterprises (such as recapitalization of ANCAP's subsidiary abroad); (vi) upward by BHU restructuring costs related to the assumption of financial liabilities or capitalization up to a limit of US$1 billion; (vii) upward by a maximum of US$40 million for the amount of debt issued to onlend to the deposit insurance scheme; (viii) for capital expenditure on identified projects in the period July 2006–June 2007, up to a limit of US$50 million; (ix) downward by the amount of gross revenues (net of any associated fees and commissions) (excluding receipts in form of shares) from the sale of NBC; (x) upward (downward) by the amount that the unadjusted NIR floor is exceeded (falls short) with the upward adjustment limited to the amount of the upward revision of the NIR target, up to a limit of US$500 million; and (xi) upward (downward) if the change in the net credit position with the Fund exceeds (falls short of) programmed amounts as specified in Schedule A.

Schedule A
(In millions of U.S. dollars)

	Sept.-05	Mar.-06	Jun.-06	Sept.-06	Dec.-06
Stock of net credit with the Fund	2,337	2,507	2,517	2,396	2,249

Statement by the MF Staff Representative
June 28, 2006

Since the issuance of the staff report, the following additional information has become available. It does not alter the thrust of the staff appraisal.

1. ***Performance Criteria.*** Final data (unchanged from staff report) confirm all end-March 2006 quantitative performance criteria were observed.

2. ***Economic growth.*** Real GDP grew 6.8 percent in the year ending in March 2006, suggesting that the 4.6 percent growth rate envisaged for 2006 may be exceeded.

3. ***Bankruptcy law*****.** The law is expected to be submitted to congress with a small delay, in early July, as more time was needed for its legal review and incorporation of comments received during its public consultation (end-June benchmark).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/85
FOR IMMEDIATE RELEASE
July 31, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with Uruguay

On June 28, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Uruguay.[1]

Background

Since the 2002 financial crisis, the Uruguayan economy has significantly recovered in the context of a supportive external environment, strong macroeconomic policies and implementation of an ambitious structural reform agenda that have resulted in impressive economic and financial outturns and a return in market confidence in Uruguay's prospects.

Real GDP is now above pre-recession level, and expected to continue to grow at 4½ percent in 2006. Cautious monetary management within a flexible exchange rate regime has contributed to a rapid decline in inflation, but—after falling below the central bank's target range of 5½–7½ percent in 2005—inflation has recently picked up, particularly reflecting a full pass-through of oil prices and drought related food price increases.

Uruguay's combined public sector primary balance has strengthened rapidly and in 2005 reached 3.9 percent of GDP, well above the 3.5 percent of GDP target. In December 2005, congress approved a five-year budget consistent with the 4 percent of GDP medium-term primary surplus target. The strong fiscal performance, combined with a recovery of the peso

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

and strong growth, has helped Uruguay to bring down its public debt from 105 at end-2003 to 70 percent of GDP at end-2005.

Uruguay's external position has also strengthened considerably. Sovereign spreads have dropped significantly, and faster than emerging market trends. With strong exports, the current account only posed a modest deficit in 2005, despite a sharp increase in imports. Favorable global market conditions and the return of capital have contributed to an appreciation of the peso, and the central bank has started to intervene to build reserves, which reached US$3.4 billion in May 2006. The government has also taken advantage of these favorable external conditions to improve the public debt structure by increasing the share of domestic currency debt and lengthening maturities, and has already started to prefinance some of its 2007 external financing needs.

Financial soundness indicators have strengthened significantly. The government has made good strides in restructuring the domestic banking system and enhancing supervision. Overall, banks are well-capitalized and have excess liquidity, and profitability has started to return, but state-dominance in the financial system remains large. A Financial Sector Assessment Program was carried out for Uruguay, the results of which were discussed at the Board.

Notwithstanding these strong performances, which have helped in the context of the favorable global environment to reduce near-term risks, significant underlying vulnerabilities remain, including the still high and dollarized public debt, large gross financing needs, as well as regional dependencies. Also, the banking system remains highly dollarized, banking intermediation is still well below pre-crisis level and deposits are overwhelmingly at short maturities. Addressing those vulnerabilities was the focus of the Article IV consultation.

Executive Board Assessment

Executive Directors commended the Uruguayan authorities for their strong policies which, supported by generally favorable external conditions, have led to a vigorous economic recovery from the 2002 financial crisis and a considerable decline in short-term risks. Directors were reassured by the authorities' continued commitment to implement strong macroeconomic policies in order to help reduce, over time, the declining though still high public debt and financial dollarization, and thereby address the remaining medium-term vulnerabilities.

Directors stressed that strong primary fiscal surpluses have been central to the authorities' success in helping to reduce the public debt to GDP ratio and boost market confidence. Continuation of these efforts will be needed to lower the still high debt ratio to more comfortable levels. Directors stressed the importance of the impending tax reform, which will improve the fairness and efficiency of the tax system, and called on the authorities to continue improving tax administration to meet their ambitious revenue targets in the years ahead.

The decline in inflation to single digits is a major achievement. Directors considered that the pursuit of a prudent monetary policy within a flexible exchange rate regime has allowed the authorities to manage successfully the remonetization of the economy and the large capital inflows. They cautioned, however, that inflation risks have increased in 2006, and urged the authorities to adjust monetary policy as needed to meet inflation objectives. Many Directors welcomed the proposed new central bank law aimed at increasing its autonomy as a significant step toward the medium-term introduction of an inflation-targeting framework that would underpin the commitment to low inflation and thus anchor expectations. More broadly, Directors encouraged the authorities to increase further the transparency of the monetary and exchange rate policy framework in order to help the market better understand the actions of the central bank.

Directors welcomed the restored exchange rate flexibility after periods of rigidity in early 2006. They regarded some intervention to take advantage of capital inflows as appropriate, as it allows for an increase in international reserves, which are still low for a dollarized economy. However, building up reserves should not sacrifice exchange rate flexibility.

Directors stressed that sustaining high growth will be critical to improve social conditions, ensure fiscal and debt sustainability, and support a healthy financial system. They welcomed the authorities' pro-growth agenda and encouraged them to continue improving the investment climate. Directors supported the authorities' policies aimed at furthering the expansion and diversification of trade.

Directors highlighted the significant progress made in the financial sector. They welcomed that banks have increased their liquidity and capitalization buffers and are significantly more resilient to market risks. Directors urged the authorities to create a level playing field between state and private banks, and to develop further their reform agenda in consultation with the Fund and the World Bank. They looked forward to the early approval of the financial sector reform law, which would address a number of the vulnerabilities identified by the staff. Directors also welcomed the passage of AML/CFT legislation.

Directors supported the authorities' reprioritization of reforms, and encouraged them to undertake further reforms to improve the effectiveness of public spending and public enterprise performance. While Uruguayan demographics rule out large declines in pension outlays, Directors saw scope for increasing the efficiency of the general pension scheme. Some Directors expressed concern about slippages in reforming the specialized pension funds schemes. Directors supported the authorities' plan to improve infrastructure through public-private partnerships, while recommending that the authorities start with small projects to build expertise in managing the associated risks. Directors urged the authorities to continue with public enterprise reforms to improve service delivery. They commended the authorities on the steps they have taken to improve public debt management.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Table 1. Uruguay: Basic Data

	2000	2001	2002	2003	2004	Prel. 2005	Proj. 2006
(Annual percentage changes, unless otherwise indicated)							
Real GDP	-1.4	-3.4	-11.0	2.2	11.8	6.6	4.6
Contributions to growth							
Domestic demand (percent)	-1.3	-2.2	-15.2	1.0	9.6	2.2	5.7
Private consumption (percent)	-1.3	-1.9	-14.0	1.6	9.3	1.9	5.9
Public consumption (percent)	0.0	-0.4	-1.2	-0.6	0.3	0.3	-0.2
Investment (percent)	-2.2	-1.4	-5.0	1.9	2.7	1.4	4.5
Foreign balance (percent)	2.2	0.3	9.1	-0.7	-0.4	3.0	-5.6
Exports of GNFS (percent)	2.2	-3.2	-3.8	1.5	9.9	6.9	3.2
Imports of GNFS (percent)	0.0	3.5	12.9	-2.2	-10.3	-3.9	-8.8
Prices							
Consumer price index (period average)	4.8	4.4	14.0	19.4	9.2	4.7	6.1
Consumer price index (eop)	5.1	3.6	25.9	10.2	7.6	4.9	5.5
GDP deflator	4.0	5.3	18.7	18.4	7.5	1.7	5.1
Terms of trade	-5.2	-0.4	3.5	2.2	-2.4	-6.3	-2.9
Exchange rate (UR$/US$, eop)	6.7	10.1	84.2	7.3	-9.9	-8.3	...
Real effective exchange rate (UR$/US$, eop)	0.2	-5.9	-20.6	-13.2	9.2	12.0	...
(In percent of GDP)							
Public sector finances							
Total revenues	32.3	33.8	32.1	32.0	30.9	31.8	32.7
Non-interest expenditure (incl. discrepancy)	33.8	35.0	32.1	29.3	27.2	27.9	29.0
Primary balance	-1.5	-1.2	0.0	2.7	3.8	3.9	3.7
Interest	2.6	2.9	4.7	6.0	6.0	4.6	4.6
Overall balance	-4.1	-4.2	-4.6	-3.2	-2.2	-0.7	-0.9
Public sector debt 1/	37	43	96	104	92	69	66
(Annual percentage change)							
Money and credit							
Base money (eop)	-8.9	-2.2	22.1	24.9	11.1	34.1	22.7
M1	-5.2	-2.8	1.7	34.6	13.4	29.4	28.0
M3	10.2	19.6	15.8	21.7	-2.0	0.1	7.7
Credit to the private sector (constant exchange rate)	0.3	-3.8	-17.6	-23.9	-11.2	2.7	9.9
(In percent of GDP, unless otherwise indicated)							
Balance of payments							
Current account	-2.8	-2.9	3.2	-0.5	0.3	-0.5	-4.3
Merchandise exports, fob	11.9	11.5	15.9	20.3	23.7	22.3	22.3
Merchandise imports, fob	16.5	15.7	15.5	18.7	22.6	22.7	26.6
Services, income, and transfers (net)	1.8	1.3	2.8	-2.1	-0.8	-0.1	0.0
Capital and financial account	3.8	4.3	-18.5	9.3	0.5	5.1	7.1
Foreign direct investment	1.4	1.7	1.5	3.6	2.4	3.6	6.9
Overall balance of payments (US$ millions)	166	302	-2,328	1,380	454	951	525
Outstanding external debt	44.2	48.1	87.5	98.2	87.4	67.8	61.9
Of which: Public external debt	30.3	31.4	68.9	85.3	76.9	60.4	55.2
Debt service ratio (in percent of exports of goods & services)	35.7	43.6	55	52.3	44.8	47	54.8
Gross official reserves (US$ million)	2,779	3,099	772	2,087	2,512	3,438	3,963
In percent of short-term debt	82.1	85.2	25.1	86.8	158.0	153.5	139.7
In percent of short-term debt and FX deposits	45.8	42.4	7.0	20.0	27.7	32.9	35.2
Net international reserves (stock)	...	...	-1,088	-763	-2,218	-1,166	-257

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

1/ Covers debt of the NFPS and the central bank (excluding monetary policy instruments and free reserves).

Press Release No. 06/146
FOR IMMEDIATE RELEASE
June 28, 2006

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fourth Review Under Uruguay's Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) completed today the fourth review under the three-year, SDR 766.25 million (about US$1.13 billion) Stand-By Arrangement for Uruguay (see Press Release No. 05/136). Completion of this review makes an additional SDR 85.8 million (about US$ 126.2 million) immediately available to Uruguay.

In completing the review, the Board granted a waiver for the non-observance of the performance criterion on police pension reform and its resetting for end-October 2006; the modification of the performance criterion on tax reform; and the modification of the end-June monetary performance criteria and targets.

In commenting on the Board review, Mr. Agustín Carstens, Deputy Managing Director and Acting Chair, said:

"Uruguay's recent economic performance under the Stand-By Arrangement, and the outlook for 2006, remain strong. Sound economic policies and market confidence in Uruguay's prospects, a strengthened external position, and an improved debt structure have helped the economy weather well the recent volatility in international financial markets. The authorities remain committed to continue implementing forward-looking policies to address medium-term vulnerabilities, including the high public debt and widespread financial dollarization.

"Robust growth provides Uruguay an opportunity to strengthen further its fiscal position. Exceeding the 2006 fiscal target is desirable, as it would help further lower the high public debt, control inflation, and moderate appreciation pressures. Efforts to strengthen tax administration and fully pass through international oil prices will also be important in this regard. In addition, approval of the tax reform, with its revenue-neutral and base-broadening elements, will be a key step toward improving the efficiency and equity of Uruguay's tax system.

"Monetary policy has successfully brought inflation to single digits in an environment complicated by remonetization and large capital inflows. The central bank's focus on building up reserves, while maintaining appropriate exchange rate flexibility, is well placed. The recent pickup in inflationary pressures is being monitored carefully, and the authorities stand ready to tighten monetary policies should developments suggest that the end-2006 target range could be missed.

"Financial sector reforms are progressing well. A financial sector bill currently under the Congress' consideration will, once approved, address several improvements identified by the government in consultation with the Fund and the World Bank.

"Looking ahead, Uruguay's key challenge will be to implement crucial structural reforms over the next months—including the tax, financial sector, and pension reforms currently before Congress. Over the medium term, the authorities should continue with the sustained implementation of strong macroeconomic polices, while persevering with steps to improve the business climate and strengthen labor market flexibility. Together, these will reduce vulnerabilities further and lay the basis for lasting growth," Mr. Carstens said.

**Statement by Hector Torres, Executive Director for Uruguay
and David Vogel, Advisor to Executive Director
June 28, 2006**

Background

1. Uruguay's economy keeps showing a satisfactory performance, which is based on sound pillars of prudent macroeconomic policies, structural reforms, and proper incentives established by the authorities' measures. Thus, Uruguay's government continues going forward with its objectives of higher and sustainable growth, high level and better quality of employment, and more social equity.

Recent Economic Developments

2. In the first quarter of the year, GDP increased robustly (7.2 percent) compared to the same period in 2005. In this broad-based growth there have been outstanding performances as in industry (increase of 18 percent) and construction (16 percent). Meanwhile, investment (33 percent) and exports (10 percent) are leading the activity expansion. At the same time it is important to note that private consumption increased by a healthy 6.4 percent, showing upward trend rates. This reflects higher consumer confidence, consistent with the prudent expenditure policies that will make possible a new tax system which, whereas permitting a more equitable and efficient distribution, will not impose a higher tax burden.

3. Inflation is within the target range established by the Central Bank for September 2006 (5-7 percent). Admittedly, inflation rates have risen in recent months reflecting the full pass-through of oil prices, along with the effect on food prices of a drought that is currently receding. However, the Central Bank is following these developments closely and is ready to take all adjustments in monetary policy that may be needed to meet the Central Bank's inflation target. Meanwhile, the authorities are adhering to a flexible exchange rate system, even though, if necessary, they will intervene to mitigate possible short-term volatility due to large capital inflows. This approach is clearly supported by the staff's assessment on competitiveness. At the same time, we would like to reiterate that our authorities have no exchange rate target and are determined to avoid signaling the existence of any.

4. Primary surplus in 2005 exceeded the authorities' target, and the same behavior has been observed during this year, with figures approaching to the government's medium-term targets. It is important to note that the social emergency plan, although it was not fully implemented in 2005 because of temporary delays, has been critical to allow the country to reduce the poverty rate by three percentage points, generating more social inclusion and a better environment for reforms.

5. Strong fiscal performance has made possible a steady and ambitious reduction of the debt-to-GDP ratio that is currently already under the 70 percent figure. Admittedly this is

still a high ratio that needs to be further reduced, but it is far below the ratio observed less than three years ago (105 percent). Meanwhile, the recently created Debt Management Unit continues to make efforts to further reduce debt cost, increase maturities, and diminish exchange rate risks.

6. Our authorities do not fully agree with the staff on some assessments regarding underlying vulnerabilities. In particular, comparisons among different countries' reserves relative to short-term debt and foreign exchange deposits does not take duly into account different circumstances. For instance, unlike what happened to other countries in the region, when Uruguay underwent the climax of its 2002 financial crisis, foreign-owned banks responded to deposit withdrawals with their own reserves. The Central Bank did not have to assist those banks with its reserves. Moreover, all of the private banks are currently owned by first rank international banks, accounting for about the half of the banking system assets. Meanwhile, it is a little bit strange that the staff report underscores the bunching of maturities on debt exchange falling due 2022 and 2033 as a vulnerability without recalling that the debt exchange itself was a big success.

Our Authorities' Firm Commitment to Structural Changes

7. A long series of efforts over the last sixteen months clearly reflect the government's strong ownership of the reforms. In the Uruguayan government's view reforms must be lasting and well-implemented, which requires an adequate discussion in Congress, and a good dissemination and explanation to the people about the benefits that such changes will bring about. This is the reason why the authorities have preferred to introduce some minor variations to their comprehensive structural agenda.

8. As in any democratic country, in Uruguay the Congress is free to schedule priorities and the time it needs to consider each of the bills that are put forward by the Administration. In this regard, it has decided to consider our authorities' core reform, the new tax system, prior to other reforms. We are confident that the small time adjustment that we are requesting will help the Congress to better discuss reforms whose architectures are quite sophisticated.

Further Inserting Uruguay into the Global Economy

9. Another critical structural issue involves Uruguay's further insertion into the global economy. The Uruguayan government gives high priority to trade diversification since it will allow Uruguay to continue minimizing its dependency on one region. In this respect we would like to stress the significant improvement made since 1998 when exports to Mercosur represented 55 percent of total exports in goods whereas this percentage was reduced to just 23 percent in 2005. Consequently, Nafta countries' share is showing an expansion (7.5 percent in 1998 and 29 percent in 2005), as is Europe (18 percent in 1998 compared to 20 percent in 2005). Furthermore, since the recent visit of the President of Uruguay to the United States of America, a process towards deepening trade relations between both

countries has begun, which would complement the investment agreement ratified by the Uruguayan Congress in December 2005. Uruguay has already signed a Free Trade Agreement with Mexico, and will continue efforts to negotiate trade agreements with many other countries in order to diversify not only markets but also Uruguay's export product base.

Reforming and Establishing Proper Incentives in the Financial System

10. After a deep economic and financial crisis as the one Uruguay suffered in 2002, it takes some time to rebuild confidence, putting together a strong banking sector with reduced vulnerabilities. However, there has been a steady and substantial improvement in confidence and the system is already harvesting benefits from an important number of structural changes. While the financial system still presents a high proportion of sight deposits, this is mainly due to the fact that demand for credit is still low. In this context, the banking sector has not had strong incentives to offer high interest rates to attract longer-term deposits, which in turn affects depositors' decisions. This situation is no different from many other experiences of post-crisis recoveries in which bank credit tends to pick-up with some delay. In Uruguay, something similar has occurred. While credit is starting to delineate a slightly positive trend, it is expected that the continuation of macroeconomic stability and, particularly, the projected reforms in the financial system and capital market (many of which are included in the staff recommendations made in Chapter IV of the Selected Issues report) will allow the Uruguayan economy to enjoy a higher access to finance.

11. Much greater confidence in the system can be observed in some indicators and events, but we would like to underscore two of them. First, the episode of Cofac – negative in itself – was isolated and did not have any effect on the rest of the financial system. Second, the privatization process of Nuevo Banco Comercial (NBC) was successfully completed. It is important to recall that NBC was created after the 2002 financial crisis with the good assets of three failed banks, and approximately three years later the process was concluded after arranging a very convenient operation, considering the buyers' reputation and the fair price. As our authorities have underscored, this operation continues to demonstrate investor confidence in Uruguay, and particularly in its financial system.

12. We would like to reaffirm that our authorities are fully aware that much more remains to be done to further improve the financial system and mitigate remaining vulnerabilities. In this regard, as recognized by the staff, recent efforts include the significant strengthening of the regulation and supervision of the financial system. Likewise, the government continues progressing towards critically transforming Banco Hipotecario del Uruguay (BHU) into a viable institution. Regarding Banco de la Republica Oriental del Uruguay (BROU) our authorities are setting aside dogmatic approaches ("public banks are intrinsically good, or intrinsically bad"). For them it is good governance that counts most. The existence of a strong public bank based on sound pillars should not discourage private competence but

rather entice it while serving the interests of the country and its people. In this vein, the authorities continue making significant advancements, among others, in risk management and internal controls.

13. The Uruguayan government aims to reinforce habits of honoring debts and, in general, accountability on both sides, banks and their customers. It is important to recall that over the last decades, many laws have been passed establishing debt refinancing with lax conditions for the generality of debtors. Our authorities have underscored that they are firmly committed to break these kind of detrimental solutions, and that policies will not reward those who are unwilling to honor their debts, waiting for the next debt amnesty. Instead, the reward will be aimed at encouraging people to meet their obligations, hence avoiding a burden on the whole community.

Further Improving the Investment Climate

14. Considering the critical need for Uruguay to attract private investment, our authorities' strategy is designed to forge a favorable investment climate. As noted by the staff, after completing the work of the growth commission (Compromiso Nacional), our authorities have incorporated many of the identified measures in their agenda, which will help them to fulfill their objectives. In this regard, the creation of an investor relations office at the Ministry of Economy, and the adoption of a detailed plan to strengthen government procedures have been incorporated as new structural benchmarks. These will add to other critical reforms such as a new bankruptcy law.

Conclusions

15. Despite a not entirely favorable external environment (high oil prices and a drop in tourism due to occasional blockades of bridges connecting with Argentina) Uruguay has been showing a very positive performance –outstanding if compared to the country's economic patterns during the last decades. Among other things, GDP has grown robustly, inflation has been within the Central Bank's target range for September 2006, fiscal performance has exceeded original projections, and poverty – though still high – has decreased. The authorities are fully aware that much remains to be done in all of these areas. At the same time, the Uruguayan government has pointed out that macroeconomic achievements do not make sense if they are not accompanied by critical reforms included in the authorities' comprehensive agenda.