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Uruguay: 2008 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice 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 the 2008 Article IV consultation with Uruguay, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on August 19, 2008, 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 October 9, 2008. 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 October 22, 2008, updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 24, 2008 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Uruguay.

The document listed below has 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.

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URUGUAY

Staff Report for the 2008 Article IV Consultation

Prepared by the Staff Representatives for the 2008 Article IV Consultation with Uruguay

Approved by José Fajgenbaum and Adnan Mazarei

October 9, 2008

Background

Despite recent volatility, Uruguay has so far weathered the global financial crisis and slowdown well. In September, the exchange rate depreciated, offsetting about half of the appreciation of the previous 12 months, while interest rates and country spreads rose. However, NIR and banks' liquidity have remained high, public sector's financing requirements are covered through 2009, and there is no evidence of deposit withdrawals. Moreover, growth is vigorous, fueled by substantial foreign investment, which has boosted productivity and improved medium-term prospects. Nevertheless, important medium term vulnerabilities remain, including because of the still relatively high and dollarized gross debt; and the financial system too is highly dollarized

Despite monetary tightening, inflation has remained above 7 percent, the upper limit of the target range, partly due to higher world commodity prices. Since 2007 the authorities have raised interest rates, allowed peso appreciation, while intervening in the foreign exchange market, and taken tax measures to partly offset the pass through of food and fuel price inflation. Even so, real interest rates are close to zero, core inflation is well above the headline rate, and the recent peso depreciation is likely to create further inflation pressures.

The overall fiscal balance targets are expected to be met, but policy is likely to be expansionary in 2009. With low deficits, the debt-to-GDP ratio is improving. With expected deficits of ½–0.1 percent of GDP in 2008 and 2009 respectively, drought related spending (mainly energy) for 2008 (1½ percent of GDP) would be replaced in 2009 by higher domestic spending.

Key policy recommendations

Curtail domestic demand to reduce inflationary pressures. Monetary policy should be tightened, but the extent of the tightening could be reduced through a stronger fiscal stance.

Building resilience to protect prospects. Despite rapid credit, the financial system has remained sound; still, vigilance is warranted, in light of developments in financial markets and high dollarization. Adopting cyclically adjusted fiscal targets would enable a credible fiscal stimulus during downturns. Progress in structural reforms, including with the expected approval by Congress of the bankruptcy and financial sector reforms will help further protect prospects and enhance the business environment.

Authorities' views. The authorities stressed that they felt prepared for a significant deterioration in global or regional prospects, that inflation was a global phenomenon, and that pressures had been contained relatively well. They preferred to wait somewhat to better assess the need for monetary tightening. They argued that they had maintained fiscal discipline, while addressing the most pressing needs of society.

Mission. The team, comprising Messrs. Piñón (Head), Gelos (Resident Representative), and Mansilla, and Ms. Babihuga (all WHD); Mr. Adler (SPR); and Mr. Wezel (MCM), visited Montevideo during August 6-19, 2008. Mr. Vogel (OED) also participated in the meetings.1/

1/ In light of developments in world financial markets following completion of the mission, the Resident Representative continued the discussions in September.

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EXECUTIVE SUMMARY

Uruguay weathered the global financial crisis and slowdown well, although in September experienced some volatility. The economy is booming, fueled by a revival of bank credit and substantial foreign investment in the tradable sector, which has boosted productivity and improved medium-term prospects. During the market turmoil, the exchange rate depreciated, while interest rates and country spreads increased. The situation has since generally stabilized but warrants close monitoring.

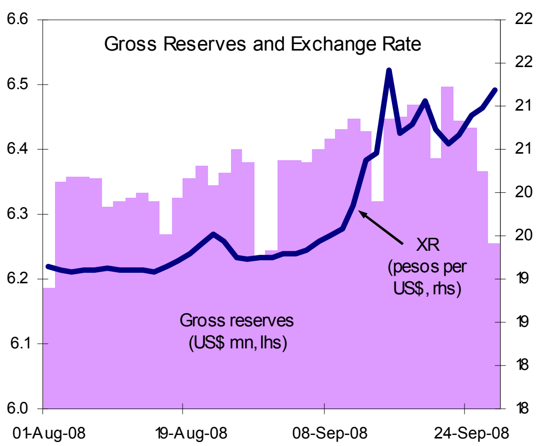
Despite better preparedness, vulnerabilities remain. Banks are well capitalized and provisioned, have substantial liquidity, their direct exposure to distressed assets appears to be small, and deposits have continued to grow. Sovereign debt spreads have increased, peaking at nearly 400 basis points in mid September, but have broadly moved in line with other emerging markets. In the meantime, gross international reserves have remained broadly stable, and there is no evidence of deposits withdrawals. Earlier in the year the government continued to tap international markets to improve the debt profile, including by de-dollarizing through swaps with support from the World Bank. About 85 percent of the debt is at fixed rates and financing needs are covered through 2009. The current account is mainly financed with FDI. Still, the debt and the financial system remain highly dollarized and many non-exporting companies are indebted in foreign currency, exposing them to the risk of sharp peso movements.

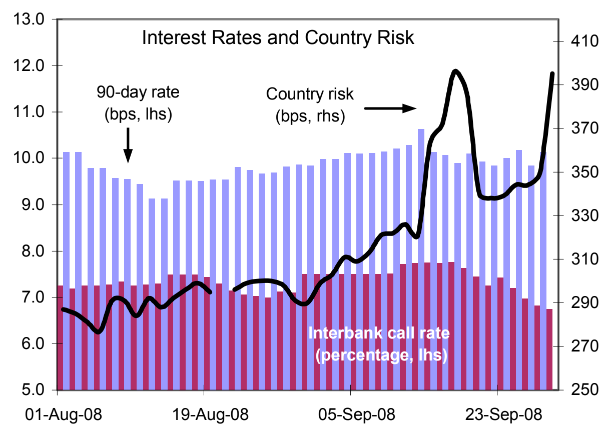
High capital inflows have challenged monetary management, and led to a sharp rise in reserves and central bank debt earlier in the year. Until recently, while allowing significant appreciation of the peso, the authorities continued to intervene to smooth movements, with NIR rising by about US$2.4 billion (10 percent of GDP) since mid-2007—i.e., by about the size of the monetary base. Sterilization operations have increased central bank debt by US$1.7 billion (7 percent of GDP) to US$3.7 billion during the same period, with estimated quasi-fiscal costs of about 0.3 percent of GDP. While the recent financial volatility resulted in some outflows, the trend of FDI- related capital inflows is likely to persist, provided global financial conditions stabilize.

I. Background

1. **With sound policies and a broadly supportive environment, Uruguay has further consolidated economic gains.** With growth at over 13 percent during the first semester, even if real GDP remained constant during the second semester, growth would still exceed 9.5 percent in 2008. Poverty has continued to fall, and unemployment has reached record lows. Several years of real income increases and a recent pick up in bank lending are boosting consumption. Capital formation has also risen strongly, particularly in the agriculture, industry, and transport sectors, aided by strong FDI flows. Cautious fiscal policy has helped reduce the debt-to-GDP ratio, while debt management operations have continued to improve the structure of the public debt.

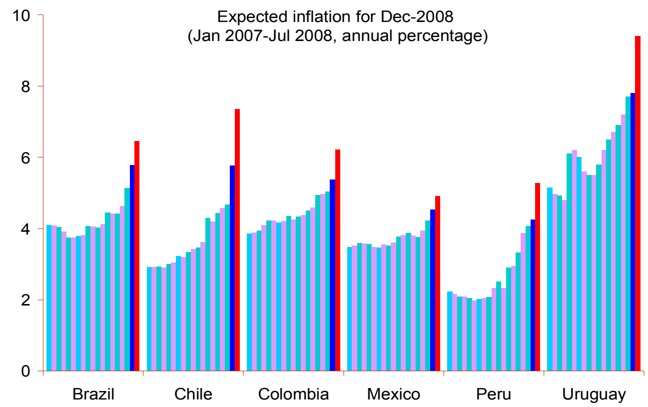
2. **The impact of the recent global financial turbulence has been felt, but so far remains relatively contained.** After persistent earlier appreciation pressures, Uruguay experienced a peso depreciation in recent weeks; interest rate rose somewhat, and sovereign debt spreads peaked at nearly 400 basis points in mid September. Deposits, however, remained stable; .rates and spreads have fallen from their peaks but remain mostly at higher levels than a few weeks ago.





3. **Supported by high commodity prices, export growth remains strong.** Exports earnings continued to increase (merchandise exports were up almost 50 percent in the first quarter of 2008), despite some deceleration in volume growth. The beginning of operation of the Botnia pulp mill has contributed to the strong export performance, with the positive effect on GDP this year estimated at 2½ percentage points. Higher oil imports—resulting from high prices and a drought—and rapidly growing imports of capital goods have largely offset the impact of strong agricultural commodity prices on the trade balance.

4. **However, with the run up in commodity prices, underlying inflationary pressures have been high.** Inflation has increased from less than 4 percent in late 2005, to around 7–8 percent since end-2007. These rates are above the target range, which was widened in January 2008 from 4–6 percent to 3–7 percent. As pressures mounted, inflation expectations were revised upward in Uruguay and in other countries in the region.



5. **The authorities have tightened monetary policy while taking administrative measures to contain price increases.** The central bank increased the policy rate by 275 basis points to 7¼ percent in 2007 and has left it broadly unchanged so far in 2008. More recently, in May, it raised reserve requirements for peso deposits from 17 to 25 percent, and for foreign-currency deposits from 25 to 35 percent. It also allowed the exchange-rate channel to operate more freely than before, with the peso appreciating against the U.S. dollar by about 19 percent since July 2007. In addition, in 2007, the authorities implemented administrative measures, including tariff cuts, to prevent headline inflation from reaching double-digits last year, which would have triggered more frequent pension and wage adjustments. The fiscal cost of these measures, which reduced headline inflation by 1.5 percentage points in 2007/08, is estimated at 1¾ percent of GDP.

Table 1. Administrative Measures to Control Consumer Prices
(2007 to present)

Date	Measure	Permanent/ Temporary	Fiscal cost annualized (% of GDP)	Impact on price level (percent)
Sep-07	Renewal of VAT exemption on poultry meat	T	0.0	0.1
Sep-07	Fuel and telephone tariffs reduced by 3.7 and 7.9 percent resp.	P	0.1	0.3
Sep-07	Telephone tariffs reduced by 7.9 percent	P	0.1	0.2
Sep-07	ICOME tax abrogated	P	0.4	…
Sep-07	Health insurance quota reduced by 2.5 percent.	P	…	0.2
Sep-07	Electricity tariffs reduced by 3.8 percent	T	0.4	0.1
Oct-07	Subsidy to passenger transport companies	T	0.4	0.2
Dec-07	Renewal of VAT exemption on pork meat	T	0.0	0.0
Jan-08	Internal Specific Tax (IMESI) on fuel tariffs reduced by 20 percent	P	0.2	0.5
Jan-08	VAT on drinking water public enterprise (OSE) reduced by 3.7 percent	P	0.0	0.0
Total			1.8	1.5

6. **While the overall deficit has been below target, fiscal spending has been expansionary, particularly in non-drought years.** The primary balance declined from 3.8 percent of GDP in 2006 to an estimated 2.7 percent of GDP in 2008, and is projected to increase to above 3 percent of GDP in 2009. Still, with lower interest payments, the overall deficit is expected to remain between 0–0.3 percent of GDP, below the authorities' medium targets adopted in 2005. Also, the gross debt-to-GDP ratio has continued to fall, to below 70 percent of GDP; net of NIR, the debt stands at 55 percent of GDP. However, the recovery from the 2006 and 2008 droughts (reflected as a higher surplus of public enterprises) was accompanied by increases in spending in 2007, and a similar pattern is projected for 2009. On a cyclically adjusted basis and excluding drought-related costs, both the primary and overall balances have deteriorated in recent years. With an estimated cumulative impulse of about 1.7 percent of GDP in 2008-09, fiscal policy is increasing the burden on monetary policy.

Table 2. Public Sector Operations
(in percent of GDP)

	2006	2007	2008 Est.	2009 Proj. 1/
Revenues	31.8	33.8	32.4	33.8
o/w Public enterprise surplus	1.4	2.6	1.5	2.4
Non-interest expenditure	28.0	30.2	29.7	30.8
o/w Wages	6.1	7.1	7.1	7.3
Primary Balance	3.8	3.6	2.7	3.1
Interest	4.4	3.6	3.0	3.2
Overall Balance	-0.6	0.0	-0.3	-0.1
Memo items:				
Structural Balance: 2/				
Primary balance	5.3	3.3	3.1	1.6
Overall balance	0.9	-0.3	-0.1	-1.8
Fiscal impulse 3/	-0.4	1.9	0.2	1.5
Output gap (in percent)	-1.7	1.2	6.1	7.3

Source: National authorities and Staff estimates
1/ Projection based on budget for 2009
2/ Excludes drought-related import costs in 2006 and 2008 of 1.1 and 1.5 percent of GDP, respectively
3/ Defined as the change in the structural primary balance

7. **Despite recent volatility, Uruguay has so far weathered the global financial crisis and slowdown well**. Gross international reserves have continued to rise, reaching US$6.3 billion. Earlier in the year the government continued to tap international markets to improve the debt profile, including by de-dollarizing through swaps with support from the World Bank. Banks are well capitalized and provisioned, their direct exposure to distressed assets appears to be small, and deposits have continued to grow. Foreign owned-banks' behavior so far does not appear to have been affected by the losses of their parent banks. FDI flows—among the highest in the region—are expected to reach US$1.4 billion, compared to US$1.2 billion last year. With a widening interest differential with the U.S. and appreciation expectations, non-FDI inflows also accelerated earlier in the year.

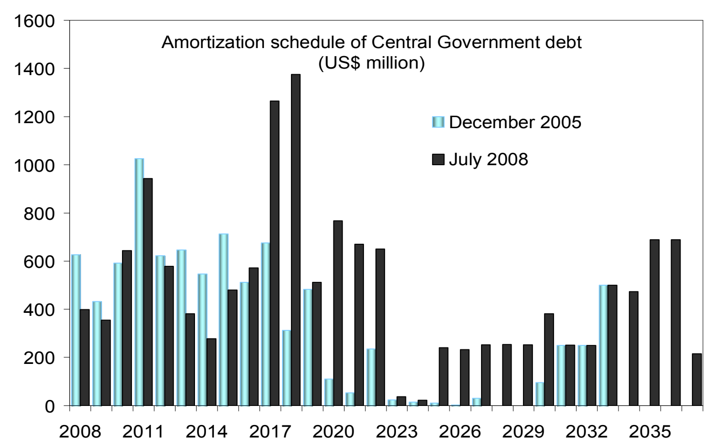
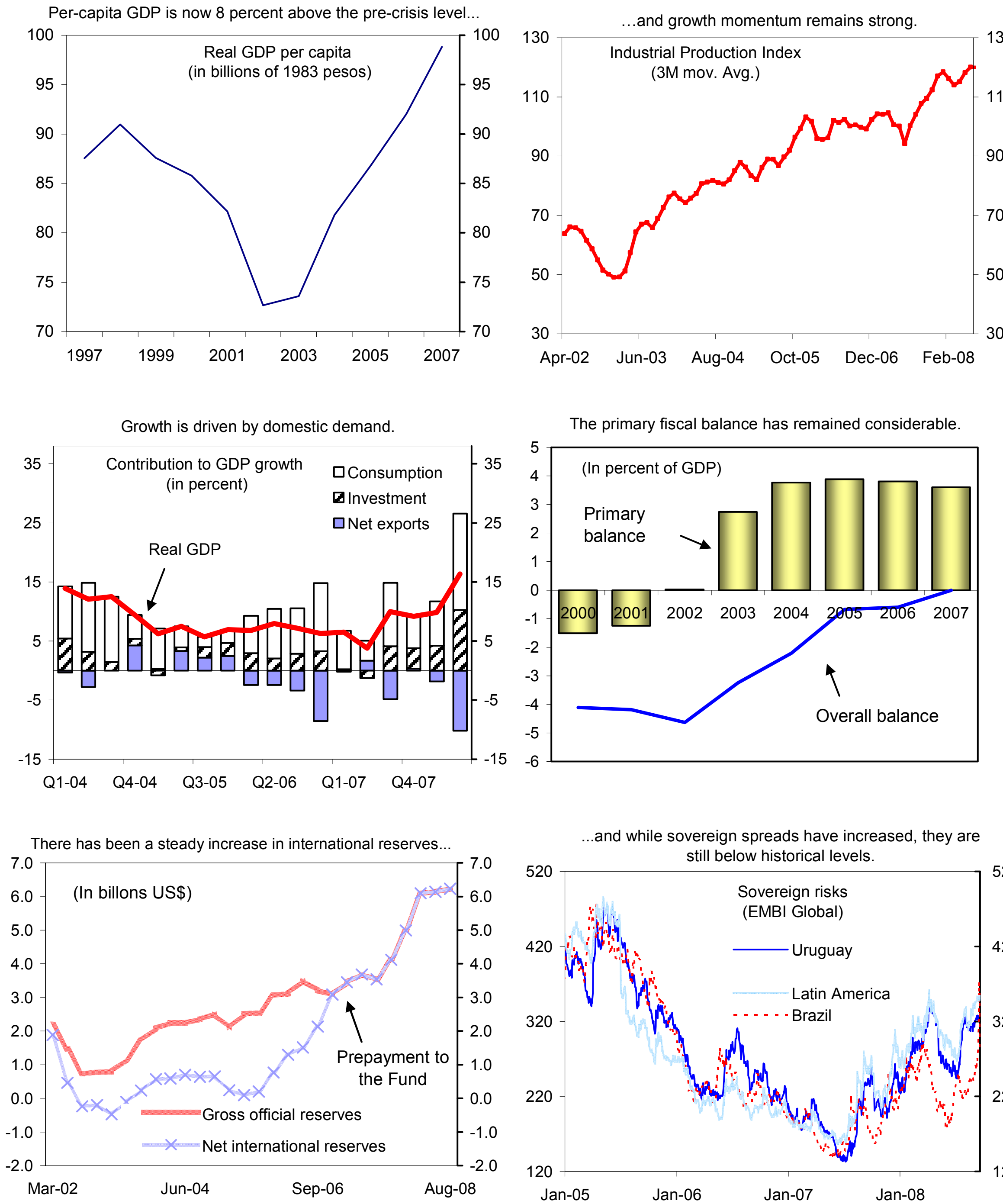
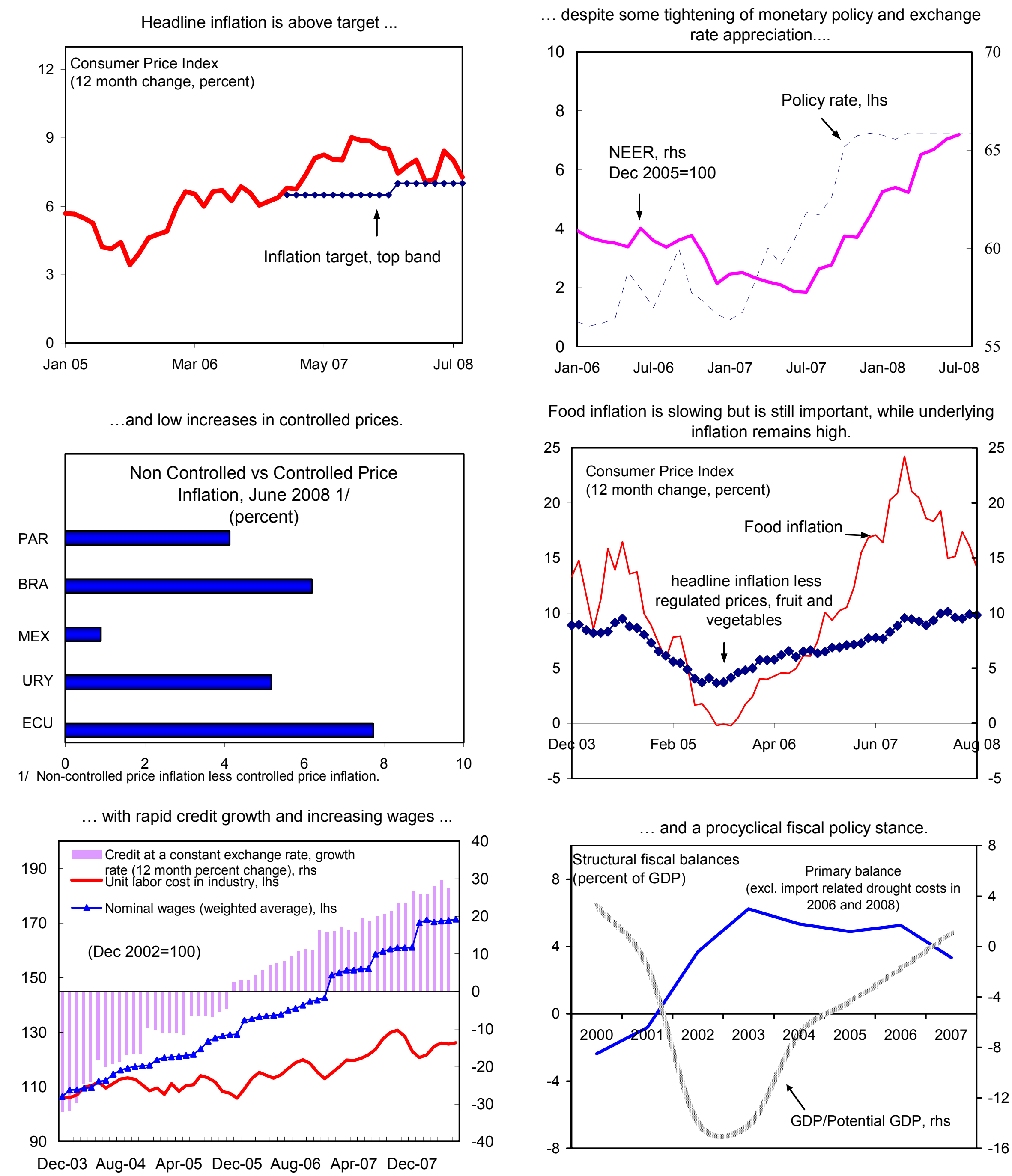


Figure 1. Recent Macroeconomic Performance



Sources: Central Bank of Uruguay; Fund staff estimates.

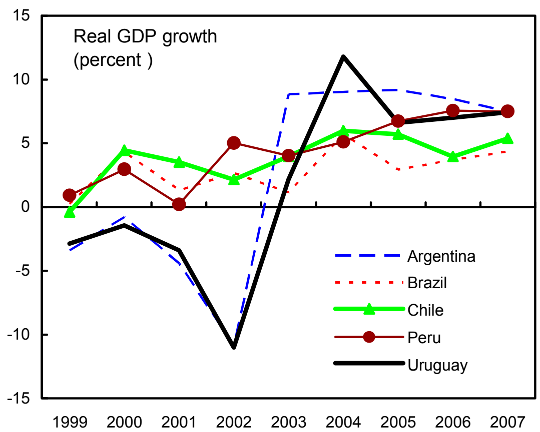
Figure 2. Inflation—the challenge persists.



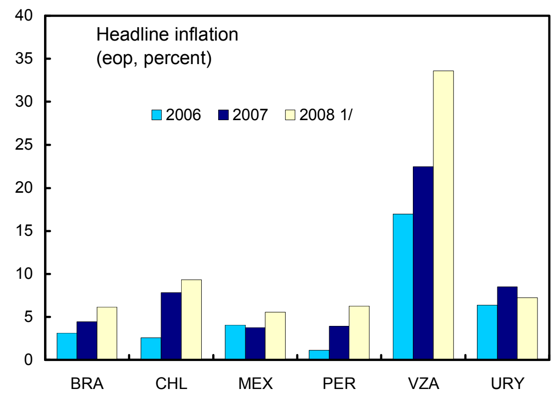
Sources: Central Bank of Uruguay; Ministry of Economy and Finance; National Statistic Institute and Fund staff estimates.

Figure 3. How are Uruguay and its peers coping with higher commodity prices?

Despite external shocks, growth has remained strong.

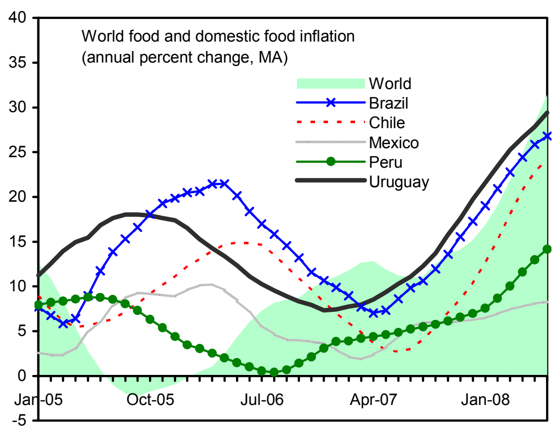


Although inflation has risen across the region...

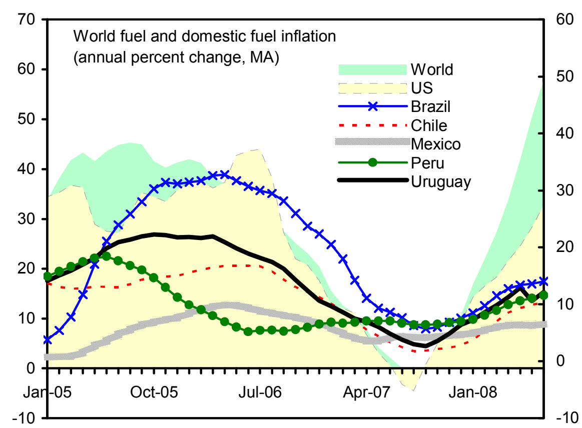


1/ August 2008

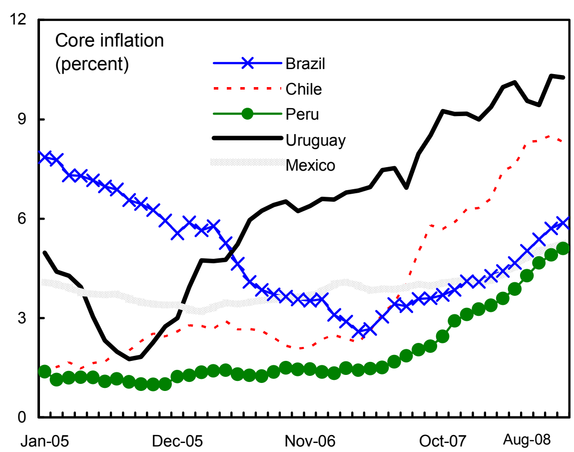
...partly due to a sharp increase in food prices...



...and despite efforts to contain the full pass through of fuel prices.



...while core inflation has accelerated sharply, particularly in Chile and Uruguay.



Source: National authorities, WEO and staff estimates.

Policy responses have included a mix of monetary tightening and allowing exchange rate appreciation.

	Monetary Policy				Exchange rate policy
	Current Policy Rate	Real Rate 1/	Change 2007	Change 2008	NEER 2/ percent change 2007-08
Brazil	13¾	8.8	(-) 2	(+) 2½	13.6
Chile	8¼	0.4	(+) ¾	(+) 2	-1.5
Mexico	8¼	3.9	(+) ½	(+) ¾	4.1
Peru	6½	2.0	(+) ½	1	1.6
Uruguay	7¼	-0.8	(+) 4¼	0	11.0

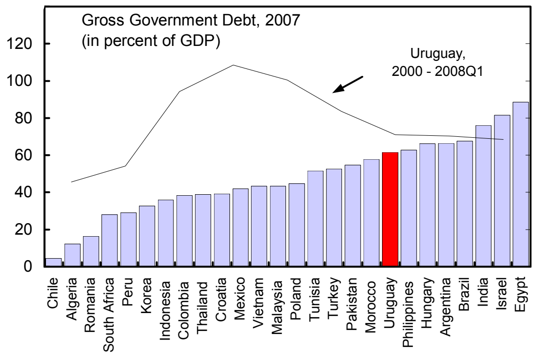
Source: Central banks

1/ Nominal rate less average of 12 month before inflation (Aug 2008)

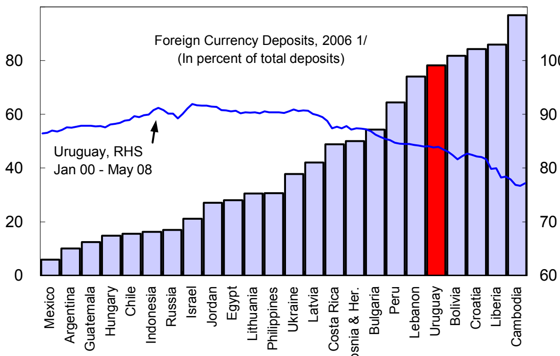
2/ Positive means appreciation

Figure 4. While medium term vulnerabilities are still important, Uruguay is appropriately hedged against worsening external conditions in the near term.

Public debt has declined, but remains relatively high.

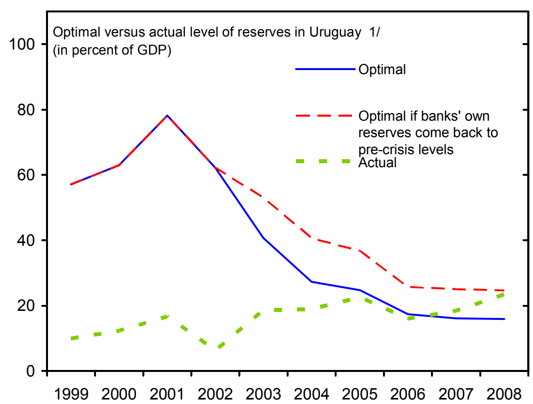


Financial dollarization has also declined, but remains significant.



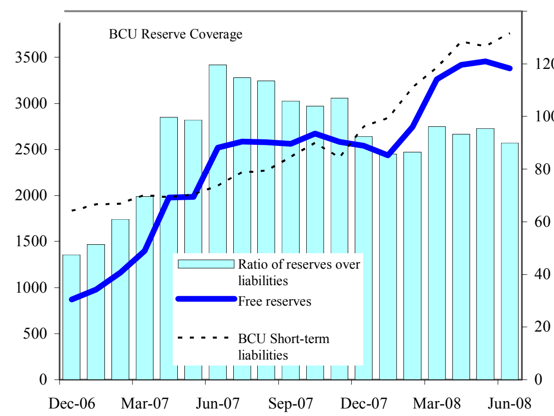
1/ 2007 data for Uruguay.

Reserve coverage of foreign currency denominated short term debt and deposits has reached appropriate levels...

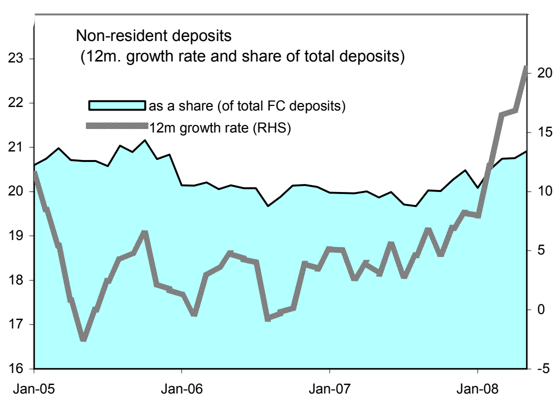


1/ Based on a consumption smoothing model. See Goncalvez (2006).

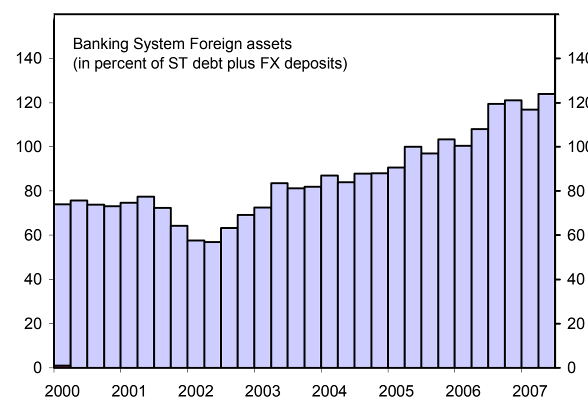
...although the ratio of reserves over central bank liabilities has declined in recent months.



Non resident deposits have picked up in recent months, but remain low compared to pre-crisis levels...



...and FX deposits are well covered by financial system liquidity.



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

II. Outlook and Challenges

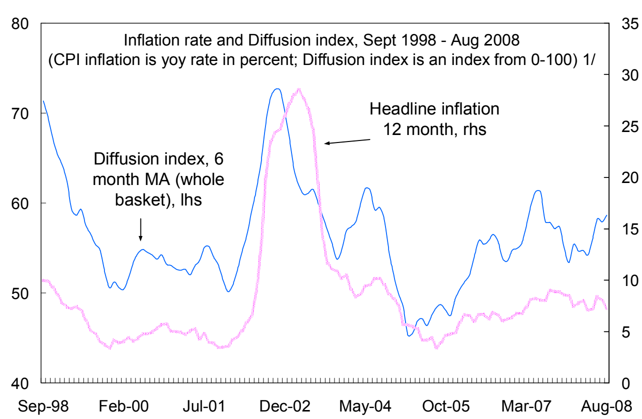
8. **Barring a severe further external deterioration, growth prospects remain strong**. Following the one-off effect of the start of operations of the Botnia pulp mill, growth is expected to slow to about 5½ percent in 2009. The medium-term outlook remains positive, with major foreign investments in the tradable sector—among others, ENCE is proceeding with its plans for another pulp mill and the Portuguese company Portucel recently announced a major investment in the sector.

9. **Vulnerabilities have declined considerably, but remain important.** With lower public debt ratios, high reserve coverage of dollar-denominated deposits, and vigorous growth momentum, Uruguay has built significant buffers to external shocks. Over the past years, short-term government debt has fallen substantially (although the 1–3 year maturity central bank debt has risen owing to sterilization) and government external financing needs are covered through 2009. Until end-2009, debt totaling only US$542 million is maturing, US$128 million of which is in local markets – if the sovereign were to be completely shut off from both local and international markets, it could in principle finance itself through the beginning of 2010. Nevertheless, gross public debt remains high by emerging market standards, and mostly denominated in foreign currency. Financial dollarization has declined but, at about 75 percent of both loans and deposits, is among the highest in the world (Figure 4).

A. Dealing with High Inflation and Capital Inflows

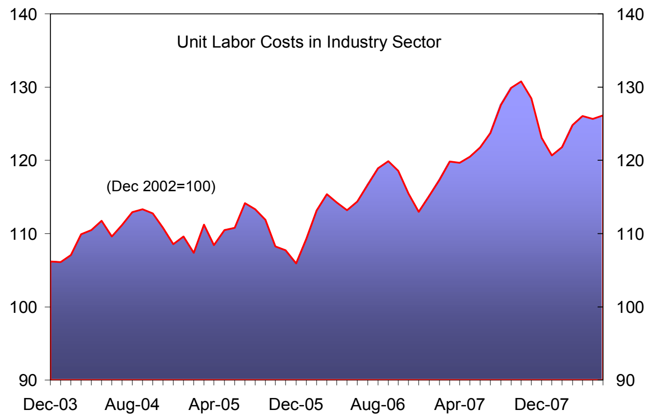
10. **Both external and domestic factors have played a role in pushing up prices.** Food inflation of 14 percent and fuel and electricity price increases of 13 percent have led headline inflation since mid-2007. Staff analysis suggests that international food prices have contributed 2–2.5 percentage points to headline inflation (Box 1). At the same time, output is above potential, and domestic pressures are visible in high inflation of nontradable goods (7.7 percent). Fiscal policy has not helped in containing demand; while the precise effect is difficult to quantify, staff estimated that a 1 percent of GDP fiscal stimulus tends to raise inflation by about 0.7 percentage points after 6 months (see IMF Occasional Paper 263).

11. **Moreover, there are indications of further inflationary pressures.** High core inflation (9–10 percent) and limited increases in controlled prices (2–3 percent) point to upward pressures for headline inflation. The diffusion index (DI) confirms that inflation has permeated to most consumption items. In this context, inflation expectations are at 8.0 percent for this year but declining to

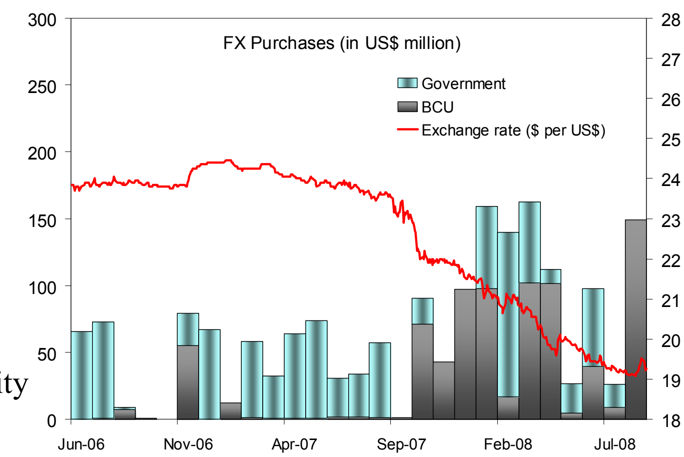


1/ Diffusion index measures share of CPI items with positive m/m price changes about 7 percent by end-2009, in large part because of expected lower commodity prices.

12. **Wage policy has largely validated past inflation, increasing the persistence of price adjustments**. While the authorities have emphasized expected over past inflation in recent negotiations, public wage increases have been consistently above past inflation; and, pensions are adjusted once a year by past inflation. Private wage agreements, reached through tripartite councils, have also included adjustments above past inflation. As a result, unit labor costs have tended to increase in recent years.

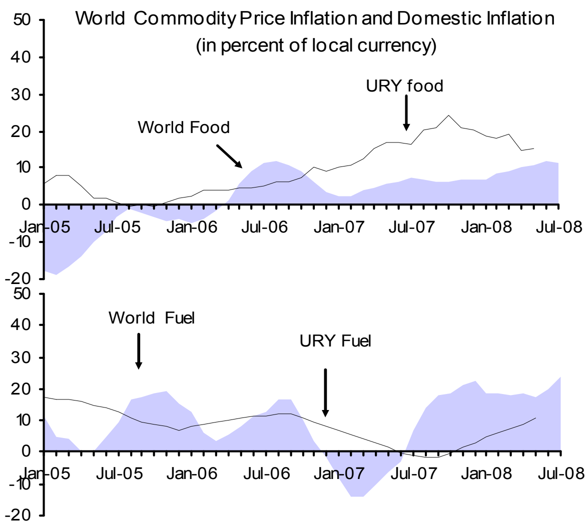


13. **Until around end-August, high capital inflows had challenged monetary management, and led to a sharp rise in reserves and central bank debt**. While allowing significant appreciation of the peso, the authorities have continued to intervene to smooth movements, with NIR rising by about US$2.4 billion (10 percent of GDP) since mid-2007—i.e., by about the size of the monetary base. Sterilization operations have increased central bank debt by US$1.7 billion (7 percent of GDP) to US$3.7 billion during the same period, with estimated quasi-fiscal costs of about 0.3 percent of GDP. While the recent financial volatility has dampened pressures somewhat, the capital inflows are likely to persist, provided global financial conditions stabilize.



Box 1. Sources of Inflationary Pressures

Food price shocks have had a significant impact on headline inflation. Econometric analysis based on vector autoregressive estimations and confirmed by an "augmented" Phillips' curve estimation, suggest that a 10 percentage point increase in world food prices raises domestic prices by 1.2 percentage points after one year. This implies that 2–2½ percentage points of current inflation can be attributed to world food price increases. The estimated pass-through coefficient of 0.12 is in the upper range of estimates for other emerging markets. The impact of world fuel price increases on headline inflation could not be statistically confirmed.



Second-round effects are also considerable. There has been a sizable spillover from world food price shocks to different measures of core inflation. The pass-through to prices excluding fruits and vegetables, for example, is nearly as high as that to headline inflation.

Pass through of Food Price Shocks to Inflation

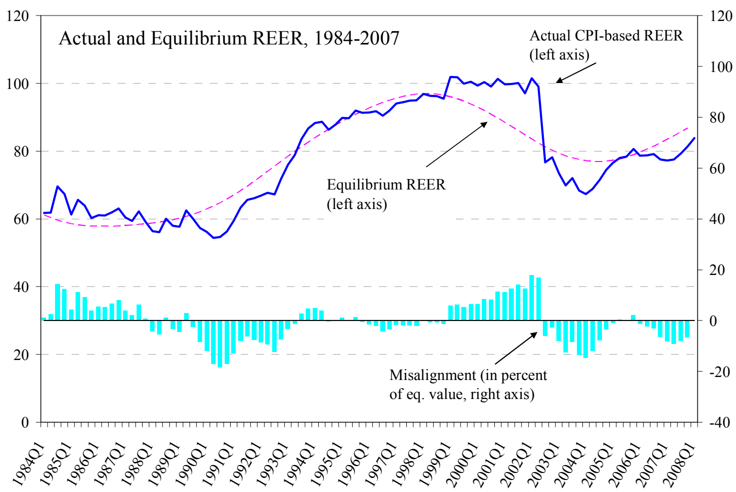
Horizon	Headline	CPI less fruits and vegetables	CPI less regulated prices	CPI less fruits, vegetables and regulated prices	CPI less fruits, vegetables, regulated prices and housekeeping	CPI less fruits, vegetables, regulated prices, housekeeping and tobacco products	Principal component index
1 quarter	0.53	0.43	0.91	0.82	0.94	0.94	0.72
1 year	1.17	1.07	1.87	1.82	1.89	1.71	1.75
2 years	0.97	0.86	1.75	1.75	1.76	1.50	1.59

Source: authors' estimates
1/ Estimates are the percentage point change in inflation in response to a 10 percentage point increase in food commodity prices
2/ Official measures of core inflation

[1] Based on a Selected Issues Paper by R. Babihuga and G. Gelos.

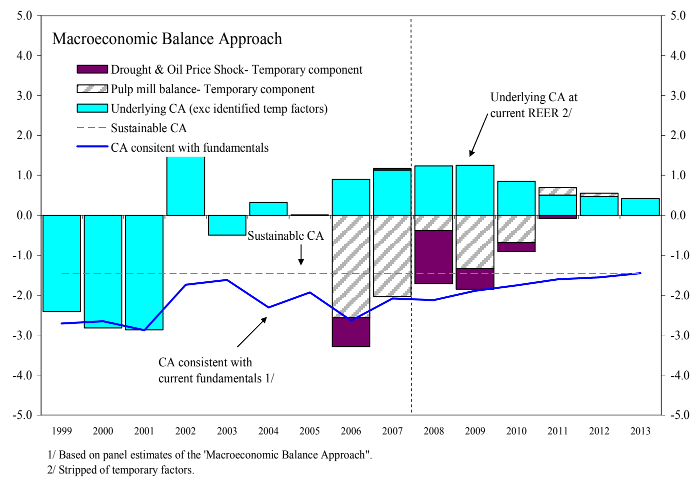
Box 2. Exchange Rate Assessment

Standard methodologies to assess the level of the exchange rate suggest that, prior to the financial turmoil in September, the REER was slightly undervalued. The CPI-based REER appreciated almost 11 percent in the previous 12 months, but still was significantly below pre-crisis levels. Export profitability measures had remained broadly constant, and also significantly above pre-crisis levels, on account of high export prices. As of mid-2008:



- **Equilibrium real exchange rate approach.** Econometric estimates of the long-term relationship between the REER and key economic fundamentals—relative income, net foreign assets, terms of trade—pointed to an undervaluation of less than 3–5 percent.

- **Macroeconomic balance approach.**[1] Panel data estimates suggested that a 5 percent appreciation of the REER would close the gap between the underlying current account balance (1.0 percent of GDP) and the sustainable level of the current account (-1.4 percent of GDP).



- **External stability approach.**[2] Calibrations of the sustainable level of the CA suggest that a level of about -1 percent of GDP would stabilize net foreign assets at the current level. Such a CA balance would require a REER increase of about 2–4 percent.

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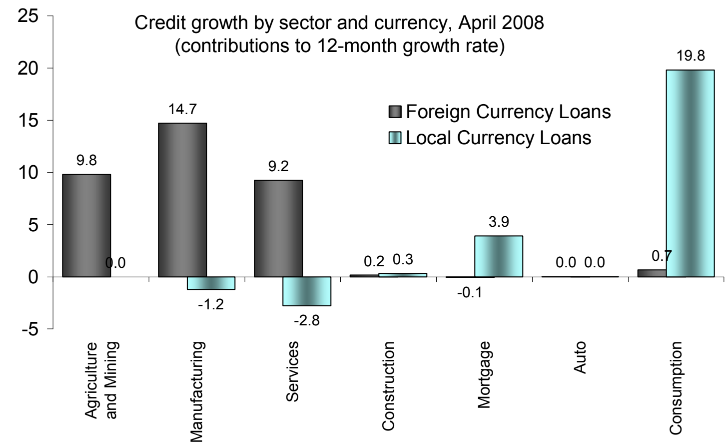
[1] See "Exchange Rate Assessment: CGER Methodologies" Occasional Paper No. 261. Uruguay's results are based on a recent update of estimates by Rahman (2008).

B. Global Financial Crisis, Credit Growth, and the Banking System



Source: BCU and IMF staff's estimates.
1/ Excludes "Casas Financerias" and liquidated banks.

14. **Despite rapid credit growth and the deterioration in global financial conditions, the banking system remains generally sound.** Capitalization is adequate, non-performing loans are low, and the system's liquidity remains high. With falling interest rates on foreign assets, bank credit to the non-financial private sector has picked up considerably (Box 3), largely financed by higher deposits by domestic residents. While strong demand by the agricultural and manufacturing sectors has been the main driver of credit growth, banks have also diversified into consumer and mortgage lending.

15. **However, profitability has declined despite high economic growth.** The average return on assets has dropped to 1.0 percent (from 1.7 percent a year ago), with some banks now registering losses, owing to: (i) declining yields on foreign assets; and (ii) peso appreciation, which raised peso costs relative to earnings on dollar assets. Moreover, the recent increase in unremunerated reserve requirements will further compress profits; persistent low profitability could lead to a relaxation of lending standards in search of higher yields.

Selected Financial Soundness Indicators

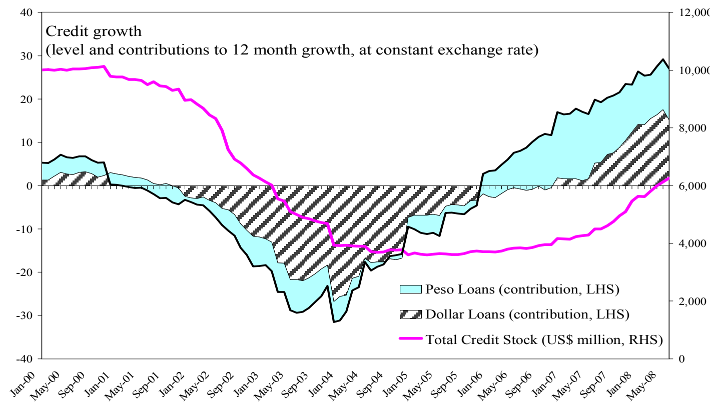
	Dec 2005	Dec 2006	June 2007	Dec 2007	June 2008
Book equity capital in percent of total assets	8.2	9.4	10.1	10.5	10.6
Return on assets	0.8	1.0	1.7	1.3	1.0
Liquidity ratio (30 days)	80.7	110.6	69.1	53.9	62.2
Non-performing loans in percent of total loans[1)]	5.6	3.7	3.3	1.1	1.1
Loan loss reserves in percent of non performing loans[1)]	82.8	166.5	155.2	340.1	269.1

Central Bank of Uruguay and IMF staff calculations; [1)] loans to the nonfinancial private sector (without BHU)

16. **Nonresident deposits have recently risen but their share in total deposits has remained broadly stable.** While increasing by some US$200 million during the first half of the year, nonresident deposits have remained at about 15 percent of total deposits, half their level prior to 2002. Vulnerabilities are much reduced, but medium term risks persist given their still considerable levels and past high volatility; risks would be higher if over time banks were to use these deposits to finance domestic credit.

Box 3. Uruguay's Credit Growth and Prudential Regulation[1]

Following years of depressed levels, credit is now expanding rapidly, supported by increased deposits; and a bank portfolio shift from lower-yield foreign assets to local assets. In the 12-months to June 2008, credit to the private sector expanded 35 percent, with local currency loans growing at 33 percent and foreign currency loans at 39 percent.



Source: BCU and IMF staff's estimates.

Regulatory norms are broadly adequate to contain risks associated with the credit boom. Beyond high required reserves, provisions are high (well above the regional average), owing to low delinquencies and a stringent loan classification system. Provisioning against performing loans is based on stress tests that gauge borrowers' repayment capacity under strong economic shocks. In addition, a general provisioning requirement of 3 percent of total loans effectively links provisioning to credit growth. As a result, overall allowances amount to 5 times nonperforming loans.

Loan loss provisions in % of non-performing loans (Latest observations available)	
Argentina	122%
Brazil	182%
Chile	188%
Colombia	120%
Mexico	184%
Panama	129%
Peru	139%
Uruguay	269%

Stress testing by SIIF appropriately accounts for the main intermediation risks, including exchange rate, interest rate and credit risk. Currently, under all but extreme scenarios, banks' capital adequacy ratio would remain above required levels in all banks.

The regulatory framework needs to be improved further to deal with the risks associated with the rapid credit expansion. Capital adequacy should be better aligned with indirect credit risk by differentiating the weight on foreign currency loans used in determining risk-adjusted assets between unhedged and hedged borrowers. While banks are not intermediating the potentially volatile non-resident deposits in the local economy, the SIIF could reduce such risk by establishing internal, bank-specific liquidity benchmarks (beyond those contained in prudential norms) against which institutions are assessed.

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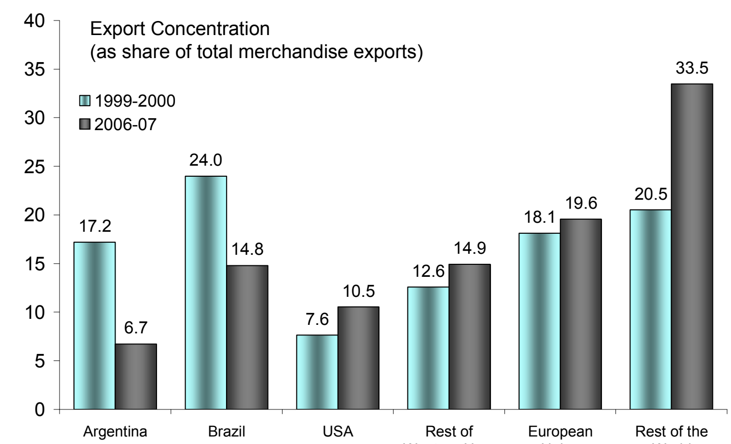
[1] See Selected Issues Paper on Credit Growth.

17. **The main effect of a sustained "sudden stop" for corporate financing would likely come through a weakening of balance sheets through the exchange rate channel.** Uruguayan corporations' main source of financing are internal funds, followed by suppliers' credit and bank lending. Neither local corporate bond nor stock markets are important, the use of foreign credit lines is negligible, and there have been no bond placements by Uruguayan corporations abroad. In the case of a sustained 'sudden stop', domestic bank lending growth would decelerate, and, more importantly, any exchange rate depreciation would weaken balance sheets of non-exporting companies indebted in foreign currency and reduce their access to bank finance. The weakening of balance sheets in turn, would raise credit risk for banks.

C. Regional Links

18. **Despite reduced linkages with Argentina and Brazil, conditions in the region have a significant bearing on developments in Uruguay.** While trade has been significantly diversified away from the region, Uruguay's linkages remain considerable. In particular, Argentina and Brazil are among Uruguay's largest trading partners; non resident deposits remain considerable; and, importantly, links through investment in agriculture, construction, and real estate have increased in recent years.

19. **Nevertheless, the Uruguayan economy could weather a drop in regional growth.** Econometric estimates suggest that, even in the event of a slowdown of about 3 percentage points, coupled with significantly higher risk aversion toward emerging markets, Uruguay's growth would decline but remain well above historical levels.(Box 4). Recent movements of Uruguay's sovereign spreads have been consistent with the evidence of relative resilience, exhibiting strong co-movement with Brazil and other emerging markets but decoupling with the recent spike in the spreads for Argentina. That said, a more severe shock, such as one leading to a contraction in regional GDP; or a continued deterioration in the global financial environment would, directly, and indirectly, affect Uruguay significantly.



Source: Direction of Trade Statitistics.

Box 4. External Linkages and the Changing Global Environment[1]

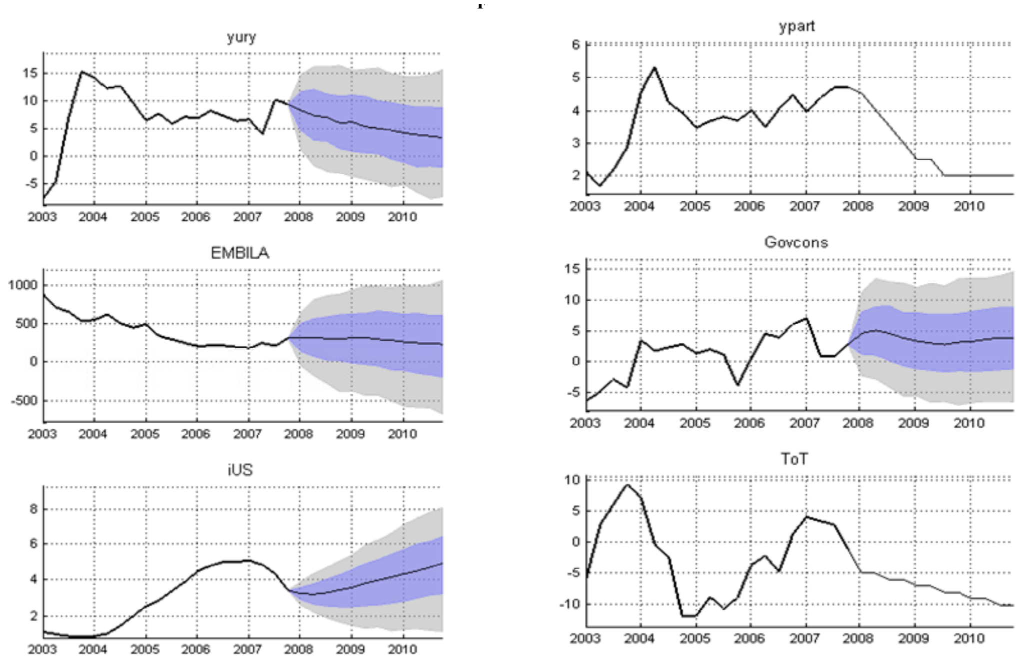
A Bayesian VAR model suggests that growth in Uruguay is sensitive to the performance of trading partners, the Latin American EMBI spread, the US interest rate, and the terms of trade. A one standard deviation shock, equivalent to: (i) a 1 percent deceleration in trading partners' growth would reduce growth in Uruguay by ½ percentage point; (ii) a 180bps increase in the spreads would reduce growth by about ½ percent point; (iii) a 50 bps increase in the US interest rate would reduce growth by ½ percentage point; and (iv) a 4 percent fall in ToT would reduce growth by 0.3 percentage points.

Benchmark: In the absence of shocks, the model forecasts growth of about 7.5 percent in 2008, slowing to 6 percent by 2010. This would be supported by strong growth in trading partners (3.8 percent on average) and relatively low EMBILA spreads (about 320 bps on average). Alternative scenarios:

Asymmetric commodity price shock (chart): Uruguay would not be particularly vulnerable to a generalized fall in commodity prices, as the lower agricultural export prices would be offset by lower oil import prices. However, a more pronounced fall in agriculture prices, would impact Uruguay both through its ToT and its regional trading partners with similar export structure. A 7 percent average fall in ToT and 1.6 percent lower growth in trading partners would reduce growth by 2.5 percent by 2010.

Financial shock: A 100bps higher US interest rate and a 250bps EMBILA spread increase over the medium term would reduce growth by 2.2 percentage points by 2010.

Regional slowdown: A regional slowdown, equivalent to 3 percent lower GDP growth in Argentina and Brazil, coupled with higher risk aversion reflected in an EMBI spread of about 600bps—would result in a slowdown of close to 2 percentage points by 2010.



[1]This box is based on a Selected Issues Paper prepared by G. Adler and M. Mansilla.

III. Report on the Discussions

A. The External Environment

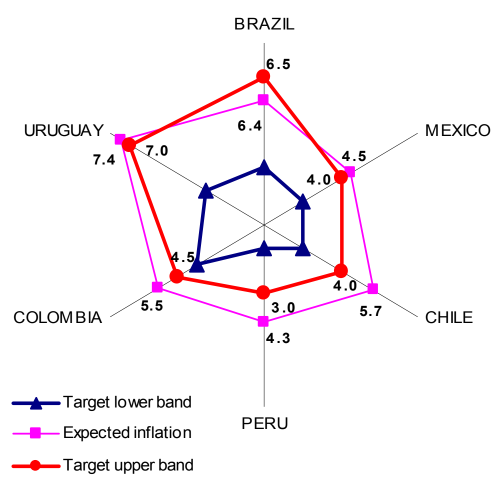
20. **The authorities stressed that Uruguay was well-prepared to weather a deterioration in the regional or global environment**, with increased diversification of export destinations and reduced financial links with the region. Moreover, Uruguay had only indirectly benefited from high commodity prices as its terms of trade had not improved during the last few years. While they shared staff's view that a severe financial crisis or a pronounced regional slowdown would not leave Uruguay unaffected, they explained that they were prepared to face such an adverse shock. In particular, they stressed that the significant FDI inflows would likely continue and pointed to the health and ample liquidity of the financial system, the absence of near-term financing requirements, and their readiness to lower expenditures should revenues fall below expectations.

21. **With a relatively high level of reserves, there is scope for reserve asset diversification to better insure against external shocks.** Staff research suggests that there is scope for Uruguay to further reduce risks by acquiring financial instruments that provide hedging against large negative shocks—i.e., instruments that are correlated with shocks to the Uruguayan economy and those of its big neighbors, such as exchange traded funds (cattle or oil), VIX, or MSCI indices, so that reserves would tend to increase when they are needed the most. The authorities welcomed the ideas in principle and indicated that they would be interested in insurance mechanisms, including possibly through hedging against oil price fluctuations at the state oil company.

B. Monetary Policy

22. **The authorities shared staff's concern about inflation.** However, they stressed that inflationary pressures were a worldwide phenomenon, driven largely by commodity prices. They noted that inflation and inflation expectations were closer to their target range, compared with other countries in the region; and temporary deviations from targets caused by external shocks were understandable, as long as inflation expectations remained well-anchored. Staff pointed to measures of core inflation suggesting significant additional pressures; and, noted that while expectations foresaw a decline, inflation would remain at about the top of the target range even by end-2009.

12-month ahead expected inflation and
target bands for Aug 2009 annual inflation (percent)

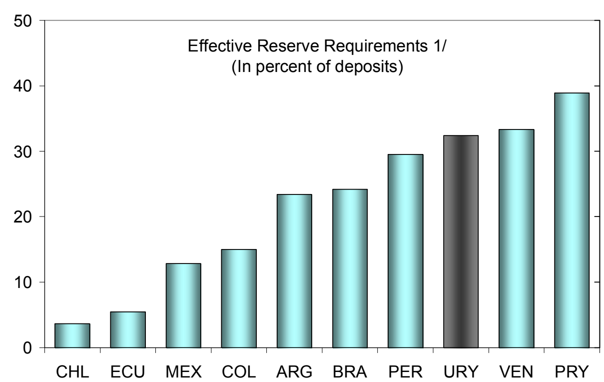


23. **Further monetary tightening would help bring inflation expectations back to well within the target range**. Staff took the view that there was scope for an interest rate hike of at least 100 basis points, given the strength of the economy. The authorities pointed out that monetary policy aimed at striking a delicate balance between containing inflation and, until recently, avoiding an excessive appreciation of the peso. Moreover, they noted that world prices were unlikely to continue exerting pressure on domestic prices; and that efforts to contain upcoming wage increases, which would be guided by forward-looking inflation, would also help limit second-round effects and dampen inflation dynamics. Nevertheless, they indicated that they did not rule out a further interest rate hike, depending on a further assessment of inflation developments in the next few months.

24. **Staff cautioned against further reliance on administrative measures to contain prices.** Tax exemptions and similar measures typically have a one-off effect on the price level without addressing underlying pressures, often with expansionary implications and permanent fiscal costs. The authorities stressed that by avoiding triggering biannual pensions adjustments (Text Table 1) inflation expectations had been dampened, avoiding undesirable inflation dynamics and substantial additional fiscal outlays. However, the authorities regarded such measures as exceptional.

25. **Reduced foreign exchange intervention would enhance the effectiveness of monetary policy.** According to several measures, the REER was slightly undervalued (Box 2) prior to the events of recent global financial turmoil. Moreover, likely productivity improvements in the tradable sector, should ease concerns about reduced foreign exchange intervention. Staff stressed that reduced intervention, under the current managed float regime, would help contain one-sided bets on the exchange rate.

26. **The mission encouraged the authorities to focus on the interest rate as a monetary instrument rather than on reserve requirements.** Higher reserve requirements increase the wedge between borrowing and lending rates, may encourage banks to take on higher risks, and lead to disintermediation. The mission suggested that, if the authorities wanted to focus on reserve requirements, remunerating them would reduce adverse effects, including on profitability. The authorities emphasized that both the hike in reserve requirements on peso and dollar deposits helped contain domestic demand pressures stemming from dollar lending, which was not affected by the peso policy rate; and viewed the measure as a way to prevent an increase in capital inflows. The authorities agreed, however, that changes in reserve requirements should not be used as a regular policy tool.



Source: IFS and Country authorities
1/ As of June 2008. CHL and PER February and BRA May 2008.

C. Fiscal policy

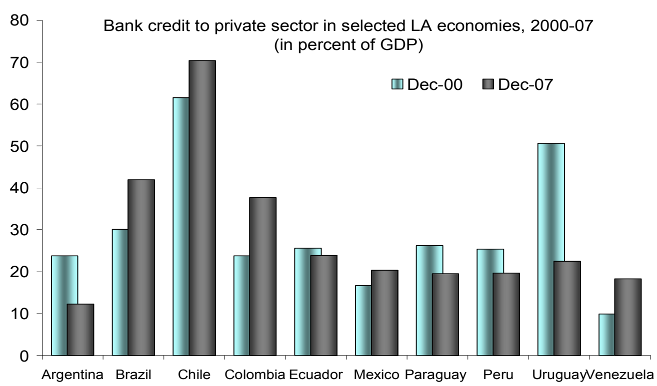
27. **A tighter fiscal stance would help reduce the burden on monetary policy.** Staff advocated more ambitious fiscal targets by a cumulative 1½ percent of GDP during 2008-09 to avoid adding pressures on domestic demand and reduce the burden on monetary policy in its efforts to reduce inflation. With likely higher revenues owing to strong growth, and without drought-related spending in 2009, this seems feasible and could be achieved by containing current expenditures, and reducing non-priority capital spending. The authorities noted that fiscal performance was already strong by historical standards and questioned the impact that fiscal policy could have on inflation. Staff pointed to empirical evidence to this effect (see ¶10).

28. **Staff supported the authorities' efforts to protect the vulnerable, and encouraged them to concentrate further on well targeted subsidies.** Staff took the view that, while there is clearly need to alleviate the effects of shocks on the poor, measures to prevent price increases generally are generally costly. The authorities agreed, pointing out that their efforts are in the proposed direction, including a recent program for poor families that temporarily grants an electronic card to purchase priority goods.

29. **The credibility of the framework would be enhanced by aiming at cyclically adjusted fiscal targets.** The medium term projections assume a broadly constant fiscal deficit target of about 0.1 percent of GDP, implying a primary surplus of 2½-3 percent of GDP. While high growth is facilitating the achievement of such targets, gross public sector debt of about 40 percent of GDP by 2013 would still be above levels regarded as safe for emerging market economies. A more ambitious medium term fiscal target, by say, 1–1½ percentage points of GDP, in a framework that allows countercyclical policies, would help fiscal policy become more effective and reduce public debt faster to 30–35 percent of GDP. Officials considered the current targets as appropriately balancing different objectives but broadly agreed with the desirability to moving to a countercyclical policy rule in the future.

D. Financial Sector: Safeguarding Stability

30. **While the financial system appears sound, even in the current context of global instability, staff recommended tackling remaining vulnerabilities (Box 3).** The authorities and staff agreed that regulation is adequate to contain risks associated with current rapid credit growth and potentially volatile non resident deposits; and that credit as a proportion of GDP remained moderate, loan loss provisions were significant, and nonresident deposits are not financing the



Source: IFS, WEO and IMF staff estimates.

current credit expansion. Still, staff recommended benchmarking bank liquidity against a minimum ratio of disposable liquid assets to deposits to minimize potential risks. With a view to promoting gradual de-dollarization, staff proposed to differentiate between unhedged and hedged borrowers when determining risk-adjusted assets. The authorities welcomed these proposals, but considered that further study was needed before making decisions.

31. **Regulations specifying legal powers of bank supervisors could be improved.** Staff pointed out that, as recommended by the 2006 FSAP, prudential procedures could spell out specific measures to deal with cases of capital insufficiency. The formal powers of supervisors in dealing with state banks, notably direct intervention measures, need to be further strengthened and the appointment of state banks' directors should be subject to fit-and-proper criteria. While broadly agreeing, bank supervisors noted that in the recent past they have been able to deal with non-compliant state banks through administrative measures.

E. Structural Reforms and the Business Climate

32. **The authorities expect the financial sector reform to be passed soon.** The draft bill —including the changes in the supervisory and bank resolution framework—is likely to remain largely unchanged, except for the provision to de-link the central bank's board's term from the electoral cycle, which would not be included due to lack of political consensus. Staff stressed the importance of making price stability the primary objective of the central bank; and regretted the likely changes to the appointment of Directors, which had been a key element for strengthening central bank independence. The authorities emphasized that, even without this element, the reform implied a significant institutional advancement.

33. **Progress is also expected on various pending reforms.** Following the approval of the competition law, the bankruptcy law is expected to be voted by Congress soon. Similarly, the authorities believe that by December, Congress will likely consider the reform of the pension funds for the police and for banking employees. Progress on the reform of the housing bank, BHU, has now gained momentum with the appointment of a new board of directors, the submission of a business plan to the Bank Superintendency, and the start of the personnel transfers from BHU. The bad loan portfolio is expected to be separated by November. The authorities agreed that, with housing agency in charge of housing policy, BHU should only resume lending on commercial terms.

34. **Despite further improvements in the investment climate, some concerns remain.** The new investment office has been working well, attending an increasing number of requests. The large FDI inflows are evidence that Uruguay is an attractive place for investment. While Uruguay's business climate ranks highest in Latin America according to a key survey, Uruguay does not fare as well in other worldwide comparisons, partly due to perceptions of a still slow and cumbersome bureaucracy. Moreover, entrepreneurs remain concerned about aspects of labor legislation, such as the law on subcontracting (which partly makes the company liable for labor law violations by subcontracting firms).

IV. Staff Appraisal

35. **Uruguay has continued to make important economic strides, and the effects of the recent global financial turmoil have been relatively contained.** Based on sound policies, growth has been vigorous, and the authorities have taken advantage of favorable conditions to reduce vulnerabilities. Strong foreign investment, coupled with key structural reforms, have helped raise productivity and modernize the economy. Barring a severe deterioration of global or regional prospects, Uruguay seems much better positioned than in the past to weather the current financial instability, with high reserves, no financing needs through end-2009, and substantial financial system liquidity. Nevertheless, with still significant medium term vulnerabilities and linkages with the rest of the world, close monitoring of conditions in Uruguay and its financial system is warranted in the current environment.

36. **Inflation, however, has remained a challenge and requires further monetary tightening.** As in many countries around the world, inflation pressures have been high. Lowering inflation to single digit levels has been a significant achievement in Uruguay that needs to be protected. It is important for fostering private investment, protecting vulnerable segments of society, and reducing vulnerabilities. In light of persistently high core inflation and low real interest rates, a tighter monetary stance would be required to ensure that inflation returns to well within the target range.

37. **At least until recently, the challenge was compounded by strong capital inflows, underlining the need for further exchange rate flexibility.** Containing peso appreciation while raising interest rates can exacerbate capital inflows by encouraging one-way bets, and lead to a further build-up of central bank debt—due to sterilized intervention—and associated quasi-fiscal costs. The trend of FDI- related capital inflows is likely to persist, provided global financial conditions stabilize.

38. **The authorities' commitment to their overall fiscal targets is commendable but a tighter fiscal stance, particularly in 2009, would help bring inflation down.** The authorities' fiscal efforts in 2008, even while facing substantial drought-related revenue losses and implementing measures to protect the population from higher food and fuel prices, are welcome. Nevertheless, with expected high continued growth, and higher operating surpluses by public enterprises, as they recover from the drought, fiscal targets could be more ambitious, particularly in 2009. This would contribute to reducing domestic demand pressures, thereby easing the burden on monetary policy.

39. **The adoption of cyclically adjusted and a stronger fiscal stance would also help in further reducing medium term vulnerabilities.** This would imply tighter targets in the context of the currently vigorous growth, while facilitating the implementation of fiscal stimulus when needed; help reduce debt to safer levels; and, enhance the credibility of fiscal policy.

40. **The economy has built significant resilience to shocks in the last few years, but shifting external conditions pose risks.** Uruguay's economy has become more diversified; high central bank's reserves and commercial banks' liquidity provide important buffers against a weakening of external conditions; and debt management operations have reduced short term government financing needs and significantly improved the debt profile. That said, the rapid increase in central bank debt implies some vulnerabilities. Moreover, given that Uruguay is a small, open, and dollarized economy, a severe deterioration in the regional and global outlook entail important risks.

41. **It is important that credit growth be accompanied by continued proactive bank supervision to ensure that lending standards remain high**. Financial regulation appears adequate to contain near-term risks derived from credit growth and from non resident deposits, but continued vigilance is needed. While banking system liquidity is still significant, the current high growth of bank lending, if sustained over time, could risk deterioration in the quality of banks' assets.

42. **The authorities' determination to press ahead with the pending structural agenda is commendable**. The approval of the competition law and expected approval of the bankruptcy law are steps that should further enhance the business environment. In particular, the authorities' expectation that the financial reform of the central bank charter, financial sector supervision, and the bank resolution framework, are likely to be passed this year, is encouraging. The intention not to de-link the terms of central bank board directors from the political cycle is, however, unfortunate. Progress in restructuring BHU is welcome and should be sustained. It is also positive that the pension reforms of the police and of bank employees are expected to be approved this year.

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

Table 1. Uruguay: Selected Economic and Social Indicators

Latest information available

Population (estimate)	3.5	Physicians per 1,000	3.7
		Hospital beds per 1,000	4.4
Life expectancy at birth (years)	75.7		
Crude birth rate (per thousand)	14.9	Access to safe water	
Infant mortality rate (per thousand live births)	12.0	(percent of population)	98.0
Income share held by highest 10 percent of households	34.7	Adult literacy rate	98.0
Income share held by lowest 20 percent of households	4.5	Gross enrollment rate	
Gini coefficient	46.1	Primary education	113.1
Unemployment rate	7.2	Secondary education	106.9
Poverty rate	25.3	Tertiary education	42.0
GDP per capita in 2007 (in US$)	6,712		
Human Development Index Rank	43 (out of 177)		

					Prel.	Projected					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
	(Percent change, unless otherwise specified)										
I. Output, prices, and employment											
Real GDP	2.2	11.8	6.6	7.0	7.4	9.5	5.5	4.3	3.8	3.8	3.8
Real consumption	1.1	9.5	2.8	8.6	9.7	9.8	7.8	4.0	3.8	4.0	4.0
Real investment	18.0	22.0	12.7	24.7	2.6	16.5	8.0	6.6	5.0	5.0	2.6
GDP (Ur$ billions)	315.7	379.4	406.7	464.8	541.9	639.3	721.2	803.3	884.4	968.8	1,056.8
GDP (US$ billions)	11.2	13.3	16.7	19.3	23.2	32.4	38.2	42.7	47.0	51.5	56.2
GDP deflator	18.4	7.5	0.6	6.8	8.5	7.7	7.2	7.1	6.2	5.6	5.2
CPI inflation (average)	19.4	9.2	4.7	6.4	8.1	7.6	7.4	7.0	6.0	5.2	5.0
CPI inflation (eop)	10.2	7.6	4.9	6.4	8.5	8.5	7.5	6.5	5.5	5.0	5.0
Exchange rate change (Ur$/US$)(average)	30.4	1.5	-15.0	-1.0	-3.0	…	…	…	...	…	…
Exchange rate change (Ur$/US$) (eop)	7.3	-9.9	-10.1	3.2	-11.9	…	…	…	...	…	…
Unemployment (in percent)	16.9	13.1	12.1	9.1	7.7	…	…	…	...	…	…
II. Monetary indicators											
Base Money (eop)	24.9	11.1	34.1	13.0	16.4	29.9	…	…	...	…	…
M-1	34.6	13.4	29.4	21.8	29.4	22.7	…	…	...	…	…
M-2	17.4	12.8	24.1	21.4	30.6	28.9	…	…	...	…	…
M-3	21.7	-2.0	0.4	12.3	3.8	2.6	…	…	...	…	…
Credit to the private sector (constant exch. rate)	-23.9	-11.2	2.7	9.1	22.1	28.6	…	…	...	…	…
	(Percent of GDP, unless otherwise indicated)										
III. Public sector operations											
Revenue	32.0	30.9	31.8	31.8	33.8	32.4	33.8	33.8	33.8	33.8	33.8
Non-interest expenditure (incl. discrepancy)	29.3	27.2	27.9	28.0	30.2	29.7	30.8	30.7	30.7	30.7	30.7
Primary balance	2.7	3.8	3.9	3.8	3.6	2.7	3.1	3.1	3.1	3.1	3.1
Interest	6.0	6.0	4.6	4.4	3.6	3.0	3.2	3.2	3.2	3.2	3.2
Overall balance	-3.2	-2.2	-0.7	-0.6	0.0	-0.3	-0.1	-0.1	-0.1	-0.1	-0.1
Public sector debt 2/	110	97	75	66	62	58	53	48	43	40	39
Public debt service (as a percent of GDP)	14.1	18.8	15.6	26.8	6.5	5.2	5.0	5.3	5.6	4.6	4.2

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

	2003	2004	2005	2006	Projected 2007	2008	2009	2010	2011	2012	2013
					IV. Savings and investment						
Gross domestic investment	12.6	13.1	13.1	16.4	15.1	14.7	13.6	12.6	11.6	11.9	11.6
Gross national savings	12.1	13.4	13.1	14.0	14.3	13.0	12.0	10.6	10.3	10.5	10.2
Foreign savings	0.5	-0.3	0.0	2.4	0.8	1.7	2.4	2.0	1.3	1.4	1.4
					V. External indicators						
Merchandise exports, fob (US$ millions)	2,281	3,145	3,758	4,389	5,063	7,274	7,878	8,277	9,123	9,608	10,095
Merchandise imports, fob (US$ millions)	2,098	2,992	3,730	4,863	5,554	7,893	8,853	9,240	9,755	10,341	10,887
Merchandise terms of trade (percentage change)	2.2	-2.4	-6.3	-1.6	0.6	-0.3	0.2	-0.1	0.1	0.0	-0.1
Current account balance	-0.5	0.3	0.0	-2.4	-0.8	-1.7	-2.4	-2.0	-1.3	-1.4	-1.4
Of which: excluding pulp mills projects	-0.5	0.3	0.0	-1.1	0.0	-1.6	-1.4	-1.6	-1.3	-1.4	-1.4
Foreign direct investment	3.6	2.4	4.3	7.1	3.8	3.3	2.8	2.4	1.8	1.8	1.7
Overall balance of payments (US$ millions)	1,380	454	951	-337	1,005	2,275	555	301	331	233	249
External debt 3/	98.2	87.4	68.3	54.7	52.3	41.3	36.2	32.8	30.1	27.4	25.5
Of which: external public debt	85.3	76.9	60.8	48.2	47.3	36.3	31.3	27.8	25.1	22.4	20.6
External debt service (percent of exports of goods and services)	52.3	44.8	53.1	92.5	25.0	16.5	15.9	19.8	19.1	17.6	16.5
Gross official reserves (US$ millions) 4/	2,087	2,512	3,438	3,091	4,096	6,371	6,926	7,227	7,558	7,791	8,040
In months of imports of goods and services	6.6	6.5	7.1	5.5	5.2	7.2	7.5	7.4	7.2	7.2	7.2
In percent of short-term debt	131.3	112.4	153.8	492.1	495.3	648.3	597.7	556.0	527.2	495.8	468.4
In percent of short-term debt plus bank non-resident deposits	51.2	55.4	75.8	101.5	118.0	166.5	168.9	164.7	167.1	163.8	160.5
In percent of short-term debt plus FX deposits	20.0	27.7	32.9	32.8	40.2	61.7	61.1	59.2	58.1	56.5	55.7
REER (percentage depreciation -, e.o.p.)	-13.2	9.3	9.4	-6.2	8.0	…	…	…	...	…	…

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

1/ 2006-09 numbers are large driven by the large scale FDI project in pulp mills.
2/ Debt of the NFPS, net of free reserves of the central bank of Uruguay.
3/ Excludes nonresident deposits.
4/ Includes reserve buildup through reserve requirements of resident financial institutions.

Table 2. Uruguay: Summary Accounts of the Banking System
(In millions of U.S. dollars)

	2003	2004	2005	2006	2007	Proj. 2008
			1. Banco Central del Uruguay			
Net foreign assets	-52	-51	1,307	3,333	5,252	7,402
Net international reserves 1/	-321	-164	1,135	3,091	4,121	6,371
Gross international reserves	2,087	2,512	3,438	3,091	4,121	6,371
Reserve liabilities 1/	-2,407	-2,675	-2,304	0	0	0
Other net foreign assets	269	113	172	242	1,130	1,030
Net domestic assets	553	775	-253	-2,010	-3,603	-5,226
Net credit to the public sector	2,464	2,626	1,970	862	17	-3
Net credit to the financial system	-2,091	-1,781	-1,941	-1,937	-2,014	-2,376
Credit to the private sector	71	62	65	63	69	66
Securities issued by the BCU	-243	-563	-904	-1,444	-2,642	-4,055
Other	352	431	556	445	968	1,142
Peso monetary liabilities	501	724	1,054	1,323	1,649	2,176
Memorandum items:						
Monetary base 2/	473	584	857	957	1,475	2,141
			2. Public and Private Banks 3/			
Net foreign assets	1,213	1,887	2,030	2,233	2,417	1,971
Net domestic assets	5,331	5,090	5,397	5,907	6,864	9,032
Net credit to the public sector	219	437	0	25	-486	-386
Net credit to the financial system	2,612	2,256	2,602	2,715	2,732	3,223
Credit to the private sector	4,726	4,307	4,533	4,933	6,331	8,216
Other	-2,226	-1,909	-1,738	-1,766	-1,713	-2,021
Liabilities to the private sector (residents)	6,544	6,977	7,426	8,140	9,281	11,004
Public banks	3,409	3,670	3,842	4,172	4,695	5,539
Local currency	394	520	682	847	1,228	1,572
Foreign currency	3,016	3,149	3,160	3,324	3,466	3,967
Private banks	3,135	3,307	3,584	3,968	4,587	5,465
Local currency	349	405	574	659	1,040	1,407
Foreign currency	2,785	2,902	3,010	3,309	3,546	4,058
			3. Banking System			
Net foreign assets	1,161	1,835	3,337	5,566	7,669	9,373
Net domestic assets	5,788	5,738	4,979	3,654	2,995	1,793
Credit to the public sector	2,684	3,063	1,970	887	-468	-388
Credit to the rest of financial system	425	347	497	535	451	-1,167
Credit to the private sector	4,797	4,369	4,598	4,997	6,400	8,283
Other	-2,118	-2,041	-2,086	-2,765	-3,388	-4,934
Broad money (M3)	6,949	7,573	8,315	9,220	10,664	11,166
Memorandum items (in pesos):			(Percentage change)			
Base money (end-of-period)	20.0	10.6	55.4	12.5	16.4	32.0
Currency issued	22.4	15.7	22.0	27.6	11.6	21.0
M-1	33.2	14.3	33.5	23.6	29.4	24.8
M-2	28.1	13.2	26.7	25.7	30.6	31.0
M-3	15.2	-3.0	0.0	14.8	3.8	4.7
Credit to private sector (constant exchange rate)	-31.8	-31.4	6.3	11.0	22.1	30.9

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

1/ Includes all outstanding liabilities to the IMF, but excludes liabilities to resident financial institutions.
2/ Monetary base excludes from peso monetary liabilities the net government and BPS deposits with BROU, which are subject to 100 percent reserve requirements.
3/ The Banco de la Republica Oriental de Uruguay (BROU), Banco Hipotecario de Uruguay (BHU; mortgage institution), private banks, and cooperatives.

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

					Prel.	Projections					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Revenue	**101,081**	**117,367**	**130,824**	**147,936**	**182,488**	**206,968**	**244,298**	**272,422**	**300,344**	**329,198**	**359,594**
Taxes	70,096	83,002	92,280	107,146	130,273	150,843	172,507	193,665	213,515	234,026	255,634
VAT and excise taxes	37,667	47,200	53,124	61,574	70,849	82,035	95,291	105,324	116,119	127,274	139,025
On income and profits	15,621	17,683	20,148	23,314	21,041	24,364	25,590	31,280	34,486	37,799	41,289
On foreign trade	3,780	4,958	5,195	5,995	7,077	8,195	9,519	10,521	11,600	12,714	13,888
On property and other	13,028	13,161	13,813	16,264	31,306	36,249	42,106	46,540	51,310	56,239	61,431
Social security contributions	14,696	16,657	21,532	25,115	28,333	34,383	40,178	43,388	47,835	52,431	57,272
Nontax revenue	6,200	7,831	8,399	9,027	10,511	12,059	13,967	15,441	17,025	18,661	20,385
Current surplus of public enterprise	10,090	9,876	8,614	6,577	13,370	9,683	17,646	19,927	21,970	24,080	26,304
Noninterest expenditure	**92,431**	**103,082**	**114,859**	**130,320**	**163,780**	**189,570**	**222,205**	**247,393**	**273,145**	**298,933**	**326,533**
Current	84,623	93,780	105,277	118,008	147,590	169,659	198,931	221,400	243,618	265,615	289,099
Wages	19,701	23,409	25,499	28,468	38,365	45,237	53,094	58,871	64,908	71,147	77,705
Goods and services	15,031	17,015	19,392	22,548	27,294	28,555	34,412	39,530	43,584	47,773	52,185
Social security benefits	44,218	47,702	53,057	59,059	66,721	76,503	89,939	100,402	110,688	120,430	131,087
Other	5,673	5,654	7,329	7,933	15,209	19,365	21,486	22,596	24,437	26,265	28,121
Capital (Government and enterpri	7,808	9,303	9,582	12,312	16,189	19,911	23,273	25,993	29,527	33,318	37,435
Primary balance 1/	**8,651**	**14,284**	**15,964**	**17,544**	**19,575**	**17,397**	**22,093**	**25,029**	**27,200**	**30,266**	**33,061**
Interest	18,881	22,666	18,757	20,564	19,127	19,315	22,852	25,850	28,501	31,240	34,126
Overall balance 1/	**-10,231**	**-8,382**	**-2,793**	**-3,020**	**448**	**-1,918**	**-759**	**-821**	**-1,301**	**-975**	**-1,064**

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

					Prel.	Projections					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Revenue	**32.0**	**30.9**	**31.8**	**31.8**	**33.8**	**32.4**	**33.8**	**33.8**	**33.8**	**33.8**	**33.8**
Taxes	22.2	21.9	22.5	23.1	24.0	23.6	23.9	24.0	24.0	24.0	24.0
VAT and excise taxes	11.9	12.4	12.9	13.2	13.1	12.8	13.2	13.1	13.1	13.1	13.1
On income and profits	5.0	4.7	4.9	5.0	3.9	3.8	3.5	3.9	3.9	3.9	3.9
On foreign trade	1.2	1.3	1.3	1.3	1.3	1.3	1.5	1.6	1.8	2.0	2.2
On property and other	4.1	3.5	3.4	3.5	5.8	5.7	5.8	5.8	5.8	5.8	5.8
Social security contributions	4.7	4.4	5.2	5.4	5.2	5.4	5.6	5.4	5.4	5.4	5.4
Nontax revenue	2.0	2.1	2.0	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Current surplus of public enterprises	3.2	2.6	2.1	1.4	2.6	1.5	2.4	2.5	2.5	2.5	2.5
Noninterest expenditure	**29.3**	**27.2**	**27.9**	**28.0**	**30.2**	**29.7**	**30.8**	**30.7**	**30.7**	**30.7**	**30.7**
Current	26.8	24.7	25.6	25.4	27.2	26.5	27.5	27.5	27.4	27.3	27.2
Wages	6.2	6.2	6.2	6.1	7.1	7.1	7.3	7.3	7.3	7.3	7.3
Goods and services	4.8	4.5	4.7	4.9	5.0	4.5	4.8	4.9	4.9	4.9	4.9
Of Which: SEP	0.0	0.0	0.2	0.5	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Social security benefits	14.0	12.6	12.9	12.7	12.3	12.0	12.4	12.4	12.4	12.4	12.3
Other	1.8	1.5	1.8	1.7	2.8	3.0	3.0	2.8	2.7	2.7	2.6
Capital (Government and enterprises)	2.5	2.5	2.3	2.6	3.0	3.1	3.2	3.2	3.3	3.4	3.5
Primary balance	**2.7**	**3.8**	**3.9**	**3.8**	**3.6**	**2.7**	**3.1**	**3.1**	**3.1**	**3.1**	**3.1**
Interest	6.0	6.0	4.6	4.4	3.6	3.0	3.2	3.2	3.2	3.2	3.2
Overall balance	**-3.2**	**-2.2**	**-0.7**	**-0.6**	**0.0**	**-0.3**	**-0.1**	**-0.1**	**-0.1**	**-0.1**	**-0.1**
Memorandum item:											
GDP (billions of pesos)	**315**	**379**	**411**	**465**	**542**	**639**	**722**	**807**	**889**	**975**	**1,064**

Sources: Ministry of Finance; and Fund staff estimates.
1/ Starting in 2007, includes BSE (Banco de Seguros del Estado)

Table 4. Uruguay: Public Debt Profile

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
					(in US Dollars)					
Debt Stocks 1/ 2/	12,855	12,575	12,801	14,374	18,676	20,162	20,639	20,466	20,836	21,968
Domestic Currency 3/	1,306	513	122	607	116	110	102	93	88	84
Inflation Linked 4/	899	1,262	2,407	4,391	9,693	11,105	11,533	11,512	12,135	13,042
External Currency	10,650	10,800	10,271	9,377	8,867	8,948	9,003	8,862	8,613	8,842
Interest				920	1,373	1,276	1,318	1,314	1,319	1,143
Domestic Currency				21	220	19	3	3	3	3
Inflation Indexed				161	487	530	508	444	408	356
External Currency				738	667	726	806	867	908	784
Amortization	1,711	1,859	2,663	833	856	895	1,184	1,302	959	721
Domestic Currency				8	7	6	8	9	5	4
Inflation Indexed				157	300	330	440	356	332	235
External Currency				669	550	558	736	937	622	482
Gross Financing	2,504	2,588	3,653	1,200	1,864	996	1,170	1,169	668	1,005
Domestic Currency				0	0	0	0	0	0	0
Inflation Indexed				1,200	664	131	163	165	95	147
External Currency				0	1,200	865	1,007	1,004	573	858
					(in Uruguayan Pesos)					
Debt Stocks 1/ 2/	367,539	305,793	308,031	335,395	368,288	381,103	388,181	384,769	391,721	412,991
Domestic Currency 3/	37,339	12,479	2,944	14,163	2,283	2,077	1,924	1,748	1,655	1,580
Inflation Linked 4/	25,692	30,700	57,923	102,446	191,151	209,897	216,917	216,423	228,133	245,181
External Currency	304,509	262,614	247,164	218,787	174,854	169,129	169,340	166,598	161,933	166,231
Interest				21,126	28,339	25,541	26,161	25,905	25,912	22,463
Domestic Currency				447	4,729	417	64	67	68	70
Inflation Indexed				3,460	10,460	11,396	10,931	9,537	8,771	7,661
External Currency				17,219	13,150	13,729	15,166	16,302	17,074	14,732
Amortization				15,774	17,435	17,782	23,466	25,455	18,930	14,194
Domestic Currency				171	141	128	162	200	107	86
Inflation Indexed				0	6,451	7,104	9,453	7,649	7,139	5,046
External Currency				15,602	10,843	10,550	13,851	17,606	11,684	9,062
Gross Financing				28,000	36,760	18,830	22,007	21,969	12,556	18,898
Domestic Currency				0	0	0	0	0	0	0
Inflation Indexed				28,000	13,099	2,473	3,060	3,096	1,780	2,771
External Currency				0	23,661	16,358	18,947	18,873	10,776	16,126
					(in percent of GDP)					
Debt Stocks 1/ 2/	96.9	75.2	66.3	61.9	57.6	52.8	48.1	43.3	40.2	38.8
Domestic Currency 3/	9.8	3.1	0.6	2.6	0.4	0.3	0.2	0.2	0.2	0.1
Inflation Linked 4/	6.8	7.5	12.5	18.9	29.9	29.1	26.9	24.3	23.4	23.0
External Currency	80.3	64.6	53.2	40.4	27.4	23.4	21.0	18.7	16.6	15.6
Interest				4.0	4.2	3.3	3.1	2.8	2.5	2.0
Domestic Currency				0.1	0.7	0.1	0.0	0.0	0.0	0.0
Inflation Indexed				0.7	1.5	1.4	1.2	0.9	0.8	0.6
External Currency				3.2	2.1	1.9	1.9	1.8	1.8	1.4
Amortization				3.6	2.6	2.3	2.8	2.8	1.8	1.3
Domestic Currency				0.0	0.0	0.0	0.0	0.0	0.0	0.0
Inflation Indexed				0.7	0.9	0.9	1.0	0.8	0.6	0.4
External Currency				2.9	1.7	1.5	1.7	2.0	1.2	0.9
Gross Financing				5.2	5.8	2.6	2.7	2.5	1.3	1.8
Domestic Currency				0.0	0.0	0.0	0.0	0.0	0.0	0.0
Inflation Indexed				5.2	2.0	0.3	0.4	0.3	0.2	0.3
External Currency				0.0	3.7	2.3	2.3	2.1	1.1	1.5
					(in percent)					
Average Interest				6.8	8.3	6.6	6.5	6.4	6.4	5.3
Domestic Currency				0.2	1.3	0.1	0.0	0.0	0.0	0.0
Inflation Indexed				1.2	2.9	2.7	2.5	2.2	2.0	1.7
External Currency				5.4	4.0	3.7	4.0	4.2	4.4	3.7
Marginal Interest Assumptions										
Domestic Currency				7.8	5.8	7.1	8.6	8.6	8.6	8.6
Inflation Indexed				27.7	28.5	13.6	11.7	10.5	9.9	9.9
External Currency				6.3	3.8	4.6	6.1	6.1	6.1	6.1
Debt Stocks 1/ 2/	100	100	100	100	100	100	100	100	100	100
Domestic Currency 3/	10.2	4.1	1.0	4.2	0.6	0.5	0.5	0.5	0.4	0.4
Inflation Linked 4/	7.0	10.0	18.8	30.5	51.9	55.1	55.9	56.2	58.2	59.4
External Currency	82.9	85.9	80.2	65.2	47.5	44.4	43.6	43.3	41.3	40.3
Memorandum:										
GDP	379,353	406,705	464,802	541,869	639,260	722,461	806,510	889,135	974,501	1,064,451
Free Reserves	467	1,374	916	1,947	3,286	3,517	3,737	3,950	4,153	4,303

Source: Uruguayan authorities; IMF Staff estimates.
1/ Debt by currency denomination. External currency debt is net of free reserves of the Central Bank of Uruguay.
2/ Assumes the authorities place 50 percent of financing requirement if previous years' external debt exceeds 100 percent.
3/ Assumes that local currency and UI rates increase 10 percent if previous years' domestic debt exceeds 20 percent.
4/ Assumes that 80 percent of domestic financing needs are met with UI placements.

Table 5. Uruguay: Balance of Payments
(In millions of US$, unless otherwise stated)

							Projections					
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1. Balance of Payments												
Current account	**382**	**-56**	**43**	**2**	**-457**	**-186**	**-536**	**-901**	**-864**	**-609**	**-730**	**-774**
Trade balance	48	183	153	28	-474	-491	-619	-975	-963	-632	-733	-793
Exports, f.o.b.	1,922	2,281	3,145	3,758	4,389	5,063	7,274	7,878	8,277	9,123	9,608	10,095
Imports, f.o.b.	1,874	2,098	2,992	3,730	4,863	5,554	7,893	8,853	9,240	9,755	10,341	10,887
Services	153	167	365	409	361	513	465	406	387	384	412	464
Exports, f.o.b.	771	803	1,151	1,335	1,284	1,762	1,999	2,141	2,271	2,422	2,595	2,779
Imports, f.o.b.	618	636	786	926	923	1,249	1,534	1,735	1,885	2,038	2,183	2,315
Income (net)	109	-489	-588	-585	-470	-342	-522	-473	-428	-500	-551	-587
Transfers (net)	72	83	113	149	126	134	140	141	140	140	141	141
Financial and capital account	**-2,234**	**1,039**	**67**	**1,016**	**202**	**1,411**	**2,812**	**1,523**	**1,365**	**1,062**	**1,069**	**1,129**
Foreign direct investment	180	401	315	715	1,377	876	1,070	1,068	1,014	862	948	948
Portfolio investment	415	-541	-422	766	1,810	1,174	2,065	668	493	398	264	523
Government securities	171	-5	240	566	1,830	995	1,219	612	434	367	178	422
Issues	710	613	504	1,094	2,391	1,302	1,454	777	913	911	601	784
Amortization	539	618	263	528	562	307	235	165	479	545	423	362
Banks	244	-537	-663	200	-20	178	846	56	59	31	86	101
Other capital flows (net)	-2,828	1,179	174	-466	-2,985	-638	-323	-212	-142	-198	-143	-343
Of which: WB, IDB, commercial (net)	633	237	-37	80	-450	372	-447	-430	-455	-415	-420	-420
Disbursements	792	472	479	689	437	731	0	0	0	0	0	0
Amortization	159	235	517	609	887	358	447	430	455	415	420	420
Of which: IMF (net)	883	422	152	-176	-2,382	0	0	0	0	0	0	0
Errors and omissions	-476	397	345	-66	-83	-219	0	0	0	0	0	0
Overall balance	-2,328	1,380	454	951	-337	1,005	2,275	555	301	331	233	249
Reserve assets (- increase)	**2,328**	**-1,380**	**-454**	**-951**	**337**	**-1,005**	**-2,275**	**-555**	**-301**	**-331**	**-233**	**-249**
2. Reserve Adequacy and External Indicators												
Gross official reserves (stock)	**772**	**2,087**	**2,512**	**3,438**	**3,091**	**4,096**	**6,371**	**6,926**	**7,227**	**7,558**	**7,791**	**8,040**
In months of next year's imports of goods and services	3.4	6.6	6.5	7.1	5.5	5.2	7.2	7.5	7.4	7.2	7.2	7.2
In percent of short-term debt	32.3	131.3	112.4	153.8	492.1	495.3	648.3	597.7	556.0	527.2	495.8	468.4
In percent of short-term debt and nonres. deposits	16.7	51.2	55.4	75.8	101.5	118.0	166.5	168.9	164.7	167.1	163.8	160.5
Net international reserves (stock)	**-1,088**	**-763**	**-2,218**	**-1,166**	**916**	**1,947**	**4,197**	**4,751**	**5,052**	**5,383**	**5,617**	**5,866**
(As percent of GDP)												
Exports	15.9	20.3	23.7	22.5	22.7	21.8	22.4	20.6	19.3	19.3	18.5	17.8
Imports	15.5	18.7	22.6	22.3	25.2	23.9	24.3	23.2	21.5	20.6	19.9	19.2
Current account	3.2	-0.5	0.3	0.0	-2.4	-0.8	-1.7	-2.4	-2.0	-1.3	-1.4	-1.4
Underlying current account 1/	3.2	-0.5	0.3	0.0	-1.1	0.0	-1.6	-1.4	-1.6	-1.3	-1.4	-1.4
Financial and capital account	-18.5	9.3	0.5	6.1	1.0	6.1	8.7	4.0	3.2	2.2	2.1	2.0
Of which: foreign direct investment (net)	1.5	3.6	2.4	4.3	7.1	3.8	3.3	2.8	2.4	1.8	1.8	1.7
Of which: government securities (net)	1.4	0.0	1.8	3.4	9.5	4.3	3.8	1.6	1.0	0.8	0.3	0.7
Of which: IMF (net)	7.3	6.0	0.8	-1.1	-12.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	-19.3	12.3	3.4	5.7	-1.7	4.3	7.0	1.5	0.7	0.7	0.5	0.4
Changes in GIR	19.3	-12.3	-3.4	-5.7	1.7	-4.3	-7.0	-1.5	-0.7	-0.7	-0.5	-0.4
External debt	87.5	98.2	87.4	68.3	54.7	52.3	41.3	36.2	32.8	30.1	27.4	25.5
Short-term debt (residual maturity)	25.5	21.4	12.0	13.4	3.3	3.6	3.0	3.0	3.0	3.0	3.0	3.0
External public debt	68.9	85.3	76.9	60.8	48.2	47.3	36.3	31.3	27.8	25.1	22.4	20.6
External debt + NR deposits	106.8	118.1	106.1	82.0	67.2	63.7	50.0	43.9	40.0	36.6	33.6	31.3
(As percent of annual exports of goods and services)												
Total external debt	392.8	357.1	269.9	224.2	186.1	178.0	144.2	138.2	133.2	123.2	116.4	112.2
Total external debt (including nonresidential deposits)	479.2	429.3	327.8	269.3	228.8	216.7	174.9	167.6	162.5	150.0	142.6	137.8
Debt service	55.0	52.3	44.8	53.1	92.5	25.0	16.5	15.9	19.8	19.1	17.6	16.5
Of which: interest payments	24.5	19.2	16.7	16.6	15.8	12.6	7.2	7.4	8.1	7.8	7.6	7.2
(Annual percent changes)												
Exports	-10.2	18.7	37.9	19.5	16.8	15.4	43.7	8.3	5.1	10.2	5.3	5.1
Imports	-35.7	12.0	42.6	24.7	30.4	14.2	42.1	12.2	4.4	5.6	6.0	5.3
Export prices in US$ (year-on-year percent change) 1/	-7.7	7.4	6.4	5.1	6.5	8.5	18.4	1.4	-0.3	0.8	0.8	0.8
Import prices in US$ (year-on-year percent change) 1/	-10.8	5.1	9.1	12.2	8.2	7.9	18.8	1.1	-0.2	0.7	0.8	0.9
Terms of trade 1/	3.5	2.2	-2.4	-6.3	-1.6	0.6	-0.3	0.2	-0.1	0.1	0.0	-0.1
Export volume 1/	-2.1	9.4	28.7	16.2	9.2	4.6	11.5	7.2	6.1	6.0	5.5	5.2
Import volume 1/	-26.9	6.2	29.1	9.4	13.6	7.2	20.1	7.4	7.5	6.4	5.5	4.6

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

1/ Excluding imports related to the construction of pulp mill projects (Botnia and ENCE).

Table 6. Uruguay: Vulnerability Indicators

	2004	2005	2006	2007	Sep. 2008
	(Percent change, unless otherwise indicated)				
Financial sector indicators					
Broad money	-2.2	-4.0	10.5	2.1	1.0
Credit to the private sector (const. exch. rate)	-31.4	6.3	11.0	22.1	…
Share of nonperforming loans in total loans (in percent) 1/	4.7	3.6	1.9	0.5	0.4
Provisions to nonperforming loans (in percent) 1/	106.8	118.8	218.6	296.2	…
Capital to asset ratio (in percent)	8.3	8.6	9.8	10.2	11.0
Return on assets (in percent) 1/	-0.1	0.7	1.2	1.7	1.0
Interbank interest rates (percent, end-of-period) 1/	1.3	1.0	3.0	2.8	7.75
FX deposits held by residents (in percent of total deposits)	79.2	79.2	79.9	79.5	79.2
FX deposits held by residents (in percent of total deposits)	70.8	68.4	67.8	63.6	61.6
FX loans to residents (in percent of total loans)	66.0	63.5	58.9	55.8	57.2
FX loans to residents (in percent of total loans)	94.4	96.0	96.0	96.9	97.6
Public debt indicators					
Public sector gross debt incl. central bank debt (PSGD, in percent of GDP)	100.4	83.4	71.0	70.3	68.3
Of which: Exposed to rollover risk (in percent of total PSGD)	13.5	16.0	5.1	6.8	…
Exposed to exchange rate risk (in percent of total PSGD)	85.9	80.3	71.2	69.3	…
Exposed to interest rate risk (in percent of total PSGD)	44.6	40.0	19.0	18.4	…
External indicators					
Merchandise exports	37.9	19.5	16.8	15.4	…
Merchandise imports	42.6	24.7	30.4	14.2	…
Merchandise terms of trade	-3.1	-9.7	-1.8	1.4	…
REER appreciation (+)	9.3	9.4	-6.2	8.0	…
	(Percent of GDP, unless otherwise indicated)				
Current account balance	0.3	0.0	-2.4	-0.8	…
Capital and financial account balance	0.5	6.1	1.0	6.1	…
Of which : Net foreign direct investment	2.4	4.3	7.1	3.8	…
Government securities	1.8	3.4	9.5	4.3	…
Other net inflows	-3.7	-1.6	-15.6	-2.0	…
Total gross external debt (ED) in percent of GDP	87.4	68.3	54.7	52.3	…
Of which: Short-term ED (original maturity, in percent of total ED)	7.6	6.4	7.0	6.1	…
ED to foreign official sector (in percent of total ED)	50.7	48.4	25.4	22.1	…
External interest payments (in percent of exports of GNFS)	16.7	16.6	15.8	12.6	…
External amortization payments (in percent of exports of GNFS)	28.2	36.4	76.7	12.4	…
	(U.S. million, unless otherwise indicated)				
Central Bank reserve liabilities 2/	2,675	2,304	…	…	…
Gross official reserves	2,512	3,438	3,091	4,096	…
In months of imports GNFS	6.5	7.1	5.5	5.2	…
In percent of short-term external debt excl. nonres FX deposits	112.4	153.8	492.1	495.3	…
In percent of short-term external debt plus bank NR deposits	55.4	75.8	101.5	118.0	…
In percent of short-term debt plus FX deposits	27.7	32.9	32.8	40.2	…
In percent of broad money	33.2	45.0	34.6	44.8	...
In percent of base money	329.9	301.3	190.3	241.5	...
Banking system foreign assets as percent of short-term external debt plus all FX deposits 3/ 4/	65.8	71.4	80.4	71.9	...
Financial market indicators					
Foreign currency debt rating (Moody's) 1/	B3	B3	B1	B1	B1
Foreign currency debt rating (S&P) 1/	B	B	B+	BB-	BB
EMBI secondary market spread (bps, end of period) 1/	462	298	185	243	368
Exchange rate (per U.S. dollar, period average)	28.6	24.3	24.1	23.3	...
Exchange rate (per U.S. dollar, end-of-period)	26.3	23.7	24.4	21.5	...

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

1/ Excludes BHU. Financial sector indicators as of June 2008.
2/ Includes all use of Fund credit.
3/ By remaining maturity.
4/ Excludes nonreserve assets from BCU.

APPENDIX 1. DEBT SUSTAINABILITY

Appendix 1. Table 1. Uruguay: Public Sector Debt Sustainability Framework, 2001-2013

(In percent of GDP, unless otherwise indicated)

	Actual				Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing primary balance 1/**
Baseline: Public sector debt 2/	97	75	66	62	**58**	**53**	**48**	**43**	**40**	**39**	**-0.4**
Of which: foreign-currency denominated	83	63	53	40	26	22	20	18	16	15	
Change in public sector debt	-13.5	-21.7	-8.9	-4.4	-4.3	-4.9	-4.6	-4.9	-3.1	-1.4	
Identified debt-creating flows (4+7+12)	-15.0	-18.1	-11.5	-10.9	-9.1	-6.3	-5.4	-4.3	-3.7	-3.3	
Primary deficit	-3.8	-3.9	-3.8	-3.5	-2.7	-2.9	-3.1	-3.1	-3.1	-3.1	
Revenue and grants	30.9	32.2	31.8	33.7	32.4	32.7	33.8	33.8	33.8	33.8	
Primary (noninterest) expenditure	27.2	28.2	28.0	30.2	29.7	29.8	30.7	30.7	30.7	30.7	
Automatic debt dynamics 3/	-11.3	-14.2	-7.7	-7.4	-6.4	-3.4	-2.3	-1.3	-0.6	-0.2	
Contribution from interest rate/growth differential 4/	-12.6	-1.9	-5.0	-5.9	-6.4	-3.4	-2.3	-1.3	-0.6	-0.2	
Of which contribution from real interest rate	-1.7	4.1	-0.4	-1.7	-1.4	-0.6	-0.3	0.4	0.9	1.2	
Of which contribution from real GDP growth	-10.9	-6.0	-4.6	-4.2	-5.0	-2.8	-2.0	-1.7	-1.5	-1.4	
Contribution from exchange rate depreciation 5/	1.3	-12.3	-2.7	-1.5	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	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	
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	
Other (specify, e.g. bank recapitalization)	0.0	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/	1.5	-3.6	2.6	6.5	4.8	1.5	0.8	-0.5	0.6	1.9	
Public sector debt-to-revenue ratio 2/	313.2	233.7	208.2	183.8	177.9	161.2	142.5	128.1	119.0	114.8	
Gross financing need 7/	13.9	11.7	23.0	2.9	2.5	2.1	2.2	2.5	1.4	1.1	
in billions of U.S. dollars	1.8	1.9	4.4	0.7	0.8	0.8	0.9	1.2	0.8	0.6	
Debt service	...	15.6	26.8	6.5	5.2	5.0	5.3	5.6	4.6	4.2	
Scenario with key variables at their historical averages 8/					**57.9**	**56.1**	**53.7**	**49.9**	**47.5**	**46.6**	**-1.8**
Scenario with no policy change (constant primary balance) in 2005-2010					**56.9**	**51.6**	**46.8**	**42.0**	**39.1**	**39.5**	**1.9**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline											
Real GDP growth (in percent)	11.8	6.6	7.0		9.5	5.5	4.3	3.8	3.8	3.8	
Average nominal interest rate on public debt (in percent) 9/	6.5	5.1	6.7		5.8	6.3	6.8	7.3	8.1	8.7	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-1.0	4.6	-0.1		-2.0	-0.8	-0.2	1.1	2.5	3.5	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-1.5	17.6	4.8		...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	7.5	0.6	6.8		7.7	7.1	7.0	6.2	5.6	5.2	
Growth of real primary spending (deflated by GDP deflator, in percent)	7.0	10.8	6.2		7.4	6.0	7.3	4.0	3.6	3.8	
Primary deficit	-3.8	-3.9	-3.8		-2.7	-2.9	-3.1	-3.1	-3.1	-3.1	

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 and central bank issued debt (net of free reserves).

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.

Appendix 1. Table 2. Uruguay: External Debt Sustainability Framework, 2002-2013

(In percent of GDP, unless otherwise indicated)

	Actual			Est.	Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	87.4	68.3	54.7	52.3	**41.3**	**36.2**	**32.8**	**30.1**	**27.4**	**25.5**	**0.8**
Change in external debt	-10.8	-19.1	-13.6	-2.4	-11.0	-5.0	-3.4	-2.7	-2.7	-1.9	
Identified external debt-creating flows (4+8+9) 1/	-17.9	-22.3	-13.9	-12.2	-5.2	-2.4	-1.7	-1.7	-1.5	2.1	
Current account deficit, excluding interest payments	-5.4	-4.6	-1.7	-2.5	-0.2	0.6	0.3	-0.4	-0.1	-0.1	
Deficit in balance of goods and services	-3.9	-2.6	0.6	-0.1	0.5	1.5	1.3	0.5	0.6	0.6	
Exports	32.4	30.5	29.4	29.4	28.6	26.2	24.6	24.4	23.5	22.7	
Imports	28.5	27.8	30.0	29.3	29.1	27.7	25.9	24.9	24.2	23.3	
Net non-debt creating capital inflows (negative)	-2.4	-4.3	-7.1	-3.8	-3.3	-2.8	-2.4	-1.8	-1.8	1.7	
A1. Key variables are at their historical averages in 2007-11 3/	-10.1	-13.4	-5.0	-5.9	-1.7	-0.2	0.3	0.5	0.5	0.5	
Contribution from nominal interest rate	5.1	4.6	4.1	3.3	1.9	1.7	1.7	1.6	1.6	1.4	
Contribution from real GDP growth	-9.8	-4.6	-4.1	-3.4	-3.6	-1.9	-1.4	-1.1	-1.0	-1.0	
Contribution from price and exchange rate changes 2/	-5.4	-13.5	-5.0	-5.8	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	7.1	3.2	0.3	9.8	-5.8	-2.7	-1.7	-1.0	-1.2	-4.0	
External debt-to-exports ratio (in percent)	269.9	224.2	186.1	178.0	144.2	138.2	133.2	123.2	116.4	112.2	
Gross external financing need (in billions of US dollars) 4/	2.1	2.7	5.4	1.6	2.0	2.6	3.1	3.1	2.3	3.1	
B5. One time 30 percent nominal depreciation in 2007	16.1	16.1	27.7	7.0	6.0	6.8	7.3	6.5	4.5	5.5	
Scenario with key variables at their historical averages 5/					**41.3**	**40.2**	**38.3**	**36.5**	**33.9**	**26.1**	**-1.3**
Key Macroeconomic Assumptions Underlying Baseline											
Real GDP growth (in percent)	11.8	6.6	7.0	7.4	9.5	5.5	4.3	3.8	3.8	3.8	
GDP deflator in US dollars (change in percent)	5.8	18.2	7.9	11.9	27.5	11.8	7.6	6.3	5.6	5.2	
Nominal external interest rate (in percent)	6.1	6.7	7.0	7.2	5.0	4.9	5.4	5.5	5.7	5.7	
Growth of exports (US dollar terms, in percent)	39.3	18.6	11.4	20.3	35.9	8.1	5.3	9.4	5.7	5.5	
Growth of imports (US dollar terms, in percent)	38.2	23.2	24.3	17.6	38.6	12.3	5.1	6.0	6.2	5.4	
Current account balance, excluding interest payments	5.4	4.6	1.7	2.5	0.2	-0.6	-0.3	0.4	0.1	0.1	
Net non-debt creating capital inflows	2.4	4.3	7.1	3.8	3.3	2.8	2.4	1.8	1.8	-1.7	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

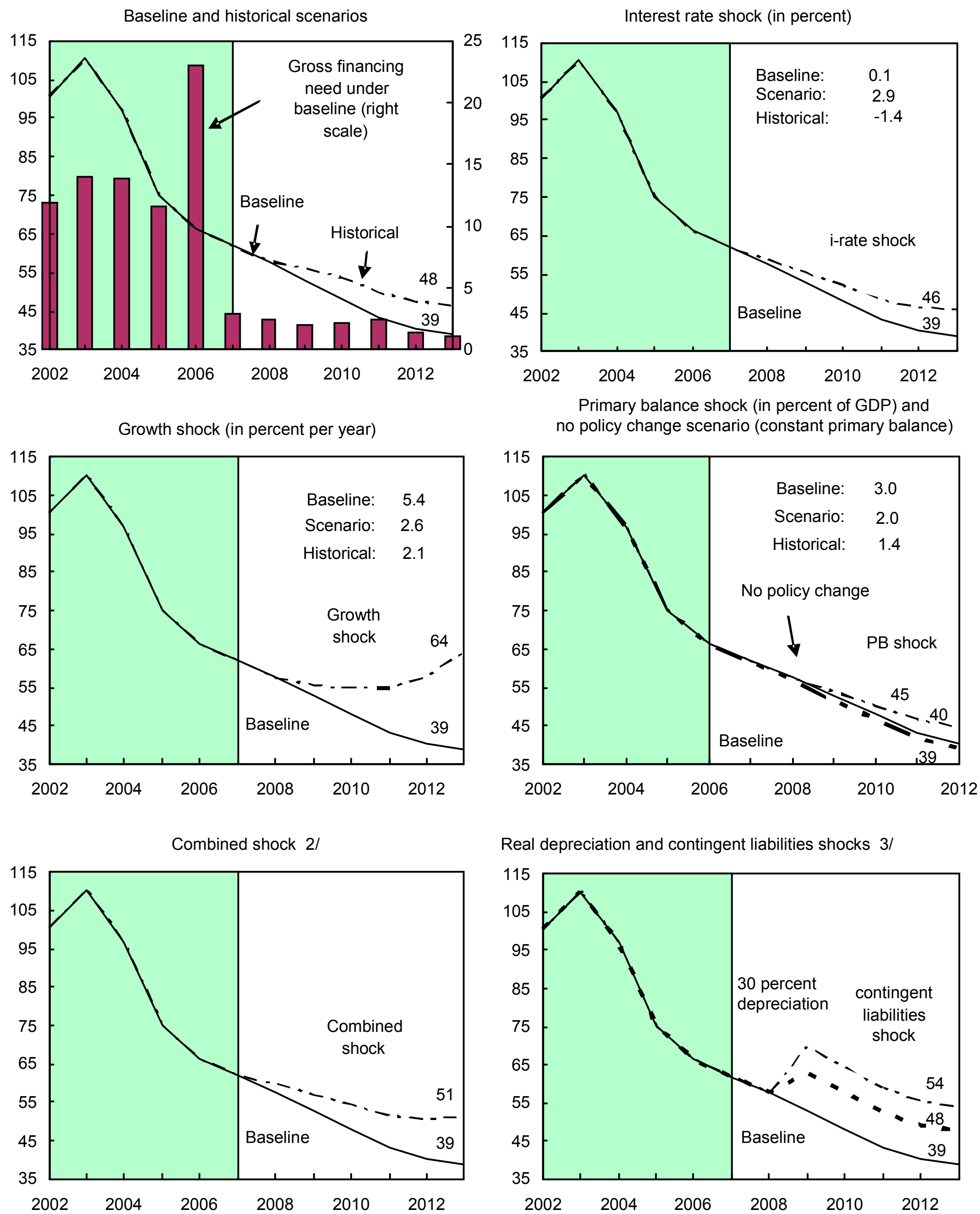
3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at of the last projection year.

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



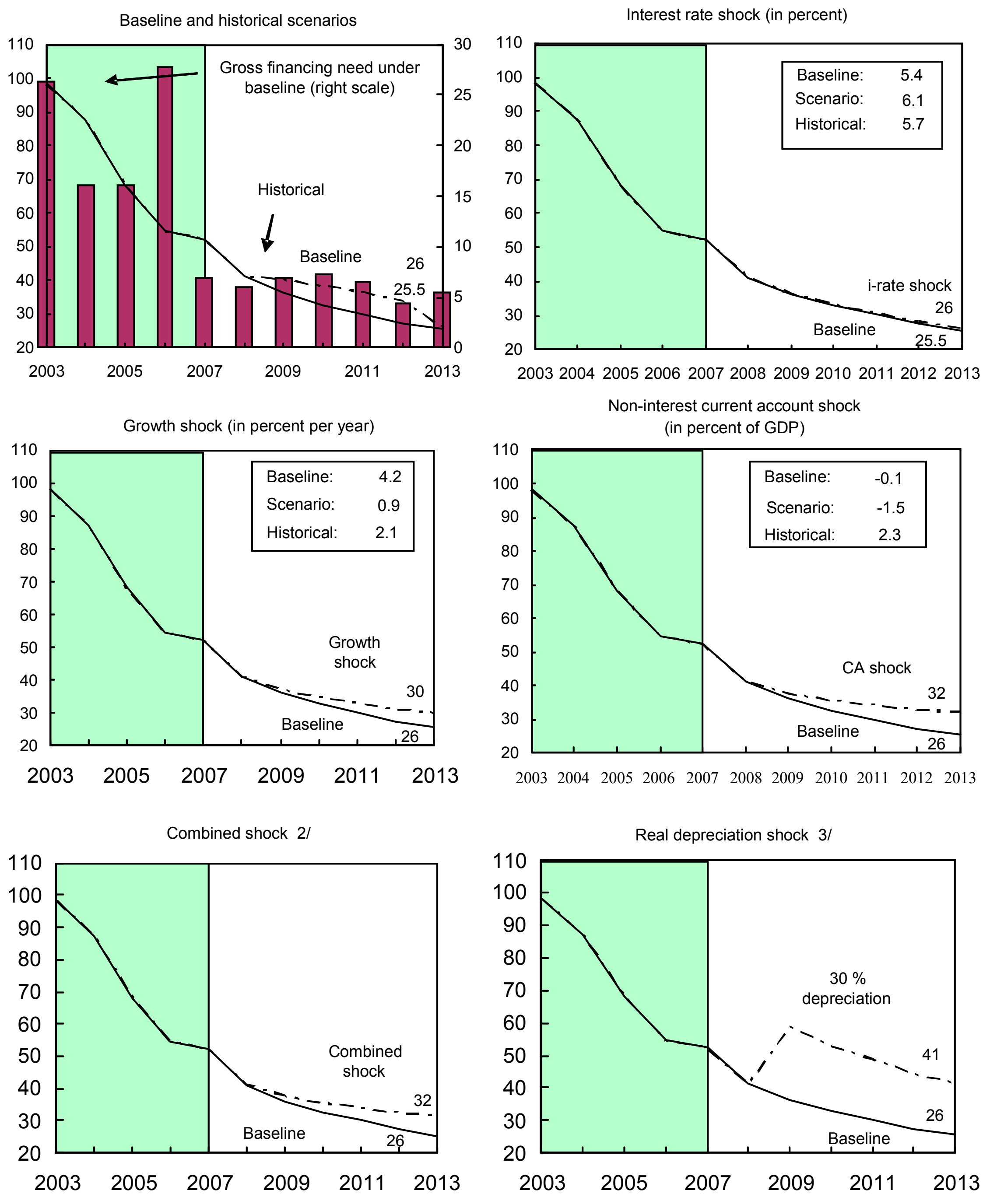
Sources: International Monetary Fund, Country desk data, and staff estimates.

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 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Appendix 1. 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 2009.

INTERNATIONAL MONETARY FUND

URUGUAY

Staff Report for the 2008 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the 2008 Article IV
Consultation with Uruguay

Approved by José Fajgenbaum and Adnan Mazarei

October 9, 2008

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ANNEX I. FUND RELATIONS
(As of July 31, 2008)

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

II. General Resources Account:	**SDR Million**	**% Quota**
Quota	306.50	100.00
Fund holdings of currency	306.51	100.00
Reserve Position	0.00	0.00
Holdings Exchange Rate		

III. SDR Department:	**SDR Million**	**% Allocation**
Net cumulative allocation	49.98	100.00
Holdings	0.54	1.08

IV. Outstanding Purchases and Loans: None

V. Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Jun 08, 2005	Dec 27, 2006	766.25	263.59
Stand-By	Apr 01, 2002	Mar 31, 2005	1,988.50	1,988.50
of which SRF	Jun 25, 2002	Aug 08, 2002	128.70	128.70
Stand-By	May 31, 2000	Mar 31, 2002	150.00	150.00

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

	Forthcoming				
	2008	2009	2010	2011	2012
Principal					
Charges/Interest	0.75	1.52	1.52	1.52	1.52
Total	0.75	1.52	1.52	1.52	1.52

[1/] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

VII. ***Safeguards Assessment***. The authorities are in the process of addressing all safeguards concerns raised in the safeguards assessment completed in September 2005, and have already implemented many of the recommendations proposed by staff. Uruguay's total obligations to the Fund are now included in the BCU's financial statements and 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$). Uruguay has followed an independently floating exchange rate regime since July 29, 2002. In April 2006, Uruguay's de facto exchange rate regime was reclassified from an independent float to a managed float with no predetermined path for the exchange rate. On September 4, 2008, the exchange rate in the official market was Ur$ 19.359 per US dollar. 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 2007 Article IV consultation was concluded by the Executive Board on August 29, 2007 (Country Report No. 08/45). 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 last Ex Post Assessment of Longer-Term Program Engagement was considered by the Executive Board on August 29, 2007 (Country Report No. 08/47).

XI. ***FSAP participation and ROSCs***. The Financial Sector Stability Assessment (FSSA) was considered by the Executive Board on June 28, 2006 (Country Report No. 06/187). 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. The ROSC on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) was published on December 2006 (Country Report No. 06/435)

XII. ***Technical Assistance***. Technical assistance on tax, customs, and social security administration was provided by FAD in February 2007, March 2006, June 2005, and July 2003, on tax policy in October 2005 and May 2003, and on public financial management in March 2005 and July 2006. In April 2003, STA provided technical assistance on adequate recording of loans funded by the FSBS. MCM 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. Further, MCM has also provided technical assistance to strengthen the formulation and conduct of monetary and exchange rate policies, including in July 2006 and May 2007. In February 2007, LEG provided technical assistance to develop a framework to elaborate and implement a national AML/CFT strategy consistent with the recommendations of the Fund's 2005 AML/CFT assessment report.

XIII. ***Resident Representative***. Mr. Gaston Gelos. The Resident Representative now covers Uruguay from the Buenos Aires' office.

ANNEX II. RELATIONS WITH THE WORLD BANK GROUP
(As of July 24, 2008)

The latest Country Assistance Strategy (CAS) for Uruguay was approved on June 9, 2005. The CAS envisaged a base case scenario of up to US$800 million in new lending over the period FY05–10, modulated on the strength of the Government's program, its ability to implement it and the evolution in the country's creditworthiness. The 2005 CAS also proposed to rebuild the investment portfolio with new operations supporting priority investments in infrastructure, social programs and innovation.

The Bank's strategy outlined in the 2005 CAS was anchored around a series of programmatic development loans (DPLs) supporting the Government in key policy areas. The first DPL (DPL1) for US$75 million was approved by the Board of Directors together with the CAS on June 9, 2005. It supported reforms in social policies as well as important measures taken by the Government with respect to health, education and social protection. A subsequent DPL, the First Programmatic Reform Implementation Development Policy Loan (PRIDPL 1) in the amount of US$100 million, was approved by the Board of Directors on May 30, 2007. This operation supported the Government's reform program in taxation, business climate and capital markets development, and aimed at improving the social protection system. The US$100 million PRIDPL1 was disbursed in local currency in May 2008, as the World Bank became the first foreign issuer to launch a public bond in (inflation indexed) Uruguayan pesos. This was the first that the World Bank has issued a local currency bond for the purpose of a back-to-back disbursement of a specific loan.

The current investment portfolio comprises nine projects totaling US$267.9 million in commitments, with an undisbursed amount of US$176.1 million as of July 24, 2008. Seven of these investment operations have been approved since the beginning of the new CAS period. These include 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, approved by the Board on June 9, 2005 together with the CAS. In addition, in December 2006, the Board approved a Supplemental Financing for the Foot and Mouth Disease Project in the amount of US$6.5 million. On May 30, 2007 an Institution Building Technical Assistance Project in the amount of US$15 million was also approved (together with the First PRIDPL). In addition, the second phase of an Adaptable Program Loan (APL) for OSE Modernization and Rehabilitation Systems (US$50 million) was approved on July 28, 2007. Another investment loan in support of the Promoting Innovation to Enhance Competitiveness Project was approved on May 1, 2007 in the amount of US$26 million, and a Non Communicable Disease Prevention Project in the amount of US$25.30 million was approved on August 28, 2008.

A CAS Progress Report (PR) to assess progress in implementing the program outlined in the 2005 CAS, take stock of achievements and lay out a program for the remainder of the

CAS period (FY08-FY10) was approved on April 1, 2008. The CAS PR confirms the validity of the overall thrust and long-term goals of the 2005 CAS. It also notes that the Bank program has achieved substantial success over the last two years, particularly in basic education, health, rural development, transport, water and sewerage, and innovation. The CAS PR recognizes the important economic developments that have taken place since the 2005 CAS was approved, most notably Uruguay's full recovery from the 2002 crisis and its marked progress in economic growth and fiscal outcomes, which have outperformed 2005 CAS projections. Given these positive developments, country requirements, as outlined in the CAS PR, have evolved within the CAS framework, with an increased interest in the Bank's technical inputs and contribution to improving results, and a reduction in financing needs, largely due to debt-reprofiling.

Because of the lower than anticipated financing needs, the Second Programmatic Reform Implementation Development Policy Loan (PRIDPL2), originally envisaged for FY07 under the 2005 CAS, has been postponed to FY08. The authorities also decided to combine PRIDPL2 and PRIDPL3 (for a combined amount of US$100 million under the 2005 CAS) into a single operation for US$300 million with a DDO (Deferred Drawdown Option). A DPL DDO provides the option of deferring loan disbursement for up to three years from loan signing and is renewable for an additional three years, thereby creating a contingency form of financing for Uruguay over an extended period of time. The possibility of an increase in the CAS envelope by up to US$60 million was included in the CAS PR to accommodate the larger amount under this new operation, which is currently at an advanced stage of preparation and it is scheduled for Board consideration in the first quarter of FY09.

The Bank has also engaged with the authorities in an active AAA program. In FY08, the program has included completion of a Programmatic DPR in Infrastructure, a PSIA on Tax Reform, an Investment Climate Assessment and a Non-Lending Technical Assistance (NLTA) on Strengthening Participatory Monitoring and Evaluation in Social Policies. A Railways Sector Study, second phase of the NLTA on Participatory Monitoring and Evaluation, and an NLTA on Human Development Reforms are underway for FY09 completion. A Country Economic Memorandum (CEM) focusing on trade is also planned for FY09.

FINANCIAL RELATIONS WITH THE WORLD BANK GROUP
(In millions of U.S. dollars)

	Commitments (Net of Cancellations)	Disbursed	Undisbursed
I. IBRD Operations (as of July 24, 2008)			
Foot & Mouth Disease (Add. Financing)	6.5	3.6	2.9
Public Services Modernization	6.0	4.3	1.7
Basic Education III	42.0	33.7	8.3
Transport Infrastr. Maint. & Rural Access	70.0	34.3	35.7
Integrated Nat. Resources & Biodiv. Mgnt.	30.0	9.1	20.9
Innovation to Enhance Competitiveness	26.0	0.4	25.6
Institutions Building TAL	2.1	0.3	11.8
OSE Modernization & Systems Rehab.APL2	50.0	6.0	44.0
Non Communicable Diseases Prevention	25.3	0.1	25.2
Programmatic Reform Implem. DPL 1	100.0	100.0	0.0
Total	**367.9**	**123.9**	**176.1**

II. IFC Operations (as of June 30, 2008)

	Loans	Equity	Quasi	Guarantees	Participation
Committed	102.5	0.0	6.7	1.1	100.0
Outstanding	87.5	0.0	6.7	1.1	100.0

III. IBRD Loan Transactions (calendar year)

	2002	2003	2004	2005	2006	2007	2008*
Disbursements	234	97	144	134	42	74	124
Debt service payments	75	78	80	104	205	61	46
Net Disbursements	158	19	64	30	-163	13	78

* As of July 24th, 2008

ANNEX III. RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK
(As of July 23, 2008)

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$1.2 million for the five-year period 2005–09, which is consistent with Uruguay's five-year budget plan, annual amendments approved by Congress, and the maintenance of a relatively neutral net flow of Bank resources (during this period of concentrated external-IFI-maturities). This program includes lending to support the Government in the key policy areas of competitiveness, the social sectors and poverty reduction, and public sector management.

To this end, within the area of competitiveness, a loan for a program to support the productivity and development of new livestock products, for US$15.8 million, was approved in July 2005; an investment project to improve cluster competitiveness for US$9 million was approved in July 2006; and a two-year programmatic loan to improve competitiveness for a total of US$150 million—for US$75 million each—is under preparation, with the first loan approved in January 2007 and expected approval of the second loan in March 2009; and a loan to strengthen the institutional capacity for international insertion, for US$5.4 million was approved in April 2008. In the social sector area, a sector loan, for US$250 million, was approved in August 2005, 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 for sanitation, for US$118.6 million, was approved in January 2006, to improve the standard of living of the population in Montevideo by increasing the coverage of sanitation service and reducing pollution in the bay; and a neighborhood improvement program for US$70 million is expected to be approved in end-2008.

Within the public sector management area, a loan to support the public debt management unit for US$2.45 million was approved in November 2005; and a three year programmatic loan to support improvements in tax administration and public sector management is being prepared. The first loan for US$50 million was approved in October 2006; a second loan for an estimated US$100 million is likely to be approved in early-2009 while the amount for the third loan is to be determined; a program related to e-government management for US$5 million was approved in March 2008. The lending program also includes investment projects with new operations planned in the area of microfinance, to support transport infrastructure, and social programs.

As of July 23, 2008 the Bank's current portfolio in Uruguay includes loans for the financing of 22 investment projects; and two policy based operations, for the social sectors and for improvements in competitiveness. The lending portfolio, which is largely aligned to the administration's priorities and consistent with the Bank's Country Strategy, amounts to US$1,037.0 million, of which US$540.6 million are pending disbursement. Portfolio performance related to investment loans in 2007 was relatively normal. PBL disbursements, however, slowed due to a robust fiscal performance and ample availability of market financing (most notably, the release of the Social Sector Loan, US$125 million, and the Programmatic Competitiveness Loan I, US$75M, scheduled for release in the first half of 2007 is now expected in late 2008/early 2009). The Bank's Operational Program for 2008 contemplates programmatic and investment projects and TCs bundled in a diversified instrument mix that includes CCLIPs to underpin a longer term commitment with the country. While work is well advanced, advancing project preparation and approval during 2008 would be desirable in anticipation of the electoral process culminating with the October 2009 presidential elections.

FINANCIAL RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK
(In millions of U.S. dollars)

Total outstanding loans: US$1,828.0[1]

Loan transactions:

	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008** [2]
Disbursements	214.2	558.6	367.2	53.1	242.3	114.8	112.9	113.0
Amortization	60.7	73.1	103.7	113.3	220.0	519.6	133.8	147.4
Net Loan Flows	**153.5**	**485.5**	**263.6**	**-60.2**	**22.3**	**-404.8**	**-21.0**	**-34.4**

Source: Inter-American Development Bank.

[1] As of May 31, 2008.
[2] IDB staff projection.

ANNEX IV. 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 accounts 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 central bank (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 work on 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.

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

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 BCU 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 Fund's external website in 2005 The BCU also disseminates quarterly external debt statistics on its website, although not in the format envisaged by the SDDS.

URUGUAY: COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of September 4, 2008)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Sep 1, 2008	9/02/08	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Aug. 2008	9/02/08	M	M	M
Reserve/Base Money	Aug. 2008	9/02/08	M	M	M
Broad Money	Aug. 2008	9/02/08	M	M	M
Central Bank Balance Sheet	Aug. 2008	9/02/08	M	M	M
Consolidated Balance Sheet of the Banking System	Aug. 2008	9/02/08	M	M	M
Interest Rates[2]	Aug. 2008	9/02/08	M	M	M
Consumer Price Index	Aug. 2008	9/02/08	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Aug. 2008	9/02/08	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Aug. 2008	9/02/08	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	June. 2008	9/02/08	Q	Q	Q
External Current Account Balance	Q2/08	August 2008	Q	Q	M
Exports and Imports of Goods and Services	Q2/08	August 2008	Q	Q	M
GDP/GNP	2007	April 2008	A	A	M
Gross External Debt	Q2/08	August 2008	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).

Statement by the IMF Staff Representative
October 22, 2008

1. **This statement reports on developments in Uruguay since the Staff Report was issued on October 9**. Although downside side risks have increased, the thrust of the staff appraisal remains unchanged.

2. **The intensification of international financial market turbulence has been felt in Uruguay**. Bond prices have fallen, pressures on the peso have persisted, and country risk has shot up to around 550 basis points. Still, despite limited intervention, since October 1 the currency has depreciated by 3.4 percent and gross reserves have declined modestly from US$6.40 billion to US$6.20 billion. Bank deposits have remained stable.

3. **Pressures on the peso lessened after the central bank tightened banks' liquidity in early October**. It raised its target rate by 50 basis points to 7.75 percent and the interest rate on its Lombard facility from 10 to 20 percent; and, closed the one-day financing facility. As a result, and with banks seeking to purchase dollars, interbank rates have shot up, temporarily reaching around 30 percent.

4. **Median survey inflation expectations for end-2008 have risen to 8.5 percent, compared to 8 percent in September**. For end-2009, inflation expectations remained broadly stable at about 7 percent.

5. **Economic activity is slowing.** Non-refinery manufacturing output rose 5.3 percent in August, compared to 13.1 percent in July (year-on-year).

6. **The Portuguese company Portucel confirmed plans for a new large-scale investment project in Uruguay**. The company intends to build a pulp and paper mill in the eastern part of the country, as well as a sea port; total investment is estimated at more than US$4 billion.

7. **The central bank reform was approved by the Senate**. Approval by the Lower House is expected to occur before end-October. The draft law also reforms financial supervision and the banking resolution framework.

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

IMF Executive Board Concludes 2008 Article IV Consultation with Uruguay

On October, 24, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Uruguay.[1]

Background

Uruguay has further consolidated economic gains, supported by strong macroeconomic policies and a broadly favorable external environment. Growth has exceeded expectations, unemployment has reached record lows and poverty has continued to fall, while economic vulnerabilities have been significantly reduced. Nevertheless, persistent inflationary pressures, together with a deteriorating global economy pose key challenges. Moreover, despite significant advances, the government's reform agenda is still ongoing. Since the intensification of the global financial turbulence, Uruguay has experienced a peso-depreciation, higher interest rates, and an increase in country risk.

Real GDP grew by 7.5 percent in 2007, continuing the strong performance following the crisis in 2002. Growth momentum has been exceptionally strong this year, with real GDP growth reaching 13 percent during the first semester, led by domestic demand. Together with food and

[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.

oil commodity prices increases, this has fueled persistent inflationary pressures. Twelve-month inflation through September 2008 was 7.5 percent, above the upper limit of the central bank's target range (7 percent). Core inflation has risen steadily, and remains in the 9-10 percent range.

The authorities took measures to contain price increases, but pressures remain. The policy rate was raised by 275 basis points to 7¼ percent in 2007 and, more recently by 50 basis points in October; in May, reserve requirements were increased. Moreover, the exchange-rate channel has been allowed to operate more freely, with, until this September, the peso appreciating against the U.S. dollar. In addition, in 2007, tax measures were implemented to prevent headline inflation from reaching double-digits, which would have triggered more frequent pension and wage adjustments. Nonetheless, while headline inflation has come down by 1½ percentage points since its peak in 2007, both core and headline inflation remain above the central bank's target range.

While the overall deficit has been below target, fiscal policy has been somewhat expansionary. The headline primary balance declined from 3¾ percent of GDP in 2006 to an estimated 2.7 percent of GDP in 2008. Adjusting for the economic cycle and excluding drought-related costs, both the primary and overall balances may imply a positive impulse in 2008–09. Still, with lower interest payments, the overall deficit is expected to remain between 0-0.3 percent of GDP. Moreover, the gross debt-to-GDP ratio has continued to fall, to about 65 percent of GDP and 55 percent of GDP (net of Net International Reserves - NIR). Nonetheless, looking ahead, more ambitious fiscal targets would help ease domestic demand pressures and reduce the burden on monetary policy in its fight against inflation, as well as help in achieving faster debt reduction.

Uruguay's external sector remains strong, with buoyant exports, and import growth driven by large foreign direct investment projects. The central bank has accumulated US$6 billion in reserves to date. Short-term debt has been sharply reduced through debt management operations, including by de-dollarizing through swaps with support from the World Bank. The debt structure has improved, and financing needs are covered through end-2009.

Financial indicators have improved considerably. Despite strong credit growth, financial system soundness indicators have improved, showing a well-capitalized banking system, low non-performing-loan ratios and high liquidity levels. However, bank profitability has declined of late reflecting in part declining yields and the strong peso appreciation until August. Still, Uruguay remains one of the most dollarized economies in the world.

Despite significant advances, various structural reforms are still pending. Progress has been made in restructuring the housing bank BHU, but the process remains to be completed.

Executive Board Assessment

The Executive Directors noted that prudent macroeconomic policies and deep-rooted structural reforms over the past few years, aided by favorable external conditions until mid-2008, have enabled Uruguay to maintain vigorous export and economic growth, lower unemployment and poverty rates, and significantly reduce vulnerability to shocks. High levels of international reserves and commercial bank liquidity are providing important buffers against deteriorating external conditions. Moreover, debt management operations have reduced short-term government financing needs, lowered the debt-to-GDP ratio, and substantially improved the debt profile. As a result, the effects of the recent turmoil in global financial markets have been relatively contained.

Notwithstanding these achievements, Directors noted that the Uruguayan economy remains vulnerable. In particular, deteriorating global financial and economic conditions pose downside risks to Uruguay's small, open, and dollarized economy. A main macroeconomic challenge will be to contain inflation in the face of food and fuel price increases and domestic demand and wage pressures. Directors also noted the recent sharp increase in Uruguay's country risk premium. They accordingly underlined the importance of continued vigilance by policymakers, and of steadfast pursuit of the government's reform agenda to help maintain macroeconomic stability and sustain robust economic growth.

Directors welcomed the measures the authorities have taken to reduce inflationary pressures, including increases in the policy rate and banks' reserve requirements and tax administrative measures. With core and headline inflation still above the central bank's target range and bank credit growing rapidly, Directors saw merit in some additional monetary tightening. A few Directors cautioned, however, that reliance on the interest rate channel could intensify capital inflows. Directors generally noted that administrative measures should be relied on to control prices only in exceptional circumstances. Directors also emphasized the importance of making price stability the core objective of monetary policy in order to strengthen the credibility of the monetary policy framework, and of securing central bank independence irrespective of the electoral cycle.

Directors noted that capital flows have complicated monetary management. Until August 2008, strong inflows and sterilized intervention to contain the appreciation of the currency led to a sharp rise in reserves and central bank debt. More recently, the deteriorating global financial conditions have created new challenges, as inflows have abated and the exchange rate has depreciated.

Most Directors considered that fiscal policy has been expansionary, particularly in non-drought years. They noted that the primary balance has deteriorated since 2006, and the structural primary and overall balances may imply a positive impulse in 2008-09. Directors stressed that, with the gross public debt ratio still relatively high, it will be essential to maintain high primary surpluses to further reduce the debt burden. Most Directors encouraged the authorities to maintain an ambitious fiscal stance to help avoid increasing the burden on monetary policy, while supporting well-targeted measures to alleviate the impact of the food and fuel price shocks on vulnerable groups. At the same time, some Directors cautioned that in the current changing economic environment, the case for a tighter fiscal stance is debatable. Most Directors also saw merit in moving to cyclically-adjusted fiscal targets—and a few suggested the adoption of a fiscal rule—which they felt would enhance the effectiveness of fiscal policy and reduce medium-term vulnerabilities. Directors welcomed the operations carried out recently to improve the debt profile and to reduce debt dollarization.

Directors noted that the banking system is well-capitalized and liquid, with low non-performing loans. They welcomed the system's increased resilience to shocks, and called for further strengthening of the financial sector, particularly in the context of declining bank profitability, global financial volatility, and dollarization of the economy. The recent rapid growth of bank credit and an increase in non-resident deposits point to the need for continued proactive bank supervision. Directors stressed the importance of deepening financial sector reforms and completing the implementation of the 2006 Financial Sector Assessment Program (FSAP) recommendations. These include further strengthening state banks and banking supervision, and completing the restructuring of the housing bank. Directors welcomed the important progress made so far in this regard. They regarded swift approval of the financial sector law to be key to enhancing central bank independence and strengthening the supervisory and resolution frameworks.

Directors noted that Uruguay's favorable business climate has led to strong foreign direct investment inflows and a diversification of exports and export markets. They welcomed the efforts being made to further improve the business climate, including the reform of competition and bankruptcy legislation.

Uruguay: Basic Data

	2003	2004	2005	2006	2007	Prel. 2008	Prel. 2009
(Annual percentage changes, unless otherwise indicated)							
Real GDP	2.2	11.8	6.6	7.0	7.4	9.5	5.5
Real consumption	1.1	9.5	2.8	8.6	9.7	9.8	7.8
Real investment	18.0	22.0	12.7	24.7	2.6	16.5	8.0
Prices							
Consumer price index (period average)	19.4	9.2	4.7	6.4	8.1	7.6	7.4
Consumer price index (eop)	10.2	7.6	4.9	6.4	8.5	8.5	7.5
Terms of trade	2.2	-2.4	-6.3	-1.6	0.6	-0.3	0.2
(In percent of GDP)							
Public sector finances							
Total revenues	32.0	30.9	31.8	31.8	33.8	32.4	33.8
Expenditure (incl. discrepancy)	35.3	33.2	32.5	32.5	33.8	32.7	33.9
Primary balance	2.7	3.8	3.9	3.8	3.6	2.7	3.1
Overall balance	-3.2	-2.2	-0.7	-0.6	0.0	-0.3	-0.1
Public sector debt 1/	110	97	75	66	62	58	53
Outstanding external debt	98.2	87.4	68.3	54.7	52.3	41.3	36.2
Of which: Public external debt	85.3	76.9	60.8	48.2	47.3	36.3	31.3
(Annual percentage change)							
Money and credit							
Base money (eop)	24.9	11.1	34.1	13.0	16.4	29.9	...
M1	34.6	13.4	29.4	21.8	29.4	22.7	...
M3	21.7	-2.0	0.4	12.3	3.8	2.6	...
Credit to the private sector (constant exchange rate)	-23.9	-11.2	2.7	9.1	22.1	28.6	...
Gross official reserves (US$ million) 2/	2,087	2,512	3,438	3,091	4,096	6,371	6,926
In percent of short-term debt	131.3	112.4	153.8	492.1	495.3	648.3	597.7
In percent of short-term debt and FX deposits	20.0	27.7	32.9	32.8	40.2	61.7	61.1
(In percent of GDP, unless otherwise indicated)							
Balance of payments							
Current account	-0.5	0.3	0.0	-2.4	-0.8	-1.7	-2.4
Merchandise exports, f.o.b.	20.3	23.7	22.5	22.7	21.8	22.4	20.6
Merchandise imports, f.o.b.	18.7	22.6	22.3	25.2	23.9	24.3	23.2
Services, income, and transfers (net)	-2.1	-0.8	-0.2	0.1	1.3	0.3	0.2
Capital and financial account	9.3	0.5	6.1	1.0	6.1	8.7	4.0
Foreign direct investment	3.6	2.4	4.3	7.1	3.8	3.3	2.8
Overall balance of payments (US$ millions)	1,380	454	951	-337	1,005	2,275	555
Debt service ratio (in percent of exports of goods & services)	52.3	44.8	53.1	92.5	25.0	16.5	15.9

Sources: Data provided by the Uruguayan authorities; and IMF staff estimates.
1/ Public sector debt, net of free reserves of the Central Bank of Uruguay.
2/ Includes reserve buildup through reserve requirements of resident financial institutions.

Statement by Hector Torres, Alternate Executive Director for Uruguay and David Vogel, Advisor to the Executive Director
October 22, 2008

Background

1. In 2008, Uruguay has been exhibiting another year of remarkable economic performance as a result of sound macroeconomic policies and a number of structural reforms. Certainly, the positive external environment observed in recent years has also contributed to this performance. Positive shocks can be dilapidated or capitalized to pave the way for medium and long-term growth. Evidently, the latter has been the case for Uruguay. Indeed, the Uruguayan government has placed the pillars to reach higher and sustainable development and critically reduce vulnerabilities in order to be well-prepared for a new stage in the global economy.

Growth: From Vulnerability to the Road to Strength

2. Some years ago, many analysts were concerned about the sources of growth and the low growth rates Uruguay had experienced over a number of decades. According to an IMF staff report issued in 2003, "over the past 40 years, economic growth in Uruguay has been relatively low, averaging 1.7 percent a year over 1960-2001."[1]

3. GDP growth is projected to be about 9.5 percent this year. Admittedly, this high figure is influenced by the opening of a large pulp mill factory, but beyond this, the country's medium-term potential growth appears to be significantly higher than the above-referred average. As noted, sound macroeconomic policies, as well as the implementation of structural changes, together with Uruguay's long tradition of respecting the rule of law, are key factors in allowing the country to attract a substantial amount of direct investment in many economic sectors. There are a number of cases where investment has already had substantial effects on the productivity of these sectors. Meanwhile, having demonstrated over the years that the country enjoys a positive investment climate, as a dynamic process, investment so far is attracting more capital, with the potential of creating an investment pole.

4. Of course, research, knowledge and technology constitute key elements to reinforce the above-referred growth trend, and, among other things, it is worth noting that the government has made important progress in discussions aimed at opening relevant scientific centers in Uruguay, following the inauguration of the Institut Pasteur of France less than two years ago.

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[1] Uruguay: 2003 Article IV Consultation and Third Review under the Stand-By Arrangement, Appendix I, August 2003.

Diversifying Markets and Products: From Regional to Global

5. Exports have continued to show a robust performance. More importantly, Uruguay has enlarged both the basket of its exports and the markets to which they are shipped. In this respect, it is worth recalling that a decade ago exports to Mercosur countries represented approximately 50 percent of the country's external sales and today it is about 25 percent. Extra-regional exports have increased significantly.

6. Of course, as an open economy, Uruguay will have to face new circumstances stemming from a substantially less benign global economic situation. The global slowdown will affect the demand for Uruguay's products; nevertheless, the country has broadened its basket of exports, improved their quality, and is currently supplying a number of promising new external markets. This puts Uruguay in a better position to face the current headwinds and constitutes a critical intangible asset for its medium and long-term development.

Fiscal Side: When the "Unprecedented" Becomes the Norm

7. By the time the Stand-By Arrangement was signed in 2005, many analysts questioned the authorities' capacity to deliver its ambitious fiscal targets. However, the developments have been quite different. For instance, in 2008, Uruguay will record another year of important primary fiscal surplus, while the overall fiscal balance is already very close to equilibrium. In recent years, the fiscal revenue agency has been critically transformed. This partially explains the country's outstanding fiscal performance, but the authorities have also enhanced their expenditure policies. Both collection and expenditure improvements have been consistently pursued to comply with our authorities' strong commitment to reinforce fiscal sustainability.

8. Furthermore, the results attained in 2008 should be taken into account considering the fiscal costs incurred by measures aimed at mitigating some of the negative effects caused by a severe drought, which occurred in a context of above-average oil prices over the medium term. Similarly, other fiscal resources were used to soften the negative impact that, through their effects on domestic prices, the surge in commodity prices (particularly, food and oil) would have had on the most vulnerable sectors of Uruguayan society.

Debt Strategy: The Benefits of Being Prepared

9. One of the first issues this administration had to deal with was associated with a stressful debt situation. Thus, the Debt Management Unit was created at the Ministry of Finance, which has significantly prepared the country to navigate through the current market turmoil. This was due to the fact that Uruguay has reduced debt costs, made solid progress on de-dollarization of the debt, and lengthened its maturity. Meanwhile, the public debt-to-GDP ratio has decreased, as noted by the staff financing needs are well covered, most of the debt is at fixed rates, and the government already has some contingent credit lines available.

Looking at Stability in a Broad Sense

10. Clearly, the steep reduction in unemployment, the prudent salary recovery from the very low level resulting from the 2002 crisis, and the better quality of employment coming from the boost in investment, have made great contributions to significantly reduce poverty conditions. Nonetheless, the above-referred developments would not have been enough to reach the results already observed. Transparent and well-targeted social plans have been essential in this regard.

11. Meanwhile, having a broader view on the issue, the Uruguayan authorities point out the importance of moving to a countercyclical policy rule when the conditions allow it. It is worth noting that using part of the fiscal space left by the debt strategy and fiscal policies, our authorities devoted an important amount of resources to education, health, and infrastructure, which, in the medium term, will entail benefits in terms of poverty reduction, employment, quality of life, and growth. Some of the social plans—for example, Plan Ceibal, which provides laptops to public school children—involve an important investment, but have initial and ending points.

12. 12. Maybe the issue of pro or countercyclical policies should be treated in another ambit, beyond Uruguay's case and with an open mind to determine to what extent fiscal policies aimed at restoring the social and economic equilibrium after a severe crisis and establishing—in a prudent, efficient, and transparent manner—expenditures expected to have a positive impact on investment and growth should be characterized as procyclical.

13. In sum, the Uruguayan authorities firmly believe that beyond its intrinsic value, social stability, which includes better income distribution and a higher fairness in the access of opportunities—particularly in education and health—, involving a virtuous cycle, is a key factor for investment, growth and even for fiscal sustainability, all of which will contribute to further improving social conditions. Even though there has been substantial progress in this regard, the authorities consider that much remains to be done in this area.

Keeping Inflation under Control

14. Like many countries around the world, inflation has been pressured by high commodity prices. However, the authorities have implemented monetary and fiscal policies to keep inflation under control. When necessary, our authorities have tightened monetary policy, as was the case of the interest rate hike decided some weeks ago. Meanwhile, the administration's rapid reaction to establish fiscal measures aimed at softening certain price increases—as noted, these measures were essential to protect the most vulnerable people—also helped to avoid the introduction of indexatory mechanisms which, otherwise, would have exerted further pressures on inflation through second-round effects.

15. Other measures aimed at further opening the economy and continuing to establish sound incentives for production and investment also play an important role in smoothing

price increases and/or forging lower inflationary expectations. The outcomes have been positive, not only looking at the present but particularly at the future and, in this regard, it is evident that inflation expectations for the coming years are at the upper limit but within the authorities' target range (the median for 2009 is 7 percent and 6.69 percent for March 2009/Feb 2010).

16. The Central Bank made some opportunistic foreign currency purchases in recent years, which has allowed Uruguay to increase international reserves and smooth some of the exchange rate volatility. With the benefit of hindsight, it was the right decision, to the extent that reserves are currently around the level considered as optimal for the country, while some changes in the relations among currencies observed in recent weeks in many countries has been significantly less abrupt and volatile in Uruguay, after having intervened with a very modest amount of reserves.

A Sounder Financial System

17. Six years after suffering a severe crisis and having implemented key structural reforms in the sector, the financial system is sound and resilient, which is clearly reflected in the financial soundness indicators. As underscored in the staff report, "capitalization is adequate, non-performance loans are low, and the system's liquidity remains high". The staff report also notes that financial dollarization is high, which has been the case in Uruguay for many decades. However, it is very important to pay attention to the declining trend, which is reflected in the figures presented in Chapter II of the Selected Issues Paper. More importantly, currency mismatching risks have been drastically minimized. In this regard, dollar loans extended to the non-tradable sector have fallen from 84 percent in 2002 to 55 percent today, while dollar loans to families represent 16 percent of the total loans to that segment. Also, on the financial system, the housing bank, BHU, has been critically transformed, and will resume activities under the best practices.

Conclusions

18. The global economic situation poses important challenges for an open and small economy such as Uruguay's. However, the global turmoil has arrived at a time when Uruguay is well prepared to face it. Growth is robust, investment is continuing to increase while unemployment and poverty are decreasing, financial needs are well covered, the financial system is solid and resilient, and fiscal and monetary policies are prudent and are set to keep inflation under control. In sum, our authorities are well aware of the substantial challenges lying ahead and they are ready to take the needed measures when necessary. Likewise, the Uruguayan authorities do believe that the progress made so far and the ongoing efforts in terms of policies and reforms will continue reaping fruits for the benefit of the country and its people.