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# Uruguay: Ex Post Assessment of Longer-Term Program Engagement—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Uruguay

In the context of the ex post assessment of Uruguay's performance under Fund-supported programs, the following documents have been released and are included in this package:

- the staff report for the ex post assessment of Uruguay's performance under Fund-supported programs, prepared by a staff team of the IMF. The staff report was completed on March 4, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 18, 2005 discussion of the staff report.
- a statement by the Executive Director for Uruguay.

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

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INTERNATIONAL MONETARY FUND

URUGUAY

**Ex Post Assessment of Longer-Term Program Engagement**

Prepared by a Staff Team from RES, FAD, MFD, PDR, and WHD

Authorized for distribution by the Policy Development and Review
and Western Hemisphere Departments

March 4, 2005

Contents Page

Boxes



Tables



Figures



Appendix

## EXECUTIVE SUMMARY

### Background and Economic Developments

Over the past decade, Uruguay has undertaken broadly prudent macroeconomic policies. An exchange-rate-based stabilization successfully reduced inflation, though it resulted in some real exchange rate appreciation. Developments in the real economy have largely been influenced by developments in the region, especially Argentina. Uruguay experienced rapid growth in 1990–98, but went into recession beginning in 1999. In 2002, Uruguay faced its most severe financial crisis, with widespread illiquidity in the banking system and insolvencies in a large proportion of the domestic banking system, a sharp depreciation, and a doubling of the debt-to-GDP ratio to about 100 percent. The economy has rebounded strongly since the crisis and inflation has returned to the single digits. However, vulnerabilities remain substantial, reflecting the high debt burden and widespread dollarization.

### The 2002 Crisis

The crisis was triggered by deposit withdrawals from cash-strapped Argentine residents and soon developed into a more generalized run on the banks. At the same time, the crisis was made possible and more damaging by long standing vulnerabilities in the banking system—dollarization but also insufficient prudential regulation and supervision (notably with respect to the public banks)—that were well known even at the beginning of the period covered by this EPA. Initial attempts to halt the bank run failed, despite being supported by an SBA with access of about 200 percent of quota in March 2002, and the largest ever IMF arrangement (as a share of GDP) in June 2002 (shortly preceded by a move to an exchange rate float). In August 2002, the IMF further augmented access, and the authorities declared a bank holiday, reprogrammed dollar time deposits, and established a fund to fully back dollar sight deposits. The bank run came to an end in the fall of 2002.

### The Precautionary SBAs

Uruguay had a series of SBAs that were treated mostly as precautionary between March 1996 and early 2002. These were viewed as a helpful seal of approval, and a vehicle for intensive IMF monitoring. The authorities undertook significant reforms during this period—notably a pension reform, a reduction in public employment, and a lengthening of wage indexation lags. However, other reforms—notably in the specialized pension funds and, most important, the banking system—were either not undertaken or completed with a delay. Vulnerabilities in the banking system were tackled, beginning in the late 1990s, though in an insufficiently forceful manner. In retrospect, the authorities' policies would probably not have been much different in the absence of the precautionary SBAs.

**Crisis Management and Resolution**

- **Access.** The IMF broke new ground with respect to the level of access and the decision to explicitly support the lender of last resort function of the central bank in a dollarized economy. IMF programs are not ideally suited to dealing with banking crises: they tend to disburse too little upfront, and continue disbursing even after the crisis may have subsided.

- **Floating.** The move to a float in June 2002 was a decisive moment in the unwinding of the crisis and, even in hindsight, a close call. Reserves had dwindled to very low levels, and the exchange rate was somewhat overvalued. At the same time, it was well understood that floating would cause major losses in the banking system and that the public debt, largely in foreign currency, would become more burdensome.

- **Debt exchange.** Extending bond maturities by about five years brought welcome breathing room. Nevertheless, the public debt is still high, implying the need for strong fiscal policies over many years to ensure debt sustainability.

**Lessons for IMF Engagement Going Forward**

Given the IMF's unprecedented support to Uruguay in 2002, intensive IMF engagement—in the form of financial support and policy advice—will likely be required for a few years. There is little doubt that a program will be needed when the current program expires. The risks to a new program are major: the debt is sustainable only under stringent conditions—notably, primary surpluses that have not been previously attained by Uruguay. A key criterion for exit from IMF arrangements over the next few years will be Uruguay's ability to tap international financial markets for the necessary amounts at reasonable spreads. Market access in turn will depend on a forceful program, including strong signals of commitment to fiscal consolidation. Priorities to foster sustainable economic growth include: completing the resolution and restructuring of the banking system, returning to normal banking intermediation, and ensuring that prudential regulation and supervision are strengthened to avoid future crises; reducing the scale of the public sector; and reforming the tax system to ensure a more equitable and efficient distribution of the tax burden.

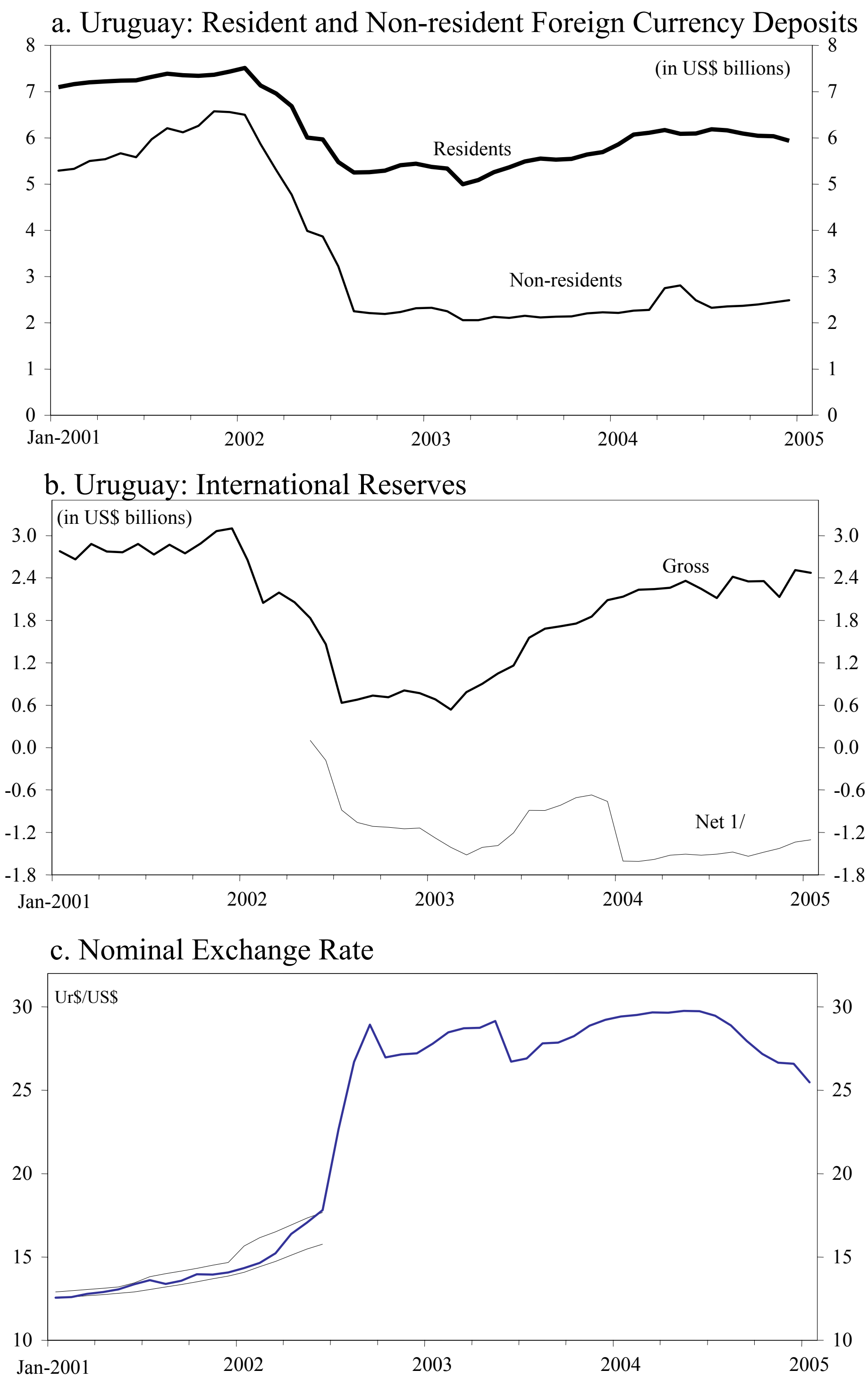
# I. Crisis[1]

1. In the first quarter of 2002, public confidence in the Uruguayan banking system began to erode. Cash-strapped Argentine depositors, unable to access their accounts in Argentine banks following a deposit freeze in late 2001 and pesification in early 2002, started withdrawing their funds from Uruguay. This clearly had the potential to deal a major blow to Uruguay's banking system, where almost half of deposits were held by nonresidents, largely Argentines. At the same time, it was still uncertain whether the situation would develop into a full-blown, systemic banking crisis. In these early weeks, deposits were being withdrawn mainly by nonresidents; problems affected primarily the local subsidiary of an Argentine bank (*Banco de Galicia*) and a large domestic private bank (*Banco Comercial*) that had substantial exposure to Argentina and was weakened by fraudulent activities on the part of some of its managers. The exchange rate weakened to the edge of the crawling band of the Uruguayan peso vis-à-vis the U.S. dollar, and the authorities widened the band and accelerated the central rate of depreciation (Figure 1). Government bond spreads doubled, and some rating agencies downgraded Uruguay's debt—previously investment grade—for the first time in many years.

2. Uruguay's real economy had experienced rapid growth in 1990–98, but had been in a recession since 1999, owing to a number of adverse shocks (Figure 2). These included crises in Brazil and Argentina—Uruguay's main trading partners, jointly accounting for almost one half of Uruguay's exports in the mid-1990s; and an outbreak of foot-and-mouth disease in early 2001, which inflicted serious damage on Uruguay's important beef sector. With Uruguay's successful exchange-rate-based inflation stabilization, and the devaluations of the Brazilian real (January 1999) and the Argentine peso (January 2002), by February 2002 Uruguay's real effective exchange rate had appreciated to 120 percent of its end-1998 level and 150 percent of its end-1992 level (Figure 3).

[1] This paper was prepared by P. Mauro (Head, RES), in consultation with a task force comprising A. Wolfe, O. Adedeji, and S. Eble (WHD), A. Arvanitis (PDR), F. Fischer (MFD), and E. Ley (FAD). The detailed description of the crisis draws on a number of documents as well as work by PDR's Crisis Resolution Issues Division.

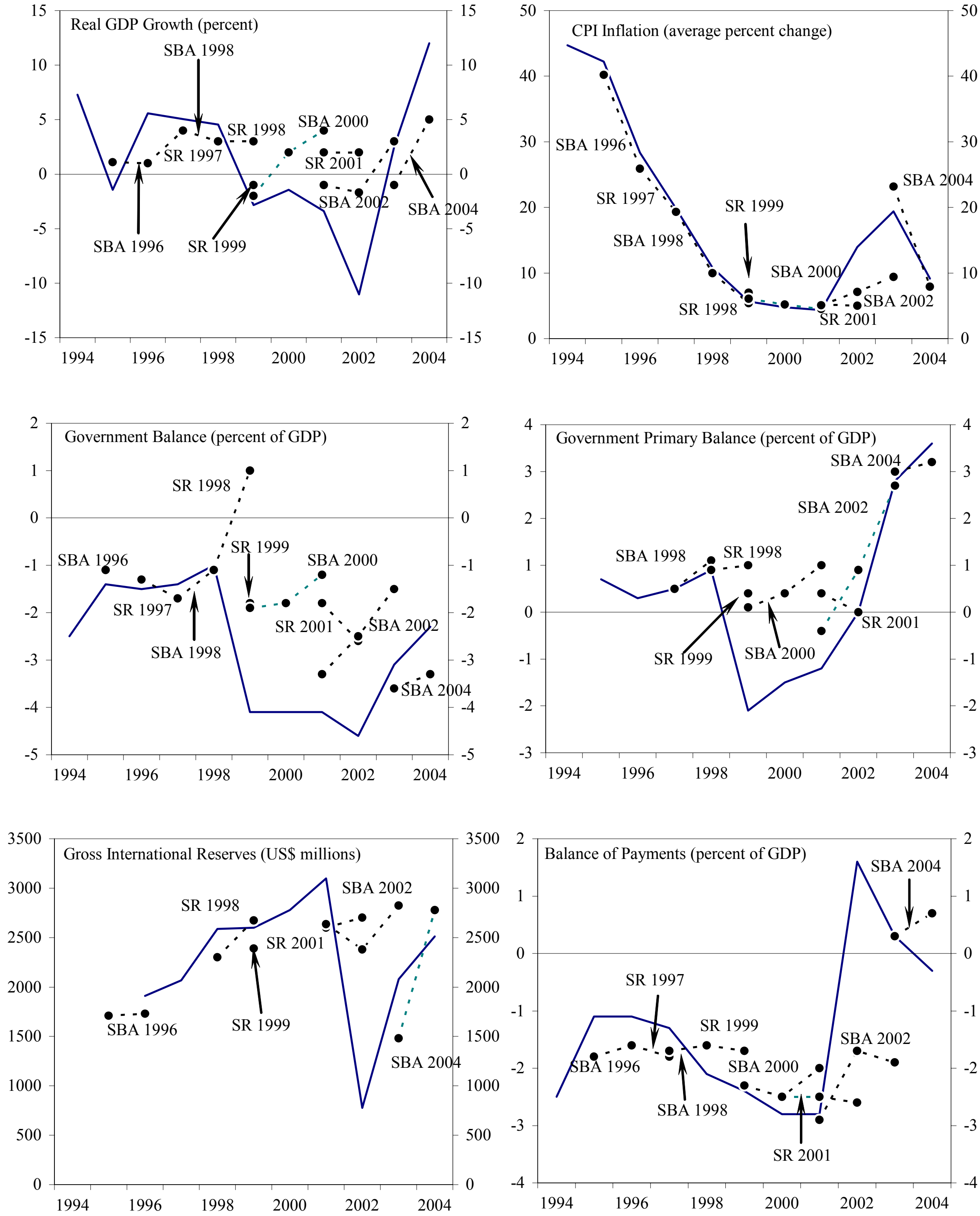
Figure 1. Uruguay: Deposits, International Reserves, and Exchange Rate




Source: Uruguay Central Bank.

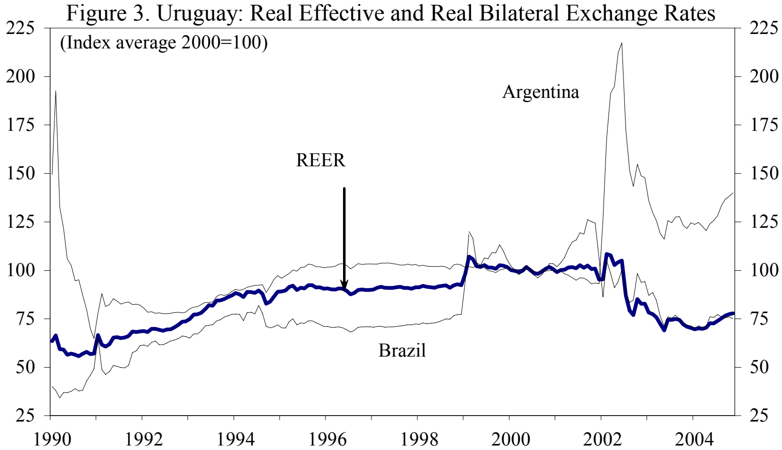
1/ Program definition, which consider banking system dollar deposits as a reserve liability.

Figure 2. Uruguay: Macroeconomic Indicators and Program Performance




Source: IMF staff reports.

Figure 3. Uruguay: Real Effective and Real Bilateral Exchange Rates



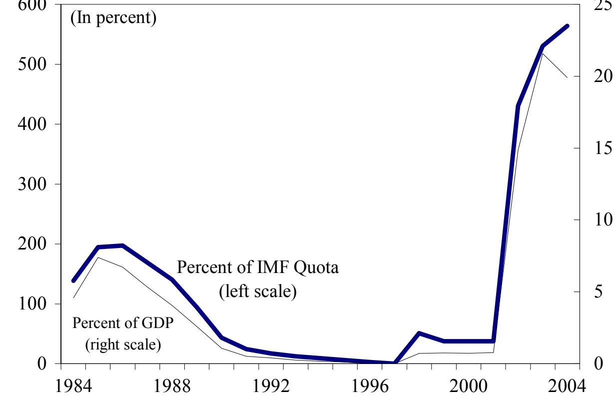

Source: INS and Fund staff

3. In early 2002, the authorities' strategy to stop the bank run focused on urging the banks, especially those that were foreign-owned, to resort to their own liquid resources and credit arrangements to meet withdrawals. As outflows intensified and became more widespread, the central bank began to provide liquidity assistance to "core banks" (essentially the large domestic banks, jointly accounting for 55 percent of resident deposits: two state-owned banks—BROU and the mortgage bank BHU; and four domestic private banks—*Comercial*, *Banco de Montevideo*, *Caja Obrera*, and *Banco de Crédito*). To boost confidence, the authorities raised interest rates, took measures to increase fiscal revenues and cut expenditures, and accelerated implementation of their structural reform program.

4. Recognizing that the crisis had been triggered mainly by contagion, many in the international community felt that Uruguay should be provided the full support one would give to an innocent bystander. However, a debate emerged on exactly how to stop the crisis. Some argued that confidence could be restored if the IMF, other multilaterals, and large advanced countries were to pledge extremely large amounts of assistance to cover fully the deposit base in domestically-owned banks (more than US$6 billion). Others pointed out that this course of action would have been unprecedented and that, despite Uruguay's relatively small economic size, the necessary amounts were unlikely to be forthcoming; moreover, they argued that the IMF should be seen as providing a "normal" degree of support, to avoid stoking concerns that the crisis was too severe.

5. On March 28, 2002, the authorities drew the US$200 million that Uruguay had accumulated under an existing precautionary Stand-By-Arrangement (SBA) from the IMF. In addition, the IMF's Board approved a new SBA for almost US$800 million over 2 years, with an upfront purchase of US$150 million (Figure 4). The financial support slowed the run for a few weeks, but deposit outflows accelerated again as a bank holiday was declared for April 19–29 in Argentina. As liquidity pressures and

Figure 4. Uruguay: Credit Outstanding with the IMF



reserve losses mounted, the largest domestically-owned banks (the two state-owned banks and four private banks) began to experience significant problems. It soon became clear that Uruguay needed further financial support.

6. However, with reserves dwindling to low levels, there was concern at the IMF about the pitfalls of supporting, and being seen as supporting, an exchange rate that looked increasingly unsustainable. It was well understood that a sharp depreciation would likely lead to major difficulties in the domestically-owned banks, with substantial fiscal consequences. Indeed, most deposits held by the domestically-owned banks were denominated in U.S. dollars, but such banks held limited dollar liquidity, and a large proportion of their dollar lending was to borrowers with no dollar earnings; state bank BROU and especially state mortgage bank BHU were financially weak; and the public debt, at 45 percent of GDP at end-2001, was almost entirely dollar-denominated. Some held the view that a devaluation at this time would unnecessarily trigger a far more damaging crisis. Others considered that competitiveness had to be restored for a program to be viable. In the end, the view prevailed that the authorities should allow the local currency to float prior to an augmentation of IMF financial support. On June 20, the authorities abandoned the crawling band regime that had been in place since the early 1990s. In the following two months, the Uruguayan peso depreciated against the U.S. dollar by a cumulative 60 percent and the public debt to GDP ratio doubled to near 100 percent. Depositors, fearing for the convertibility of their dollar savings, rushed to withdraw deposits.

7. On June 25, the SBA was augmented by US$1.5 billion (⅓ of which under SRF terms, and with US$500 million disbursed upon approval), making this the largest program, as a share of GDP, ever extended by the IMF to any member country (Table 1). The strategy now focused on enhancing the central bank's lender of last resort functions through the creation of the Fund for Fortifying the System of Banks (FFSB), with resources of US$500 million—large, but still far short of backing up total dollar deposits at the core banks. Confidence was not restored: the resources provided by the IMF under this first augmentation were used up in dealing with the acceleration of the bank run, with the FFSB providing US$450 million in liquidity support by end-July. In late July, the finance minister and the central bank governor resigned. By end-July, 42 percent of bank deposits had been withdrawn, and most domestic banks had become illiquid. With international reserves at critically low levels, the authorities imposed a bank holiday for July 30–August 4.

Table 1. Fund Credit Outstanding to Top Five Borrowing Member Countries, as of December 31, 2004

| | Billions of SDRs | Percent of Quota | Percent of 2004 GDP |
|---|---|---|---|
| Uruguay | 1.7 | 564 | 20 |
| After 2nd augmentation (Aug. 2002) 1/ | 2.1 | 694 | 23 |
| After 1st augmentation (June 2002) 1/ | 1.8 | 572 | 19 |
| Argentina | 9.1 | 429 | 10 |
| Turkey | 13.8 | 1,437 | 7 |
| Brazil | 16.1 | 531 | 4 |
| Indonesia | 6.2 | 300 | 4 |

Source: Staff calculations.

1/ Includes remaining access under the arrangement. Ratios expressed as percent of 2002 GDP.

8. The authorities sought additional financing from the IMF, though at this point they recognized that a portion of deposits would need to be reprogrammed. They estimated that another US$1.5 billion would be needed to stop the crisis decisively. Initially, there was reluctance at the IMF to augment access much further, and consideration was given to reprogramming a larger share of deposits than envisaged by the authorities. A large package of additional support was eventually agreed, facilitated by a one-week bridge loan by the United States, and with a substantially increased contribution from the World Bank and the Inter-American Development Bank (IADB).

9. On August 8, the IMF thus augmented the SBA a second time, by another US$500 million. Moreover, all remaining SRF purchases were cancelled and rephased under SBA terms. Thus the IMF made a total of US$800 million available upon approval. In addition, the IADB and the World Bank committed US$500 million and US$200 million, respectively. The authorities were therefore able to establish a new facility, the "Fund for the Stability of the Banking System" (FSBS), for US$1.4 billion. Unlike the FFSB, the FSBS was a separate account from the central bank's reserves, with the sole purpose of covering the dollar sight and savings deposits at core banks, and covered such deposits fully. The two state-owned banks had dollar time deposits subjected to government-mandated reprogramming over three years, and four private domestically-owned banks were deemed insolvent and had their operations suspended. Sight deposits and peso deposits remained unrestricted; no restrictions were placed on foreign banks, which were however expected to rely on their own resources. Some additional drain of deposits was recorded after the bank holiday was lifted (August 5), but a reflow, mostly from residents, began in October. In April–May 2003, a debt exchange postponed the bulk of payments to private creditors by about five years, implying a net present value reduction of 10–20 percent. The deal was widely viewed as well executed and relatively market friendly. Market access was regained almost immediately.

10. Although the economy is now recovering strongly, the costs of the crisis have been major. More than 10 percent of GDP was lost in 2002. Real wages fell by 20 percent between December 2001 and September 2002, and have not recovered since then. The real incomes of pensioners also dropped substantially. The unemployment rate, already high at 15 percent in early 2002, rose to 20 percent in late 2002. While Uruguay has traditionally had among the lowest levels of poverty and inequality in Latin America, the crisis had especially severe consequences for the lowest income brackets, with poverty rates almost doubling between 2001 and 2003.[2] The costs of resolving the banking crisis have amounted to 17 percentage points of GDP thus far, and additional costs of up to 5 percentage points of GDP could

[2] Poverty rates rose from 12 percent in 2001 to 21 percent in 2003 for households and from 19 percent to 31 percent for individuals. Poverty is especially widespread among households with young children, and less common among individuals above 65 years of age. About one half of children below 6 years of age are currently below the poverty line according to the National Statistical Institute's definition.

materialize in the next few years. The public debt stood at almost 90 percent of GDP at end-2004, with about 20 percent of GDP owed to the IMF and 22 percent of GDP to other multilaterals.

## II. Questions

11. **Uruguay's experience raises a number of important issues for the IMF's future engagement and for IMF policy in emerging markets more generally**. This ex-post assessment (EPA)[3] focuses on the following questions:

- While contagion no doubt played a major role, was it inevitable, after six years of precautionary SBAs, for an investment grade, relatively stable and successful emerging market, often dubbed as "the Switzerland of Latin America," suddenly to become engulfed in a major banking and debt crisis, requiring the largest-ever IMF package (as a share of local GDP)? What was the rationale for the series of precautionary stand-bys in the 1990s, and did they fulfill their objectives? (Sections III and IV)

- Were Uruguay's vulnerabilities foreseen, and were sufficient actions taken to reduce such vulnerabilities? (Section V)

- Could the crisis have been halted earlier, leading to lower economic and social costs and perhaps lower overall IMF exposure to Uruguay? Could the sequence of augmentations have been avoided, perhaps by combining a number of steps (such as the abandonment of the crawling peg and the resolution of the banking crisis)? What policies are needed to ensure medium-term fiscal debt sustainability, given the still very high level of public debt even after the 2003 debt exchange? (Section VI)

- Going forward, what kind of policies and program design would facilitate Uruguay's speedy strengthening of access to private capital markets and avoid excessively prolonged reliance on IMF financing? What areas should be the focus of the authorities' program, and IMF conditionality, in an attempt to reduce future vulnerabilities? (Section VII)

## III. Facts and Long-Standing Challenges

12. **Uruguay's economic performance was relatively strong in the 1990s.** Despite a recession that began in 1999, average growth was 3⅓ percent annually—far higher than in the

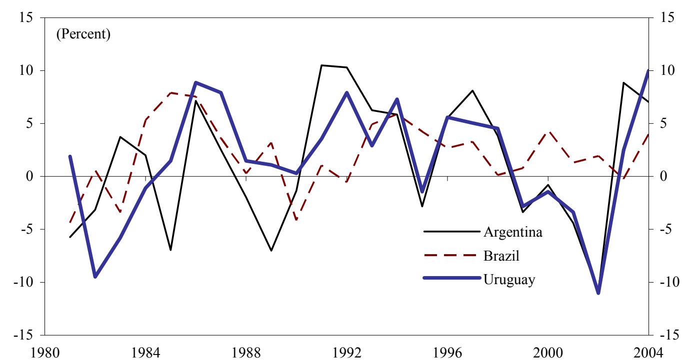
[3] Ex-post assessments (EPAs) are required for members with longer-term program engagement, including precautionary arrangements. Uruguay had almost continuous IMF Arrangements since March 1996, and thus for approximately 9 out of the 10 years through March 2005 (with largely precautionary arrangements for the first 6 of those years). Prior to the period covered by this EPA, Uruguay had two arrangements in the early 1990s, and four arrangements in the early 1980s. Over the years, Uruguay has also received substantial support from the Inter-American Development Bank (IADB) and the World Bank.

1960s–80s, when Uruguay's growth rate was among the weakest in Latin America. Inflation was also successfully brought down, in the context of an exchange-rate-based stabilization, from over 100 percent in 1990–91 to the single digits in the late 1990s. Macroeconomic policies were generally sound, and considerable progress was made with structural reforms, notably a pension reform. At the same time, a number of vulnerabilities gradually built up in the banking system and the fiscal accounts, partly as a result of real exchange rate appreciation. Moreover, a number of structural weaknesses in areas such as the tax system and state-owned banks and enterprises may have constrained economic performance, and will need to be addressed in order to ensure long-lasting growth and to restore fiscal and external sustainability.

## A. Economic Linkages with Trading Partners

13. **Many of Uruguay's vulnerabilities result from strong linkages to its larger neighbors, and are thus beyond the control of the authorities**. Uruguay's economic growth is highly correlated with developments in Argentina and, to a far lesser extent, Brazil (Figure 5). Indeed, medium-term growth developments, such as relatively slow growth in the 1970s–80s, and rapid growth in 1990–98, were similar to those in Argentina. In addition to the linkages through the banking system, developments in Argentina's GDP have a remarkably strong impact on the performance of Uruguay's large tourism sector, where Argentine residents account for more than two-thirds of total visits.

Figure 5. Real GDP Growth Rate
(Argentina, Brazil, and Uruguay)




14. **Beginning in the early 1990s, the process of trade integration under Mercosur heightened intraregional economic linkages.** The share of exports to Argentina and Brazil in Uruguay's total merchandise exports rose from one third in 1991–92 to one half in 1997–98.[4] While the IMF did not express a view on whether it was desirable for Uruguay to join Mercosur, it supported Uruguay's stance favoring liberal trade when protectionist tendencies emerged in the context of debates on policy stances to be taken by Mercosur. More recently, the IMF has encouraged Uruguay to increase openness to extra-Mercosur trade. Over the past decade, linkages with

[4] Such increases resulted from not only policies to heighten trade integration but also relatively strong economic growth in the region.

Argentina have also increased as a result of the shift toward services (financial services, tourism, and retail trade) within Uruguay's production structure.

### B. The Crawling Band and Gradual Inflation Stabilization

15. **It is worth considering whether it would have been desirable for Uruguay to move earlier to an alternative exchange rate system.** The question is especially relevant in light of the substantial real appreciation that preceded Uruguay's crisis and the relatively high frequency of crises experienced in recent years by a number of emerging markets with implicit or explicit exchange rate targets. Indeed, a crawling band may reduce economic agents' incentives to hedge against exchange rate risk. At the same time, when countries move to a float in a non-crisis context, it often takes several years for balance sheet mismatches to be reduced. This EPA suggests that, with the information available at the time, a move to a float would have seemed inconsistent with the objective of curbing inflation—until well into the recession that immediately preceded the crisis. Thus, while a move to a float in the late 1990s would have alerted economic agents to exchange rate risks, it seems unlikely that it would have prevented the 2002 crisis.

16. **The crawling band exchange rate system was a key element in the strategy to gradually reduce inflation.** As customary, the IMF largely took the exchange rate system as given, and sought to ensure that the macroeconomic policy stance was consistent with the authorities' choice. At the same time, it was recognized that the crawling band, periodically adjusted in line with targeted inflation, provided a valuable guide for inflation expectations. In 1990–95, the inflation rate differential vis-à-vis Uruguay's trading partners exceeded the rate of nominal depreciation, resulting in substantial real effective appreciation—not uncommon in exchange-rate based stabilizations (Hamann, 2001). Especially in the early years of the period covered by this EPA, staff emphasized the need for fiscal and wage policies to remain sufficiently restrictive to deliver the inflation objective and preserve Uruguay's competitiveness. Indeed, in 1996–98, the real effective exchange rate remained broadly constant.

17. **In consultations prior to 2002, the IMF and the authorities concurred that the crawling band system had served Uruguay well, and it was appropriate to maintain it.** In the aftermath of Brazil's move to a float in January 1999, it was noted that the system provided a desired degree of flexibility for a country situated between one large trading partner with a float and another with a currency board. Considering the high degree of dollarization in the economy, a step adjustment of the exchange rate was ruled out, because it could have triggered "difficulties in the banking system (especially in state-owned banks),

enterprise balance sheets, and public debt service (almost fully in dollars) and would have risked causing destabilizing capital flows" (p. 17).[5]

18. **Full dollarization did not seem desirable, and this EPA considers that there was no obviously opportune time to move to a float.** Full dollarization was rejected by the authorities, and would not have seemed desirable even while Argentina had a currency board, because Uruguay's share of trade with the United States or countries pegged to the U.S. dollar was less than one half. A possible move toward a float was not discussed. Successful exits to a float usually take place in good times, while the currency is not under downward pressure (Eichengreeen and others, 1998). Uruguay experienced rapid growth in 1990–98, but inflation was still 11 percent at end-1998, and an exchange rate anchor was still viewed as necessary to reduce inflation further. In hindsight, widening the exchange rate band in early 1999 would have cushioned the economy from the subsequent recession, and would not have stoked inflation. However, this was not known at the time: in 1999–2001, WEO forecasts overpredicted growth in Mercosur. Once the recession was well underway, a sharp depreciation would have imposed substantial strains onto the banking system, where nonperforming loans had risen rapidly. While (with the information available now) an earlier move to a float might have brought benefits, the main vulnerability was not the exchange rate regime itself, but rather the failure to undertake sufficient prudential measures in the banking system to prepare for the consequences of a sharp exchange rate depreciation.

## C. The Banking System

19. **The structural weaknesses and vulnerabilities that became evident with the 2002 banking crisis had been well known**. Indeed, exposure to exchange rate risk and weaknesses in the state banks had contributed to the severity of the 1982 banking crisis. While such vulnerabilities were emphasized in the context of surveillance and the series of precautionary SBAs in the late 1990s, the measures to which conditionality was attached in this area were, in retrospect, too timid compared with the magnitude of the task at hand. Perhaps because the authorities committed to treating the arrangements as precautionary, conditionality seems to have been imposed on measures that went in the right direction, but only at a speed that the authorities felt would not generate excessive frictions in Uruguay's consensus-based polity. Although compliance with the programs was generally good, banking was an area in which structural benchmarks would often be missed. The authorities appeared especially reluctant to challenge the status and influence of the state-owned banks, even with respect to prudential supervision of such banks.

[5] Staff added that as inflation abated, Uruguay could eventually move to a peg, which would help secure permanently low inflation. The desirability of a conventional peg as a "permanent" exchange rate regime is questionable for a country so highly integrated in international capital markets. However, this is immaterial from the standpoint of identifying the causes of the crisis.

20. **As early as the mid-1990s, the authorities' own assessment of the long-standing need for reform in the banking system was right on the mark**. Such assessment is well summarized in the 1995 Article IV Consultation, just prior to the first of the series of programs covered by this EPA: "The authorities are seeking to strengthen supervision of the financial system, particularly by bringing the state banks into compliance with the required reserve ratios, minimum capital requirements and portfolio regulations that apply to private banks. The authorities also plan to restructure the state banks with a view to consolidating their operations, curtailing employment, and reducing currency and maturity mismatches between assets and liabilities." Staff viewed these actions as "essential."

21. **Large nonresidents' deposits constituted evidence of the Uruguayan banking system's strengths, but also represented a source of vulnerability**. Strengths included relatively low lending exposure to the public sector and broadly sound indicators of capital adequacy. Moreover, Uruguay was conveniently located for Argentines residents seeking a tax haven or wishing to diversify internationally. Vulnerabilities resulting from the possibility of sudden deposit withdrawals by nonresidents were consistently highlighted in staff reports beginning in 1999.[6]

22. **Previous episodes of regional turbulence had led to even further net *inflows* of bank deposits into Uruguay, generating what ultimately proved to be a false sense of security**. Indeed, this tendency for nonresidents to treat Uruguay as a relative "safe haven" was observed during episodes such as the Tequila crisis and even the Argentine deposit freeze of 1990. Staff noted this tendency but recognized that it could not be relied upon. The World Bank's 2000 Country Assistance Strategy also saw the risk of "a change in Argentina that encourages Argentine residents to withdraw their deposits in Uruguayan banks."

23. **Other key vulnerabilities included dollarization with associated balance sheet mismatches, quasi-fiscal activities conducted by the state-owned banks, and weaknesses in prudential regulation and banking supervision**. Staff analysis of such vulnerabilities and related actions by the authorities are summarized in Box 1.[7]

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[6] For instance, in July 1999 it was stated that the high exposure of the banking system to short-term foreign deposits is a source of vulnerability which underscores the importance of maintaining bank soundness, as well as the need to preserve an extra margin of international reserves in the BCU. In May 2000, it was noted that Uruguay's ratio of reserves to imports, debt service, narrow money, and short-term debt of the nonfinancial public and private sector is adequate. Nevertheless, the banking system is large and carries a substantial amount of nonresident deposits, relative to the size of the economy, which is both a sign of confidence and a source of vulnerability. The report added that taking into account the presence of large nonresident deposits, Uruguay could be vulnerable to capital market shocks.

[7] Further detail is available in "Report on the 2002 Banking Crisis" (Country Report No. 03/247).

24. **On the whole, the authorities took a number of steps—some in the context of program conditionality with IFIs—to modernize the banking system, though eventually such steps proved too timid.** A reform program supported by a World Bank Financial Sector Adjustment Loan (approved in February 2000) centered on (i) establishing a level playing field between public and private banks, and reducing the role of the public sector in the financial area; (ii) strengthening banking supervision and regulation, and the transparency of financial information; and (iii) establishing mechanisms to allow an orderly exit of banks from the market. Some of the measures became structural benchmarks in IMF programs, and for the most part were undertaken, though often after substantial delay. Regrettably, IMF technical assistance missions on banking did not take place until late 2001. More generally, involvement by the IFIs in this area was rather limited between the early 1990s and 2000.[8]

## D. Medium-Term Fiscal Issues

25. **The fiscal area presented a number of medium-term challenges, especially with respect to Uruguay's relatively large public sector and generous social security system.** Uruguay's demographic profile, level of social security expenditure, and overall share of taxes (or expenditures) in GDP (about one third) have been more typical of an advanced economy than an emerging market. The large public sector and inefficiencies in the tax system and tax administration resulted in constraints on economic growth and medium-run pressures on expenditures. In particular, social security benefits rose from about 10 percent of GDP in the early 1990s to more than 15 percent of GDP in the late 1990s. Nevertheless, in most years, Uruguay's fiscal stance was not considered to be overly lax and debt accumulation remained modest.

26. **The main reforms undertaken in the mid- and late 1990s in the fiscal area were related to pensions, the size of the state, and de-indexation of wages.** Measures included a thorough revision of the public pay-as-you-go system and the establishment, alongside it, of a private capitalized pension system; efforts to reduce the scale and improve the efficiency of the public sector, through employment reduction and greater competition on the part of the private sector; and a lengthening of wage indexation lags. Of these measures, only the lengthening of wage indexation lags was covered by IMF program conditionality. Box 2 provides further details on these and other measures in the fiscal area.

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[8] After a considerable period of discussion, the authorities requested an FSAP for 2001. A preliminary mission took place in December 2001 and a full-fledged FSAP began only in March 2002, but was never completed because the banking crisis was well underway by then. (Prior to 2002, FSAPs had been undertaken in only 33 countries.) An earlier FSAP would have further clarified the magnitude and exact nature of the vulnerabilities, but it is not clear whether it would have led to further policy action in time to prevent the crisis.

**Box 1. Long-Standing Weaknesses and Related Measures in the Banking System**

- **Dollarization.** Uruguay is one of the most dollarized economies in Latin America. Its share of foreign currency deposits in total bank deposits rose from about 80 percent in the early 1990s to about 90 percent in the late 1990s, despite the impressive decline in inflation.

- **Weak financial position of the state-owned banks.** Lending (and refinancing of overdue loans) by the state-owned banks (BROU and BHU, jointly accounting for more than one third of total deposits and loans in the banking system) was often motivated by political economy / sectoral policy considerations (such as helping the agricultural sector). This resulted in quasi-fiscal activities and a relatively high proportion of non-performing loans. (NPLs also resulted in part from insufficient efforts to collect.) Independent external audits of the state banks conducted in the late 1990s (a structural benchmark met after some delay) helped identify specific areas for improvement. Employment in the state-owned banks was reduced (by about 20 percent in BROU between 1994 and 2000), despite opposition by the powerful bank employees union. Nevertheless, productivity in the state-owned banks remained lower than in the private banks.

- **Weaknesses in prudential regulation and banking supervision**. In particular:

  - **Lack of specific prudential rules to mitigate the risks associated with the high degree of dollarization and the large inflows of non-resident deposits.** There were no special liquidity requirements on such deposits, nor limits on exposure to currency risk or foreign currency lending. While the domestic banks accepted nonresidents' deposits in U.S. dollars, only a small portion of their assets was liquid and denominated in U.S. dollars. The domestic banks were also exposed to exchange rate depreciation risk because they held deposits mostly in U.S. dollars, but lent to the non-tradable sector, which would likely default in the event of a sharp depreciation. Exposure to the non-tradable sector was especially high for the state banks, notably mortgage bank BHU. Lending by BHU was in domestic currency, indexed to wages. Plans to improve currency and maturity mismatches at BHU were already discussed in early 1996.

  - **Failure by the state banks to comply with prudential regulations to the same extent as other banks.** Such failure may have been tolerated owing to the special role played by the state banks in pursuing political economy objectives. As early as the initial program covered by this EPA, the staff emphasized the need to bring the state banks into compliance with prudential regulation. Indeed, one of the key recommendations of the 1993 MAE TA mission (the last such mission prior to the 2002 crisis), was to give the central bank full supervisory control over the state banks. Recognizing the need to keep in check the activities of the state banks, the early programs set specific limits on the expansion of credit by the BROU and the Mortgage Bank. Beginning in the late 1990s, BROU and BHU improved their provision of information through measures such as the reduction of lags in data reporting to the central bank and, for the first time, the publication of annual profit and loss statements. Supervisory control of the state banks by the central bank was enhanced only in December 2002.

  - **Vulnerabilities resulting from excessive concentration of country risk.** For a number of banks, the share of loans to Argentine residents (or bonds issued by Argentine entities) in total assets represented a vulnerability that they would not withstand.

- **Lack of clarity in the mechanism for orderly exit of banks.** This slowed the resolution of crises (including the 2002 crisis). Intervened banks were often merged and rarely privatized. Privatization of two intervened banks (jointly accounting for almost 10 percent of the banking system) featured as a structural benchmark for three years in a row, until 1999. At that point, staff appropriately decided not to list again the promise of privatization. Staff urged the authorities to "find a way to permit market-based exit of banks or a reduction in banking capacity," though not outlining a more specific proposal.

## Box 2. Medium-Term Fiscal Issues and Related Measures

- **Pension Reform.** The reform of the main pension system was introduced prior to the precautionary SBAs (the related legislation was passed in September 1995), though it was fully supported by staff, and implemented beginning in 1996 with financial and technical support from the IADB. The reform implied costs (½ to 1 percentage point of GDP in lower social security contributions from members that shifted to the private system) in the initial years, with savings in the long run (when such members retire). As a result of the reform, social security expenditure is projected to decline to 10 percent of GDP (rather than rising to about 17 percent of GDP) by 2035. At the time of approval of the first precautionary SBA covered by this EPA (February 1996), the authorities expected to submit legislation to congress to reform the special pension funds for bank employees, police, and the military. In April 2000 this became a structural benchmark for end-June 2001. Such reforms have not been approved to date.

- **State Reform and Public Enterprises.** Following legislation introduced in December 1995, public sector employment was reduced by a cumulative 10 percent through end-1999, with costs of severance payments and incentives under this program initially amounting to about ½ percent of GDP per year. While state run enterprises have remained pervasive (their combined revenues amounted to 12–14 percent of GDP in the mid-1990s), their total employment fell by one third between 1990 and 1997, and the private sector has gradually been allowed to participate in some activities that had previously been reserved for public entities. (State run enterprises include the electricity company; the alcohol, petroleum and cement company; the telecommunications company; the water and sanitation company; the railways; and the port authority). Outright privatization has been considered a political non-starter, pointing to a 1992 referendum that overturned legislation allowing the partial privatization of the telephone company. In 2000, an FAD TA mission found that several public enterprises, in addition to the state-owned banks, engaged in substantial quasi-fiscal activities.

- **Public Sector Wage Policy and Indexation.** The early precautionary SBAs paid close attention to wage increases in the public sector, which were viewed as not only an important determinant of overall public expenditure, but also a key lever in the fight against inflation. (Relatedly, pension benefits are indexed to wages.) In December 1997, congress approved legislation to extend the period for adjusting public sector wages from every four months to six months, and to once a year when the 12-month inflation rate is below 10 percent. This was a structural benchmark under the IMF-supported program.

- **The Tax System and Tax Administration.** With revenues higher than in most emerging markets, at more than 30 percent of GDP in the late 1990s, the policy dialogue has focused on how to broaden the tax base in order to reduce distortions and make room to cut tax rates. A number of TA missions by the Fiscal Affairs Department highlighted the need to reduce the number of taxes and simplify the tax system, and to improve tax administration by providing additional human and information technology resources. Occasionally, staff would recommend tax cuts, to be financed by expenditure cuts. The staff has also suggested a reduction in tax exemptions: revenue costs associated with tax exemptions (largely VAT exemptions) have been estimated at 28 percent of net revenues (Rossa and Roca, 2001).

- **Debt Management.** The authorities successfully reduced the share of short-term debt in total public debt from its relatively high levels in the mid-1990s. (Initially, such improvement was facilitated by the IADB's financial support for Uruguay's structural reform program.) When the 2002 crisis hit, the debt's average maturity was in excess of 7 years and maturities were spread out. The debt's currency composition played an important role in exacerbating the effects of the crisis.

- **Budgetary Process.** The 2001 Fiscal Report on the Observance of Standards and Codes (ROSC) identified a number of weaknesses in the budgetary process, including the need for an improved medium-term framework and the absence of a tax expenditures budget. To put this in international perspective, according to the only rudimentary index currently available, Uruguay ranked 6th out of 20 countries in the late 1990s with respect to the quality of budget institutions (Alesina and others, 1999). Prior to 2002, the need to improve the budgetary process had not been mentioned in staff reports.

## E. The Fiscal Stance

27. **In hindsight, the occurrence of a debt exchange suggests that fiscal policies should have been more prudent in the past.** Nevertheless, two narrower questions may be appropriate in the context of this EPA. First, when should fiscal policy have been tightened? Second, could the crisis have been prevented through more prudent fiscal policies in the context of the programs under consideration (that is, beginning in 1996)?

28. **The IMF consistently argued for tighter fiscal policy.** The main rationale, however, was to reduce the degree of real appreciation, rather than to improve debt sustainability. Moreover, the effectiveness of IMF calls for fiscal tightening may have been diminished by their being repeated with little change in emphasis or sense of urgency from year to year, seemingly regardless of the economy's cyclical position.

29. **Greater fiscal tightening should have been undertaken to build up more robust cushions, especially during times of rapid growth (the early 1990s and 1996–98).** In the years following the Tequila crisis, growth rebounded strongly, but the primary surplus remained at approximately the same level as in 1995. The cyclically-adjusted fiscal stance was strongly expansionary in 1994, an election year; strongly contractionary in 1995, when a new government cut expenditures considerably, despite negative growth associated with the Tequila crisis; and somewhat expansionary again in 1996–98, even allowing for the costs resulting from the social security reform. Staff was critical of the increase in the deficit in 1999, and emphasized that this may have been in large part motivated by the elections. Regardless of the motivation, however, with growth falling by 7½ percentage points, a weakening of the primary by less than 3 percentage points of GDP implies only a small increase in the cyclically-adjusted fiscal surplus, which does not seem unusual in a recession. Similarly, the fiscal stance in 2000 and 2001 was mildly contractionary. Thus fiscal policy in 1999–2001 was not excessively expansionary from a cyclical point of view (given the recession), but proved insufficiently tight for an emerging market borrowing in foreign currency and facing a number of vulnerabilities.

30. **A desirable degree of additional fiscal tightening *during the period covered by this EPA* would have somewhat facilitated the current task of reducing the debt to sustainable levels, even if it probably would not have obviated the need for a debt exchange.** The debt-to-GDP ratio was marginally above 30 percent in 1994, and hovered at approximately that level until 1999. A consensus seems to have recently emerged that, especially with most of the debt in foreign currency, a debt-to-GDP ratio of 30 percent requires careful monitoring.[9] This said, it seems that the series of precautionary programs under consideration could have considerably reduced the likelihood of a crisis only by targeting much lower deficits, thus possibly running the risk of placing a dent in growth.

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[9] Such a ratio would not have looked out of the ordinary in the 1990s, and was not higher than average among Latin American emerging market countries.

31. **The main vulnerability with respect to the debt related to its large foreign currency share.** Indeed, the debt-to-GDP ratio increased rapidly (by more than 10 percentage points, cumulatively) only after end-1999, to 43 percent at end-2001 (Table 2). This increase is largely accounted for by the opening of a gap between the rate of nominal depreciation vis-à-vis the U.S. dollar and the inflation rate (based on the GDP deflator), with the remainder attributable to the decline in real GDP.

## IV. Precautionary Programs: CCL-Like, Seal of Approval, or Crutch?

### A. What was the Rationale for the Precautionary SBAs?

32. **The rationale for the precautionary programs was based upon a number of factors**, though the relative emphasis placed on each evolved over time, along with the challenges arising from a changing economic environment:

- **A shield against contagion.** Uruguay was viewed as a generally responsible country with strong fundamentals, but located in a volatile environment, and was thus subject to external shocks, including capital account shocks. This justification—emphasized especially in the initial program that began soon after the Tequila crisis—is reminiscent of the arguments in favor of facilities such as the Contingent Credit Lines (CCL).
- **The need to support the authorities' efforts in consolidating macroeconomic stabilization and structural reform.** A possible interpretation is that it was felt that the authorities could point to IMF conditionality as a justification for measures that, while desirable, were politically difficult.
- **A seal of approval**. Fund programs were aimed at underpinning confidence in the country' policies, presumably with a view to reassuring international financial market participants.

33. **An "exit" from precautionary programs was not really considered, and "prolonged use" would probably have been viewed as a sign of good performance and cooperation.** The authorities and IMF staff felt that the precautionary arrangements increased the intensity and quality of the dialogue, which was based on better fleshed out macroeconomic programs and enhanced data provision. It was also felt that, with money on the table, the authorities were more likely to give serious consideration to the IMF's advice. There was also a view that saw precautionary programs as an "exit" from full-fledged SBAs, leading to a reduction of IMF exposure as previous disbursements were being repaid. Justification for successive programs, on the basis of the corresponding staff reports, seemed to become a matter of routine.[10] The World Bank's 2000 Country Assistance Strategy envisaged halving the World Bank's lending to Uruguay, owing to the country's relatively high social indicators and per capita income, and its attainment of investment grade status.

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[10] The May 2000 request for a 22-month precautionary SBA referred to the need to help the new government meet the challenge of restoring growth while maintaining low inflation and, to that end, a need to boost competitiveness, through structural reforms and cost reductions, and to reestablish fiscal discipline.

Table 2. Uruguay: Accounting for the Increases in the Debt-to-GDP Ratio 1994–2004 1/
(In percentage points of GDP, unless otherwise indicated)

| | Actual | | | | | | | | | | Est. |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
| **Public sector debt** | 31.5 | 29.8 | 29.0 | 28.7 | 30.2 | 31.1 | 35.7 | 42.8 | 85.1 | 105.3 | 88.4 |
| Change in public sector debt | -0.8 | -1.8 | -0.8 | -0.3 | 1.5 | 0.9 | 4.6 | 7.1 | 42.3 | 20.3 | -17.0 |
| Primary deficit | 0.9 | -0.8 | -0.5 | -0.4 | -0.9 | 1.8 | 1.4 | 1.0 | -0.5 | -2.9 | -3.8 |
| Real GDP growth | -1.6 | 0.3 | -1.2 | -1.1 | -1.2 | 0.9 | 0.4 | 1.2 | 4.5 | -1.8 | -10.3 |
| Exchange rate depreciation and real interest rate | -0.8 | -0.4 | 1.2 | 1.1 | 1.5 | 3.1 | 3.9 | 7.7 | 37.1 | -1.6 | -2.3 |
| Bank recapitalization | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 16.9 | 0.0 | 0.0 |
| Statistical discrepancy | 0.7 | -0.9 | -0.2 | 0.2 | 2.1 | -4.9 | -1.1 | -2.9 | -15.7 | 26.5 | -0.5 |
| **Memorandum items:** | | | | | | | | | | | |
| Real GDP growth (in percent) | 7.3 | -1.4 | 5.6 | 4.9 | 4.7 | -2.8 | -1.4 | -3.4 | -11.0 | 2.5 | 12.0 |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | -30.0 | -31.8 | -17.8 | -10.9 | -1.9 | 2.6 | 4.5 | 2.4 | -5.4 | -9.7 | -3.2 |
| Nominal appreciation (increase in US dollar value of local currency, in percent) | -21.2 | -21.2 | -18.4 | -13.2 | -7.2 | -6.9 | -7.2 | -15.3 | -45.7 | -6.8 | -1.5 |
| Growth of real primary spending (deflated by GDP deflator, in percent) | 14.0 | -6.9 | 6.1 | 6.6 | 12.1 | 5.2 | -5.1 | -1.8 | -19.9 | -3.7 | 11.1 |

Source: Fund calculations.

1/ Framework covers the nonfinancial public sector (including obligations to the Fund) and debt is measured in gross terms.

### B. Were the Program Objectives Achieved?

34. **During the 1990s, the authorities conducted generally prudent macroeconomic policies, and undertook desirable structural reforms, though in a gradual, consensus-based manner.** While there was broad agreement within society on the importance of macroeconomic stability, the need to build consensus on structural reforms within coalition governments led to somewhat slower progress in this area. Inflation was reduced, and fiscal deficits were kept lower than in many comparable countries. Accomplishments on the structural front were considerable, including a reform of the pension system, a reduction in civil service employment, the introduction of competition in some of the sectors previously dominated by state companies, and a reduction in the extent of wage indexation. In retrospect, however, reforms could have been more ambitious, especially in 1996–98, when the opportunity provided by rapid growth could have been better leveraged. To support reforms, better integration of technical assistance recommendations in the monetary/banking and fiscal areas of IMF arrangements could have helped.[11]

35. **On the whole, the extent of, and compliance with, structural conditionality for Uruguay seems to have been broadly similar to those for other countries with precautionary SBAs.** The number of structural benchmarks and, later, structural performance criteria set in the context of the precautionary SBAs followed a similar rising trend as in other countries in the late 1990s (Figure 6 and Table 3). Although several structural benchmarks were missed, this was far from unusual compared with other countries.

36. **The authorities' policies (especially with respect to structural reforms) would probably not have been fundamentally different in the absence of the precautionary arrangements of 1996–2001.** This impression is based on the following considerations. The gradual reduction in inflation from over 100 percent at the beginning of the 1990s took place both under IMF programs and in their absence—though notable legislation to extend the period for adjusting public sector wages was introduced under IMF conditionality. While sharp increases in the fiscal deficit were occasionally observed in the absence of IMF programs (for example, during the election year of 1994) and IMF conditionality may have

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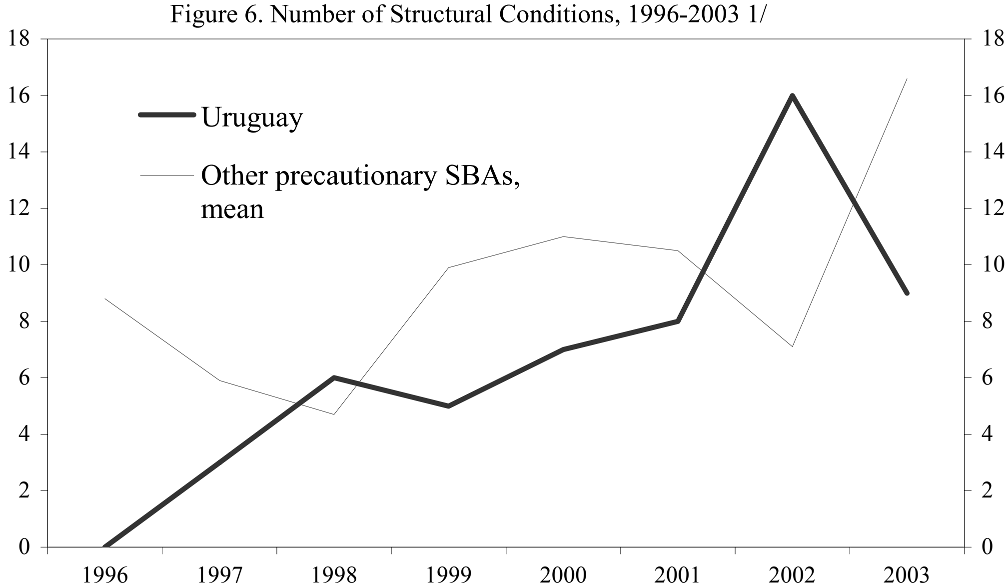
[11] With regard to structural banking issues, although it was understood that the IDB and the World Bank played a key role, the absence of IMF technical assistance missions to Uruguay between 1993 and 2001 is regrettable. The IADB provided a financial sector loan in 1991, which led to improvements in banking supervision, and a loan in 1998 that supported the supervision of nonbank financial entities. As noted, the World Bank provided an FSAL in 2000. On the whole, the IFIs provided very limited technical assistance in the area of banking, and banking supervision in particular, between the early 1990s and the 2002 banking crisis. With regard to fiscal issues, technical assistance was somewhat more frequent (though again mainly concentrated in the first half of the 1990s). Effectiveness could have been further enhanced by even greater emphasis in recommendations on cross-country perspectives and assessments of the relative impact of the various proposed measures on macroeconomic aggregates and economic efficiency.

helped minority/coalition governments counteract parliamentary pressures for higher spending or lower taxes, the authorities had already demonstrated their ability to curb the deficit prior to the IMF programs (for example, in 1995). The authorities willingly undertook considerable reforms throughout the period under review; however, while under IMF-supported programs, they did not deviate from their gradual, consensus-based approach. The reform of the main pension system was set in train prior to the precautionary programs with the IMF, though the authorities were aware that any Fund program would have had to envisage it to bring viability to the public finances. The reforms of the special pension funds were not undertaken despite almost a decade of programs with the IMF.

Figure 6. Number of Structural Conditions, 1996-2003 1/




Source: MONA.
1/ Structural performance criteria and benchmarks.

37. **One exception is the area of banking, where conditionality by the IMF and other multilaterals may have helped speed up reform, but the precautionary SBAs failed to bring about the changes that might have prevented the 2002 banking crisis.** Especially in the late 1990s, programs placed considerable emphasis on banking, and in that area, conditionality seems to have fostered, to some extent, desirable reforms. This leads to the question of why the IMF did not halt the programs when progress in reforming the banking system proved too slow. A possible factor is that, by the time concerns about banking became more severe, the Brazilian crisis had already taken place. The resulting heightened vulnerability implied greater incentives for the authorities to comply with IMF conditionality, but also for the IMF not to be seen as abandoning a generally well-performing and cooperative country.

Table 3. Uruguay: Structural Benchmarks and Performance Criteria (1996-2005)

| Structural Benchmarks (or PCs as indicated) 1/ | PC | Timing | Area | Status |
|---|---|---|---|---|
| **SBA 1996–97** | | | | |
| *No structural measures included* | | | | |
| **SBA 1997–99** | | | | |
| Reduce public sector employment | | Dec 97 | Fiscal | Observed |
| Sale of Banco La Caja Obrera | | Dec 97 | Financial | Not observed |
| Submit new bankruptcy law to Congress | | Sept 97 | Business | Not observed |
| **SBA 1999–00** | | | | |
| Finalize action plan to subscribe to the SDDS | | March 99 | Statistics | Observed |
| Reduce the BROU's reporting lag of monetary data | | June 99 | Statistics | Not observed |
| End intervention in three banks (BPA, Banco la Caja Obrera, Banco de Credito) | | June 99 | Financial | Not observed |
| Revise national account statistics and develop indicators of economic activity | | Dec 99 | Statistics | Partially observed. |
| Conduct external audit of the state-owned financial institutions (BROU, BHU, BSE) | | Dec 99 | Financial | Not observed |
| **SBA 2000–02** | | | | |
| Complete external independent analysis of the loan portfolio of BROU and BHU | | Sept 00 | Financial | Observed |
| Submit draft law to Congress to revoke ICOME | | Sept 00 | Fiscal | Observed |
| Submit draft law to Congress to eliminate social security surcharge on public enterprises | | Sept 00 | Pensions | Observed |
| Initiate study of quasi-fiscal operations of the public sector | | Sept 00 | Fiscal | Observed |
| Release monthly data of public sector finances | | Sept 00 | Fiscal | Observed |
| Reduce the BROU and BHU reporting lag of monetary data | | Sept 00 | Financial | Observed with small delay |
| Publish quarterly reports of public enterprises and financial institutions | | March 01 | Fiscal | Observed, originally set for Dec 00 |
| Complete independent external audit of BROU, BHU, and BSE | | March 01 | Financial | Missed BSE |
| Complete independent external audit of public enterprises | | March 01 | Fiscal | Missed for one company. |
| Publish audited annual reports of public enterprises and financial institutions | | June 01 | Fiscal | Missed BSE |
| Complete study on quasi-fiscal operations of the public sector | | June 01 | Fiscal | Observed |
| Submit draft law to reform special pension funds (banks, university, notaries, police and military) | | June 01 | Pensions | Observed for notaries, originally set for March |
| Private and public sector banks to place debentures in the capital market equivalent to a minimum of 2 percent of their deposits. | | Sept 01 | Financial | Dropped, missed in June and Sept |
| Submit to Congress draft law on the reform of the special pension fund for university | | Sept 01 | Pensions | Observed |
| Submit to Congress draft law for reform of special pension funds of the police | | Dec 01 | Pensions | Observed |
| Submit to Congress legislation to eliminate the petroleum import monopoly | | Dec 01 | Business | Observed |
| Submit to Congress legislation to eliminate the petroleum refining monopoly | | Dec 01 | Business | Dropped |
| **SBA 2002–05** | | | | |
| Develop peso-denominated, inflation-indexed securities. | | June 02 | Financial | Observed with delay |
| Issue decree on voluntary retirement and redundancy in public enterprises | | June 02 | Pensions | Not observed |
| Present to Congress a law extending the May tax measures | X | June 02 | Fiscal | Observed |
| Present to Congress the restructuring plan of BHU | X | July 02 | Financial | Observed |
| Develop plan to improve prudential regulation of BROU | | Aug 02 | Financial | Observed |
| Approval by Congress of the law establishing the FFSB | X | Sept 02 | Financial | Dropped because replaced |
| Present to Congress of the reform to rationalize and simplify the tax system | | Dec 02 | Fiscal | Observed |
| Do not open unviable banks | X | Continuous | Financial | Observed |
| Issue decree to foster competition in the telecommunications sector | | March 03 | Business | Observed |
| Prepare a strategy document for disposal of remaining assets of suspended banks | | March 03 | Financial | Not observed |
| Publish monthly bank balance sheets with a two month lag | | Continuous | Statistics | Observed (after modifications) |
| Agree between the BROU, the BCU and the government on a reform plan for BROU | | Aug 03 | Financial | Observed with small delay |
| Complete the external audit of the FSBS | | Sept 03 | Financial | Partly observed. |
| Submit data for the SDDS for publication | | Sept 03 | Statistics | Partly observed |
| Issue decree or regulations to foster competition in the oil sector | | Dec 03 | Business | Observed. Modified along the way. |
| Select winning bids for outsourcing of assets of liquidated banks | X | March 04 | Financial | Observed with delay |
| Fiduciary trust of BROU to enter into contract for dealing with NPLs | X | March 04 | Financial | Observed with a small delay |
| Timely service BHU note to BROU | X | Continuous | Financial | Observed |
| Complete supplementary external audit of the FSBS. | | March 04 | Financial | Not observed, in process |
| Complete external audit of assets transferred from BROU to the fiduciary trust | | June 04 | Financial | Not observed, in process |
| Complete external audit of the BCU 2003 accounts | | June 04 | Financial | Observed |
| Complete external financial audit of the liquidation funds | X | Oct 04 | Financial | Observed with small delay |
| Complete the transfer to the fiduciary trust of all Category 4 and 5 NPLs | X | Dec 04 | Financial | Observed |
| Publish semi-annual financial reports of the liquidation funds | X | Dec 04 | Financial | Observed (after modifications) |
| Submission of monthly financial statement of the liquidation funds | X | Sept 04 | Financial | Observed with delay and modified |
| Incorporate information on nonperforming borrowers into the credit registry | X | Dec 04 | Financial | Not obsrved, prior action for next review |
| Establish a Large Taxpayer Unit at the DGI | | Dec 04 | Fiscal | Not observed, SB already for Sept. 04 |
| Approval by Congress of the reform of the pension fund for bank employees | | Dec 04 | Pensions | Dropped, had been missed already |
| Approval by Congress of the reform of the pension fund for the police and military | | Dec 04 | Pensions | Not observed, SB already for June, Sept. 03 |
| Asset manager to reach 700 payment agreements | | Jan 05 | Financial | Observed |
| Complete semiannual financial reports of the liquidation funds | X | Jan 05 | Financial | Observed |

1/ Structural measures representing intermediate steps toward other structural measures that were observed are not listed

38. **The precautionary SBAs may have played a helpful role in preventing contagion prior to the 2002 crisis.** Following uncertainties related to developments in Russia and Brazil, in late 1998 the Uruguayan peso came under pressure and the authorities were able to draw US$150 million promptly under the SBA (which had been treated as precautionary until then) and to obtain additional support from the IADB and the World Bank. Combined with actions by the authorities—an interest rate hike and fiscal tightening—this stabilized the situation. The precautionary SBAs may also have reduced contagion in previous years, though few countries in Latin America experienced full-blown crises triggered by international contagion at the time of the Asian and Russian crises.

39. **IMF programs did provide a "seal of approval" that made it easier for Uruguay to borrow at lower interest rates on global markets.** Uruguay obtained its investment grade rating in 1997, maintaining it until early 2002, and an unintended effect of IMF support may have been to facilitate additional borrowing. With the country being a relatively small borrower, it is possible that many investors relied on the judgment of the IMF and of the rating agencies, rather than investing resources in closely monitoring the Uruguayan economy. Spreads on Uruguay's bonds remained broadly stable until the beginning of 2002, even though by that time—as shown in the next section—markets had already priced in a crisis in Argentina, and serious vulnerabilities had emerged for Uruguay.

## V. Vulnerabilities Building Up

40. As shown in Section III, a number of vulnerabilities had largely been identified as early as the mid-1990s. However, when did such vulnerabilities become more prominent, and was the increase recognized in a timely manner? (Appendix I reports indicators of vulnerability in greater detail.)

41. **The real appreciation that followed Brazil's move to a float (January 1999) and the economic downturn in the region were seen as considerable challenges.** Despite a substantial real appreciation in the early 1990s, in 1998 staff viewed the economy as having "adjusted well to the higher real exchange rate level." Indeed, current account deficits equivalent to 1½ percent of GDP in 1995–98 would not have seemed excessive for a country at Uruguay's level of economic development. With Brazil's move to a float, however, the real exchange rate appreciated by another 10 percentage points. Later, slowdowns in Argentina and Brazil would generate concerns regarding Uruguay's growth prospects as well.

42. **Beginning in 1999, banking soundness indicators worsened; correspondingly, the IMF expressed increasing concerns.** With the economic slowdown, profitability dropped and the share of nonperforming loans rose substantially, especially in the state-owned banks. The state-owned banks seemed to be well capitalized, though the quality of their portfolios and therefore their true level of capital were found to be lower than previously estimated, based on independent audits (structural benchmarks under the IMF program). In February 2001, staff concluded that the private banking system "appear[ed] sound," but raised concerns about vulnerability, especially for the state-owned banks (Country Report No. 01/47).

43. **In July 2001, IMF staff communicated serious concerns regarding the impact of a (then) hypothetical crisis in Argentina on the Uruguayan banking system.** The mission shared with the authorities a scenario that estimated the consequences of a sharp depreciation of the Uruguayan peso for the various groups of banks and the public finances. The scenario foresaw an increase in Uruguay's debt-to-GDP ratio to 92 percent by end-2002. These concerns were reflected in the (regularly published) September 2001 staff report. "If Uruguay were forced, by the circumstances, to adopt an exchange rate system more akin to a free float, the valuation effects would seriously impair the ability for households and businesses to service their dollar debts to the banks, leading almost inevitably to the need for financial assistance from the public sector to the banks, thereby compounding the valuation shock already present in the public debt itself" (Country Report No. 01/185). The report referred to Uruguay as "highly vulnerable," noted the recent sharp rise in the public debt, and pointed out that the state-owned banks were "not sound," highlighting increases in problem loans and declines in profitability in the state-owned banks.

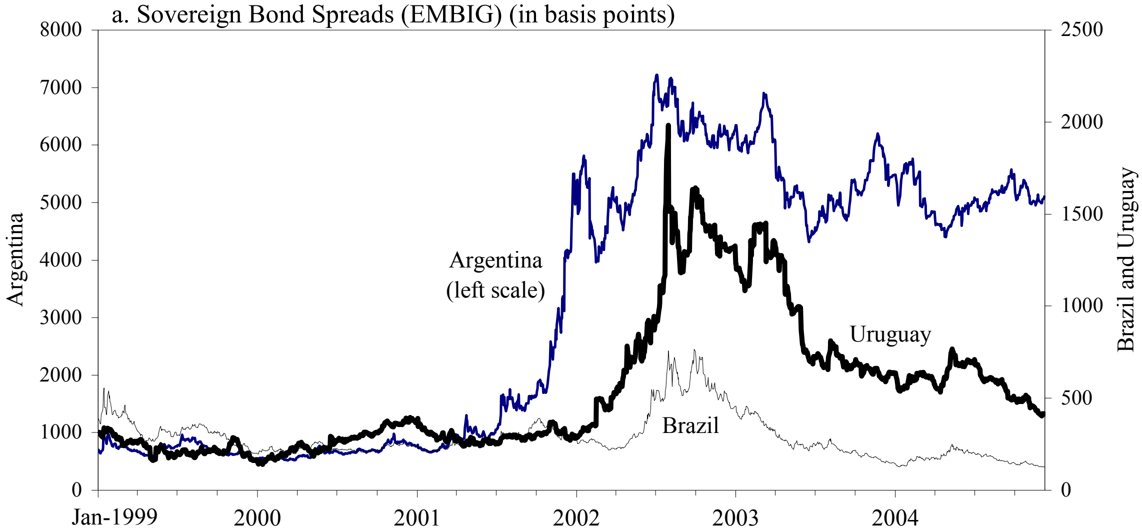
44. **Meanwhile, market participants did not seem concerned about Uruguay until early 2002, well into the Argentine crisis.** Asset prices such as the Argentine peso-U.S. dollar nondeliverable forward exchange rate and the index (EMBIG) of sovereign bond spreads increasingly signaled the likelihood of a financial crisis in Argentina beginning in the spring–summer of 2001 (Figures 7 and 8). Nevertheless, in late 2001, Uruguay undertook sizable international bond issues (US$300 million in November and US$110 million in December) at spreads of 250–300 basis points. The index (EMBIG) of Uruguay's bond spreads remained relatively low, at 350 basis points, until mid-February 2002, and the first downgrade by one of the main rating agencies did not occur until February 2002. It seems that international investors did not anticipate the crisis, nor did the rating agencies warn them about it.

45. **The immediate trigger for the crisis—deposit freezes in Argentina—was difficult to foresee.** Indeed, as late as the fall of 2001, nonresident deposits were still flowing *into* Uruguay on a net basis, consistent with previously observed patterns of net deposit inflows in times of regional turbulence. Deposit freezes in Argentina were compounded by another unexpected event—alleged fraud in one of the Uruguayan banks.

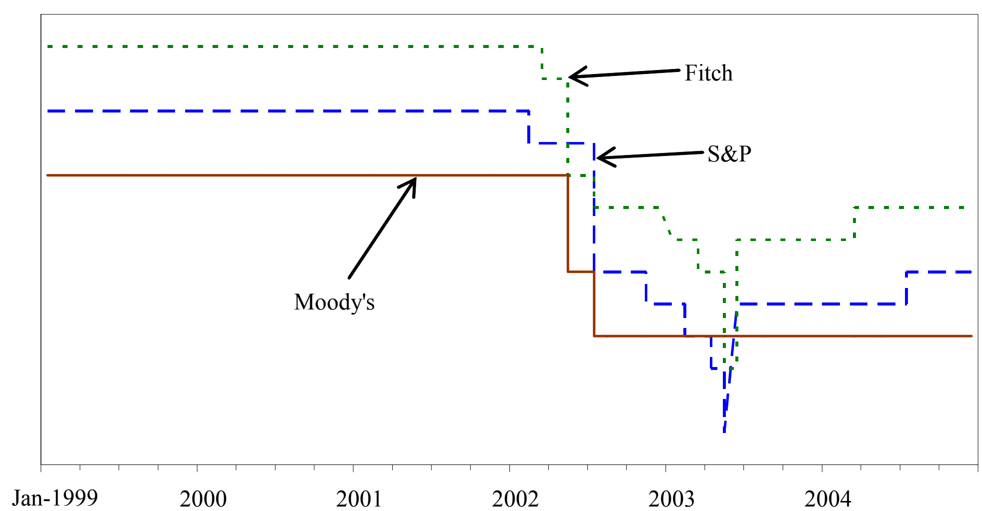
46. **In hindsight, the root causes of the crisis should have been tackled earlier.** By late 2001, more aggressive bank supervision and regulation might have helped identify especially vulnerable points in the system, but it seems unlikely that the crisis could have been avoided at this point. The requisite comprehensive reforms would have taken longer than a few months to eliminate the well-understood underlying causes of the crisis—such as currency mismatches, insufficient liquidity to back up dollar deposits in the Uruguayan banks, and weaknesses in the state-owned banks. Such reforms should have been undertaken in previous years.

Figure 7. International Comparison: Sovereign Bond Spreads and Ratings

a. Sovereign Bond Spreads (EMBIG) (in basis points)



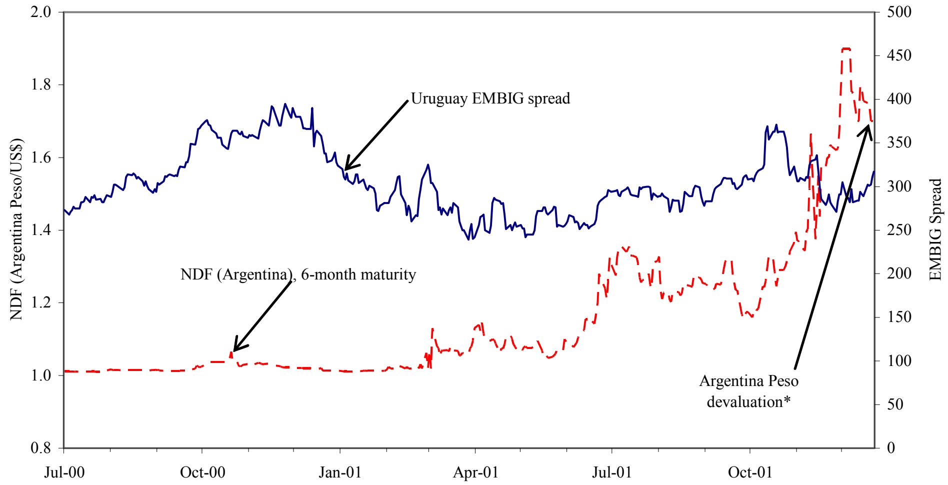

b. Uruguay's Sovereign Ratings 1/




Sources: J. P. Morgan and Bloomberg.

1/ *Fitch:* BBB- through 3/12/02; BB+ through 5/27/02; B+ through 7/29/02; B through 1/6/03; B- through 3/11/03; CCC- through 4/9/03; CCC- through 5/15/03; DDD through 6/16/03; B- through 3/28/04; and B from 3/29/04. *Standard and Poor's:* BBB- through 2/13/02; BB+ through 7/25/02; B through 11/20/02; B- through 2/10/03; CCC through 4/9/03; CC through 5/15/03; SD through 6/1/03; B- through 7/20/04; and B from 7/21/04. *Moody's:* Baa3 through 05/02/02; Ba2 through 07/9/02; B1 through 07/30/02; and B3 from 07/31/02.

Figure 8. Argentine Peso Nondeliverable Forward Exchange Rate
and Uruguay's Sovereign Bond Spreads (EMBIG)




*The Argentine Peso was officially devalued on 01/07/02.
Sources: J. P. Morgan and Bloomberg.

## VI. The 2002 Crisis: Proximate Causes and IMF Response

### A. Crisis Management and Resolution

47. **The IMF's support to Uruguay in 2002 was unprecedented in magnitude, and broke new ground in a number of respects.** This was the first program essentially aimed at strengthening a central bank's lender of last resort function in a highly dollarized economy. In order to do so, the IMF raised its exposure in Uruguay to the highest among member countries (relative to the size of the economy), and boosted its shares in Uruguay's total and multilateral debt. As was well recognized at the time, this involved undertaking major risks that would unwind, even under favorable scenarios, only over a number of years. At the present time, there is broad agreement that the support by the IMF and other IFIs helped Uruguay adjust to the consequences of its worst financial crisis, though major risks and challenges to restore the country to sustainability will persist in the medium term.

48. **However, this EPA considers that somewhat larger access under an IMF arrangement in support of stronger policy and more comprehensive action would have been desirable in early 2002.** Admittedly, in early 2002 it remained somewhat uncertain whether the crisis underway was systemic. Nevertheless, with a major crisis in Argentina, the resulting major risks for the Uruguayan economy were well understood. In hindsight, one wonders whether a somewhat larger package early on could have prevented panic among residents, who had not yet started withdrawing their deposits en masse.

49. **The design of IMF arrangements is not ideally suited to dealing with banking crises, and tends to result in lower immediate disbursements but higher total access than might be desirable.** The typical lender-of-last-resort approach in a domestic banking context is for the central bank to choose the deposits that it wishes to guarantee, and then to back them up fully. More generally, to restore confidence, large amounts of financial

assistance should be available quickly, and for as long as necessary. Standard IMF programs with various tranches disbursed over one or more years, subject to conditionality, suffer from two flaws in this context: first, they do not make sufficient funds available upfront and with certainty; second, they make funds available even after the crisis may have subsided.[12] Although the arrangement (and augmentations) involved considerable frontloading of disbursements, the customary structure with tranches was maintained. For a given amount of access, this tended to weaken the program's ability to stop the banking crisis, and to maintain access to additional resources after the deposit withdrawals had ended.

50. **Even with the benefit of hindsight, the decision to let the exchange rate float seems to have been a close call.** On the whole, compared with widening the band and accelerating the depreciation rate of the central parity, moving to a float had many drawbacks, but was a decisive and reasonable course of action; even so, the exact rationale for the move does not seem to have been fully explained in subsequent staff reports.

- **As a medium term issue:** the trade off was between possibly a number of years of slower growth owing to an overvalued exchange rate, and a more damaging crisis in the initial years followed by more rapid export growth. In May 2002, the real effective exchange rate was 20–25 percent above its level of late 1998 (when the staff viewed competitiveness as appropriate), and it would not have been unreasonable to expect the Argentine peso to rebound after overshooting. The recovery of exports following the floating of the Uruguayan peso has been substantial and has recently accelerated, but it is difficult to determine the extent to which this is to be attributed to the depreciation.

- **As a crisis prevention/management issue:** reserves had dwindled to low levels and the question was whether the IMF should provide large amounts of financing both to counteract potential pressures on the exchange rate and to stem the deposit run, or just to stem a deposit run that would however be larger because of the depreciation. In the event, the prevailing consideration seems to have been to avoid wasting reserves in a possibly futile attempt to defend the exchange rate.

51. **In retrospect, the August 2002 strategy that in the end halted the deposit run seems appropriate.** The strategy consisted of identifying the core banking system to be supported; reprogramming dollar time deposits of the state-owned banks; and fully backing up sight and savings deposits. Letting the foreign banks handle the situation on their own, with no freezes but no public support, was the right decision—and one on which there was wide consensus early on.

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[12] The SRF, used in June 2002, was closer to meeting the objective of providing large amounts of financial assistance for a relatively limited time. However, use of the SRF is somewhat questionable in this case: the SRF is to be used in cases of reversible, short-term capital account crises, and even at the time it was already clear that at least the deposits withdrawals by Argentines would not be reversed in the near term.

52. **It is worth asking whether such a strategy should have been adopted earlier.** This might have averted the need for a second augmentation and perhaps even reduced the IMF's overall exposure and Uruguay's debt burden to multilaterals. A better approach would probably have been to adopt the August strategy and the bank holiday in June, possibly in conjunction with the floating of the Uruguayan peso, and perhaps permitting somewhat earlier launching of the procedures to address the debt situation. Earlier closure of problem banks would also have reduced the fiscal costs of the crisis. More generally, the approach to crisis resolution seems to have attempted to fix problems one at a time. Even greater efforts could have been made to anticipate linkages and further developments, and to seek to tackle a number of intertwined problems simultaneously. To sum up, this EPA suggests that a desirable alternative strategy would have been to have a somewhat larger package in early 2002. Had this failed to prevent a deposit run on the part of residents, the more interventionist August approach should have been adopted in June.

## B. The Debt Exchange

53. **With the public debt-to-GDP ratio at nearly 100 percent in the late summer of 2002, and annual debt service payments due amounting to about 20 percentage points of GDP in 2003–07, it was clear that Uruguay would experience repayment difficulties.** Where a member's debt is unsustainable, the IMF is precluded from providing further financing, absent a credible program entailing the restructuring of the debt in a manner that ensures medium-term sustainability. The August 2002 augmentation was thus provided with the understanding that a solution would be found to the debt problem that would ensure sustainable debt dynamics over the medium term. In approaching the issue, the authorities sought to maintain Uruguay's reputation as a country that honors contracts, preserve their good relations with creditors, and "take the long view" regarding future market access. While the domestic banks had only small exposure to government debt (holding only 3 percent of the public debt), the authorities were concerned that if Uruguay were perceived as failing to honor contracts, depositors might run again on the state-owned banks.[13]

54. **The IMF left the design of the operation to the authorities and their advisers, while focusing on assurances that financing gaps and debt sustainability were addressed.** The deal relied on lengthening maturities of the bonds, while eschewing haircuts on principal or coupons.[14] The resulting net present value reduction is estimated at 20 percent with a discount rate of 16 percent (the implied yield when the exchange was launched) or

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[13] Thus, on the whole, had the authorities opted for a more aggressive debt stock relief operation in the summer of 2002, the debt problem would have been addressed more forcefully, but the risks would have been greater with respect to resolving the banking crisis and regaining market access in the future.

[14] Country Report No. 03/247 describes the debt exchange in detail.

13 percent with a discount rate of 12 percent (the implied yield at the settlement date).[15] Some of the technical features of the deal—including exit consents, collective action clauses, and aggregation clauses—were innovative. Moreover, efforts to involve investors at an early stage in the design of the deal have been widely viewed as beneficial.

55. **This EPA considers that the debt exchange brought welcome breathing room, though the debt remains high and will require strong fiscal policies and structural reforms to promote growth in order to bring the debt down rapidly over the medium term.** The exchange, which emphasized liquidity rather than solvency considerations, was successful in sharply reducing gross financing requirements for 2003–07. Nevertheless, the public debt still stands at almost 90 percent of GDP, of which 42 percentage points of GDP are owed to multilaterals. Uruguay's return to a sustainable debt position therefore depends on strong policies, including an ambitious fiscal effort, and leaves little scope for policy slippages and for automatic stabilizers to work in the event of an economic downturn.[16]

## C. The Post-Crisis Program

56. **Beyond providing the necessary funds to fully back up deposits in a subset of the banking system, the 2002–05 program has appropriately focused on bank restructuring, with a quantum leap in structural conditionality.** The most pressing priority—stopping the bank run—has been attained. On the whole, compliance with the numerical targets in the fiscal and monetary areas has been good, despite occasional and temporary underperformance on the primary surplus in 2002–03. Much progress has been made in the structural area, including banking, but there have also been substantial delays in program implementation and, consequently, the completion of some reviews.

57. **Although the banking system has not yet been fully restored to a state of normalcy with credit growth that would support a strong and sustainable recovery, much has been accomplished in banking resolution and restructuring:**

- **BROU.** The balance sheet has been cleaned up by transferring a substantial amount of its nonperforming loans to a fiduciary trust, and appointing an outside manager to handle asset recovery by the fiduciary trust. BROU's business strategy has been refocused onto the peso business. Operating costs have been reduced. Risk management and operating efficiency have improved.

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[15] The debt-to-GDP ratio in 2010 was projected—under the same assumptions—at 66 percent before the exchange, and 61 percent after the exchange (Country Report 03/247).

[16] While bond spreads currently around 400 basis points might be viewed as evidence that concerns regarding sustainability are limited, market participants may be expecting continued IMF support for years to come. It is also worth recalling that spreads were relatively low in the run up to the 2002 crisis.

- **BHU.** Progress has been made toward transforming the public mortgage bank into a nonbank entity, with the assistance of the World Bank. However, the process has not yet been completed, and important weaknesses remain, including a large non-performing loan portfolio. Moreover, it remains uncertain whether BHU will be able to service its obligations; failure to do so would imply additional fiscal costs.

- **Nuevo Banco Comercial.** A new bank has been formed with the performing assets of three of the liquidated domestic private banks, and the government is now looking for a strategic private investor. A private firm has been contracted to manage the disposal of the assets of the liquidated banks.

- **Bank Supervision**. With the assistance of the IADB, the central bank's ability to supervise the banking system—and, more specifically, to oversee the state-owned banks—has been somewhat strengthened.[17]

58. **While much has been achieved in the structural area, compliance with the program has often suffered from disappointing delays and key fiscal reforms remain to be addressed.** Competition has been fostered in the telecommunications sector. A tax reform and reform of the special pension plans for the military and police have been submitted to Congress, though they have not yet been approved. More generally, a number of measures envisaged as structural benchmarks were dropped, and much remains on the agenda.

## VII. Questions and Lessons

59. The mandate of this EPA is to analyze past performance with a view to drawing policy lessons for IMF engagement in Uruguay. Prior to turning to the lessons for Uruguay, however, this EPA briefly notes a few questions that may be of general relevance for IMF policy, arising from the challenges faced during the 2002 crisis.

### A. IMF Policy Issues Arising from the Crisis in Uruguay

- Uruguay was essentially the first case in which an IMF arrangement supported the central bank's lender of last resort function, in a context of high de facto dollarization. Existing Fund facilities were not designed with this setting in mind, and it may be worth considering the implications for the IMF's strategy in similar cases that might arise in the future.

- While the judgment call that the program would not have been sustainable under the existing exchange rate regime was reasonable, if close, the underlying rationale does

[17] At the same time, the state banks are not yet subject to fully equal treatment as private banks: central bank supervisors do not have the ability to order the removal of managers of the state banks, or suspend the license of these banks, in the event of insolvency or violation of supervisory orders or regulations.

not seem to have been fully spelled out. This points to the broader question of the conditions under which an exchange rate could be supported using IMF resources.

- Whether or not a member's debt should be restructured is a decision of the member, and the terms of the restructuring are a matter for the member and its creditors. At the same time, the IMF is precluded from providing further financing unless the debt is sustainable in the medium term. Assessing debt sustainability involves difficult judgments regarding a number of macroeconomic assumptions, raising the question whether an even more systematic approach might guide such judgments in cases where debt sustainability is a serious concern.

### B. Lessons for IMF Engagement in Uruguay

60. **A program with strong policies will be required to make a forceful move toward reducing Uruguay's reliance on IMF credit.** There is little doubt that a new arrangement will be needed when the current arrangement expires. In order to meet its external obligations, Uruguay would need to find private financing far in excess of the amounts it could realistically obtain at this time. And Uruguay's smooth return to a sustainable path will likely require intensive IMF engagement—in the form of financing and policy advice—for a few years. Crucial reforms, notably in the banking sector, need to be completed before macroeconomic stability can be durably assured. At the same time, policy strategy and program design should be aimed at rapidly restoring Uruguay's ability to rely fully on global capital markets rather than IMF credit.

61. **There are major risks to a possible new program.** As shown in the most recent debt sustainability analysis (Country Report No. 05/14), the debt is sustainable only under stringent assumptions regarding a number of key, interrelated variables—notably the real exchange rate; economic growth; and, especially, primary fiscal surpluses, which are required to be of the order of 4 percent of GDP in the medium term. While the Uruguayan authorities have traditionally risen to the challenge of ensuring sustainability, such surpluses are unprecedented in Uruguay's own history, and have rarely been maintained in other countries for longer than a few years. It is not difficult to imagine scenarios in which a number of intertwined macroeconomic variables would turn out worse than expected. Should growth decline, for example, the political challenges involved in maintaining primary surpluses of this size without reducing growth even further would be heightened substantially, likely resulting in higher bond spreads and a depreciation of the exchange rate.

62. **An additional risk is that, if compliance with IMF conditionality were to deteriorate, difficult choices would have to be made between letting a program go off track and making it less ambitious. A weaker program might then lead to excessively prolonged use of IMF resources.** The Uruguayan authorities have a history of relatively prudent policies and broadly good compliance with IMF advice. Moreover, they fully understand that failure to undertake the necessary macroeconomic and structural measures would place sustainability at risk. Even so, it is worth asking how the IMF would react if the authorities' policies fell short of program requirements. In situations where the IMF plays such a central role, there might be a temptation for the IMF to err on the side of leniency in

setting new targets or assessing compliance, to avoid triggering new difficulties. Indeed, compliance with program conditionality in the structural area has already been somewhat disappointing in 2002–04.

63. **A key criterion for exit from IMF arrangements over the next few years will be Uruguay's ability to tap international financial markets for the necessary amounts at reasonable spreads.** The ability to tap private sources of financing is hard to predict, implying that the IMF should be ready to re-evaluate possible future access under IMF arrangements in light of evolving market conditions. Just as there are risks on the downside, the IMF should be alert to the risks on the upside and should not to be overly cautious from the outset in gauging Uruguay's likely access to private markets in the medium term. Program design ought to allow more rapid reduction in the IMF's own exposure, should market access turn out higher than in the central scenario of the most recent DSA.[18]

64. **Market access will of course hinge on economic growth performance and a determined effort to fully restore fiscal sustainability.** Thus the first order of priority for the new government will be to generate primary fiscal surpluses that facilitate a return to an unambiguously sustainable debt position while not endangering growth prospects, and to undertake growth-enhancing structural reforms. While the incoming government's commitment to reducing poverty is commendable, it will be important for this objective to be pursued by reorienting expenditures and improved targeting. The experience of the 1990s highlights the need—when designing a medium-term path toward an improved debt situation—to ensure that years of strong growth result in larger fiscal surpluses. The target for the primary fiscal surplus should thus be especially ambitious in 2005, when economic growth is expected to be above potential; this would also convey to markets a strong signal of commitment to fiscal prudence on the part of the new administration. Lasting fiscal consolidation would also require undertaking pension and tax reforms that have been delayed for a number of years.

65. **When Uruguay's ability to rely primarily on private capital markets is eventually restored, a question that will likely emerge is whether possible precautionary arrangements would bring substantial net benefits.** The experience of the precautionary SBAs of 1996–2001 may not provide fully informative guidance for the future, because precautionary programs in the aftermath of a high-access SBA tend to differ considerably from those undertaken prior to a crisis; moreover, the form of precautionary arrangement and exit mechanisms may be revisited by the Board in the meantime. Nevertheless, based on that experience, it is an open question whether the authorities' policies would differ considerably from those that would be undertaken in the context of post-program monitoring. Indeed, the

[18] It is not inconceivable that this might happen. In 2000–01, Uruguay placed an annual average of US$850 million in long-term bonds on international markets (US$550 million net of amortization) at spreads of 200–300 basis points. These gross placements were more than twice as large as those foreseen in 2005–09 by the most recent DSA.

need to obtain financing on international private markets would impose considerable policy discipline, despite market participants' occasional lapses in monitoring a relatively small borrower.

66. **For a possible new program later this year, the immediate priorities in the structural area would continue to be in the banking system, where a return to normalcy requires completing the ongoing resolution and restructuring efforts.** Improved economic activity will need to be accompanied by normal intermediation and prudent lending, which will be made possible by a gradual reduction in reserve requirements. In turn, this will require continued improvement in credit monitoring and risk controls at BROU and NBC. It would also be important to continue efforts to collect and deal with outstanding, nonperforming loans, so as to enhance creditor discipline. To maintain public confidence, this will need to be done with full, transparent, and timely provision of information.

67. **The authorities should strive to complete the banking system reforms that might have prevented the 2002 crisis and will reduce the likelihood of such crises recurring again.** Bank supervision needs to be strengthened further, with more resources for staff and training, but also greater efforts to comply with international standards and full independence from possible political interference. Prudential regulation needs to reduce the risks arising from non-resident deposits, and dollar deposits combined with currency mismatches. Reforms are also needed to improve the authorities' ability to intervene in the case of possible future banking crises. The central bank's lender of last resort function needs to be revamped, allowing the central bank to lend more than 100 percent of a troubled bank's net worth. To that end, the financial position of the central bank requires strengthening, through recapitalization or similar measures. Moreover, there is a need to establish bank "exit rules" that are less disruptive than straight liquidation.

68. **The authorities should leverage the recent spur in economic growth, their absolute majority in Congress, and the change in the political base supporting the government to set in train reforms that had been viewed as politically difficult. This is clearly relevant in the fiscal area.** With fiscal policy now in center stage to assure sustainability, the authorities will soon need to reform the tax system and take steps to improve tax administration. One priority is to widen the tax base and reduce exemptions, to improve efficiency and promote a more equitable distribution of the tax burden. On the expenditure side, an immediate priority is the reform of the special pension funds not only for the military and police, but also other groups such as bank employees. The authorities should also begin considering changes to the parameters in the general pension system, where pressures remain substantial and the most recent reform took place almost a decade ago.

69. **The medium-term challenge is to reduce the role of the state in the economy, with a view to fostering economic growth in a lasting manner**. Discussion of this critical structural issue has been strongly conditioned by a landmark referendum in 1992 and other referendums in recent years in which the public rejected proposed privatizations. The authorities should launch a fresh, thorough review of the current, and desirable extent of the state's involvement in the various economic sectors. Appropriate options for greater involvement of private agents will likely depend on the economic sector, and may include

joint ventures, public-private partnerships, and further liberalization; nevertheless, privatization should be considered for the state bank and public entities in other sectors. On the governance of public enterprises, the state bank, and the central bank, one possibility that may be considered is to introduce fixed term, staggered contracts for key board positions, to reduce dependence on the electoral cycle.

70. **Greater independence will be especially important for key institutional functions in monetary policy and banking supervision.** A move toward an independent central bank would be highly desirable, and a precondition for inflation targeting, in which the authorities have expressed an interest. Similarly, to foster bank soundness, the entity supervising the banking system should be independent from the government—though in several countries this objective has been attained while keeping such entity within the central bank.

71. **Another medium-term challenge in the area of monetary and exchange rate policy relates to encouraging de-dollarization.** Although de-dollarization is likely to prove difficult, it would bring a number of benefits, such as lower vulnerability and increased ability to conduct an independent monetary policy. A welcome development in this respect is the recent issuance, at reasonable cost, of local currency denominated, inflation-indexed government bonds.

72. **Finally, measures in the areas of trade and labor markets should be considered for the medium term, to reduce the economy's vulnerability to external shocks and its ability to adjust to shocks:**

- **Vulnerability to external shocks would be reduced by promoting trade beyond Mercosur.** This would help render Uruguay's trade patterns better geographically diversified, moving beyond past trade policy that focused on fostering regional trade within Mercosur.

- **There is a need to consider measures aimed at making the labor market more flexible.** The unemployment rate has been well above 10 percent for more than a decade, with substantial social costs. Yet with more pressing challenges such as macroeconomic stabilization, emerging vulnerabilities, and crisis resolution, analysis of labor market issues has been limited, despite its importance. With the scope for truly independent monetary policy likely to remain constrained by de facto dollarization for a number of years, flexibility in the labor market will be necessary to help cushion the economy from shocks.

## INDICATORS OF VULNERABILITY, 1995–2002[1]

This appendix reports developments in indicators of vulnerability between the mid-1990s and the time of the crisis. The objective is to ascertain when more forceful action would have been desirable—though the indicators were compiled for this EPA and thus may not all have been available at the time. The focus is on deviations from the real exchange rate from its equilibrium levels implied by fundamentals, and on indicators of vulnerability in the banking system.

### Estimates of Real Exchange Rate Misalignment

A critical policy question in the late 1990s concerned the extent to which the real effective exchange rate (REER) might have become overvalued after a period of considerable real appreciation.

This Appendix follows a recently developed, simple approach to estimate the equilibrium REER as a function of fundamentals, including real export prices (Px), real GDP per capita relative to major trading partners (Rgdppc), and the ratio of net foreign assets to GDP (NFA).[2] All variables are in logarithms, except for NFA. The available dataset refers to 1980–2003.

Table 1. Estimates of Long-Run Relationship 1/

| | Px | RGDPPC | NFA |
|---|---|---|---|
| REER | 1.77 | 1.61 | -0.003 |
| | (0.42) | (0.38) | (0.002) |

1/ Newey-West heteroscedasticity and autocorrelation consistent (HAC) standard errors in parentheses.

The estimated long-run equation for the real exchange rate is presented in Table 1.[3] An increase in the real export prices is associated with an appreciation of the real exchange rate, consistent with higher export prices implying a positive wealth effect and thus raising domestic demand and the price of nontradables. An increase in the real output per capita relative to trading partner countries (a proxy for the productivity differential between Uruguay and its trading partners) is associated with a real effective appreciation, consistent with a Balassa-

[1] Prepared by A. Arvanitis and F. Fischer.

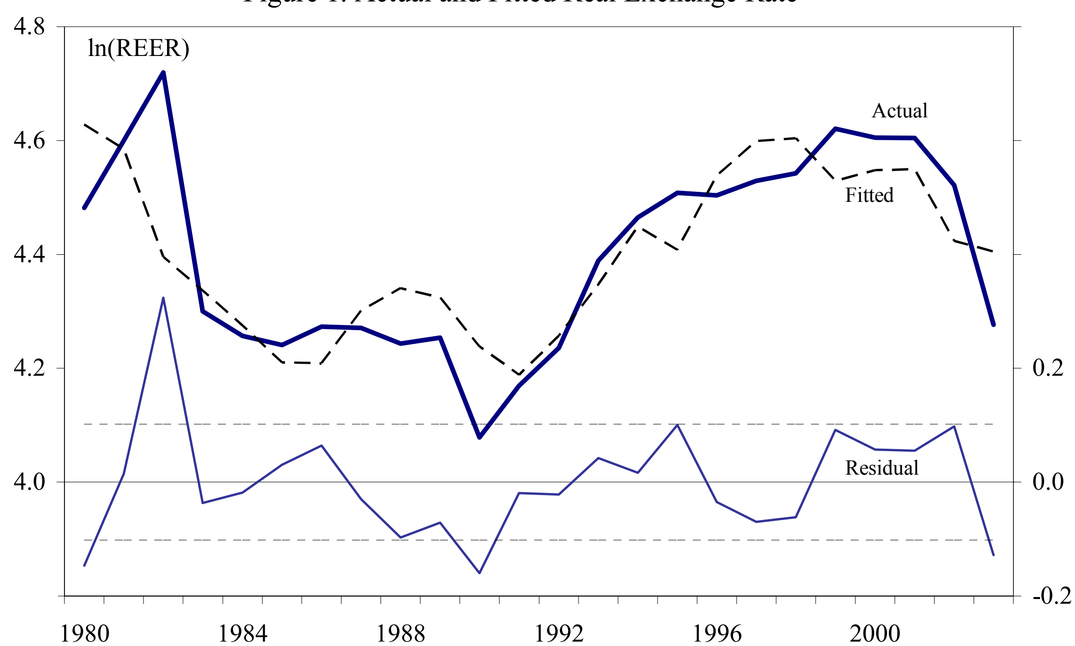
[2] See for example, Lee, Milesi-Ferretti, Ricci, and Jayanthi (2004), Hinke and Montiel (1999), Lane and Milesi-Ferretti (2000), and MacDonald and Ricci (2003).

[3] The properties of the time series suggest that a long-run co-integrating relationship exists among the posited variables. All series are integrated of order one and tests indicate the presence of one co-integrating vector at the standard 5 percent significance level.

Samuelson effect. An increase in the net foreign assets ratio to GDP tends to depreciate the REER, but not significantly.[4]

Taken at face value, a plot of the actual and fitted values from this equation shows that the REER was overvalued by about 10 percent relative to its equilibrium at end-1999 and about 6 percent at end-2001 (Figure 1). However, caution is needed in interpreting the estimates as precise measures of the level of misalignment. The methodology restricts the average overvaluation in 1980–2003 to be zero. Moreover, the relatively short sample implies that the results are sensitive to the inclusion of influential years (such as the early 1980s, when a sharp appreciation was observed). While much of the appreciation experienced during the 1990s is accounted for by fundamentals, the estimates support the view that the REER became gradually more overvalued in the 1990s, and that the depreciations of the Brazilian *real* in January 1999 and the Argentine peso in January 2002 had a marked impact.

Figure 1. Actual and Fitted Real Exchange Rate




[4] The size of NFA is generally expected to be associated with a more appreciated exchange rate in the long run as a country can afford to finance a worse current account balance, and therefore can sustain a loss in competitiveness associated with a more appreciated REER. The results in the model are likely to be influenced by the periods in the sample where higher nonresident deposits in Uruguay associated with crises in Argentina (lower NFA) exerted temporary pressures on the REER to appreciate.

**Indicators of Vulnerability in the Banking System**

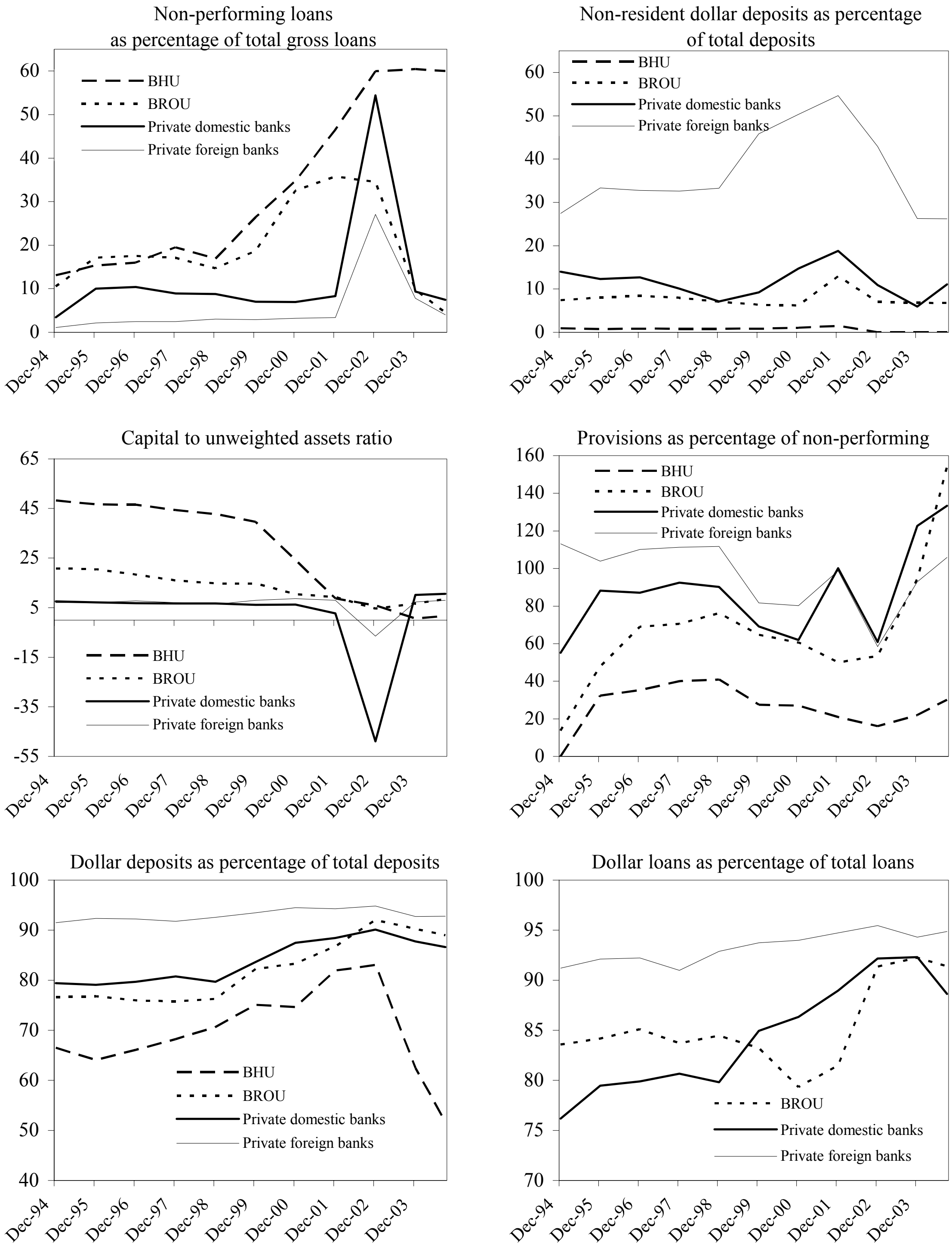
Beginning in 1999, vulnerabilities in the banking system started becoming substantially more pronounced. As shown in Figure 2–4, this is reflected in a number of indicators such as the following:

- Nonperforming loans, provisions as a share of nonperforming loans, and the capital to unweighted assets ratio reveal a consistent worsening pattern from 1999 on, especially in state-owned banks BHU and BROU.

- Nonresident dollar deposits as a share of total deposits rose considerably not only in the foreign banks, but also in the private domestic banks and BROU.

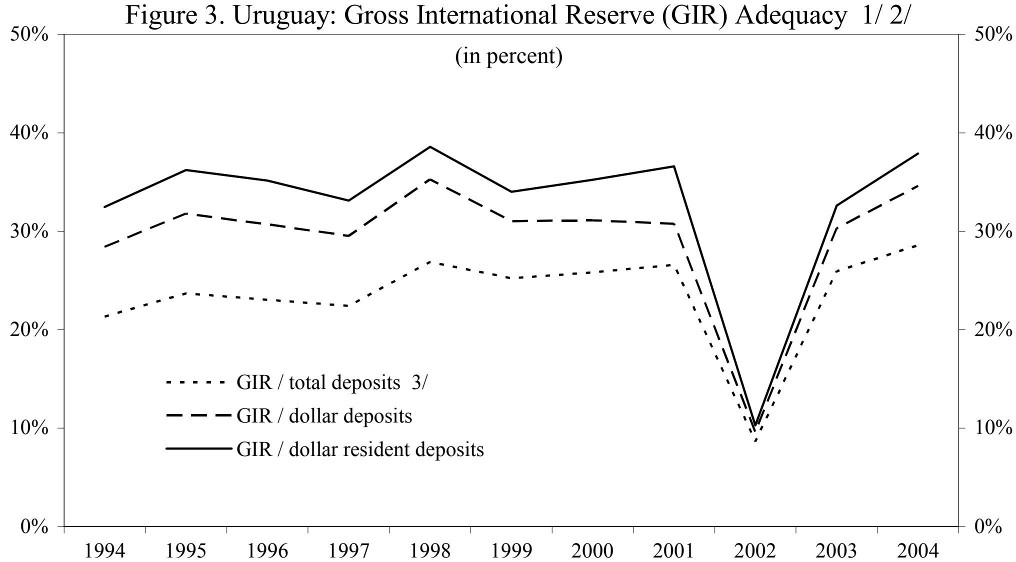
- In BHU, exposure to foreign exchange rate risk rose substantially, as evidenced by the growing hypothetical losses that would have resulted from a given devaluation of the Uruguayan peso vis-à-vis the U.S. dollar, had this taken place earlier.

Figure 2. Uruguay: Indicators of Vulnerability in the Banking System, 1994-2004 1/




Source: Central Bank of Uruguay (BCU).
1/ 2004: as of September.

Figure 3. Uruguay: Gross International Reserve (GIR) Adequacy 1/ 2/



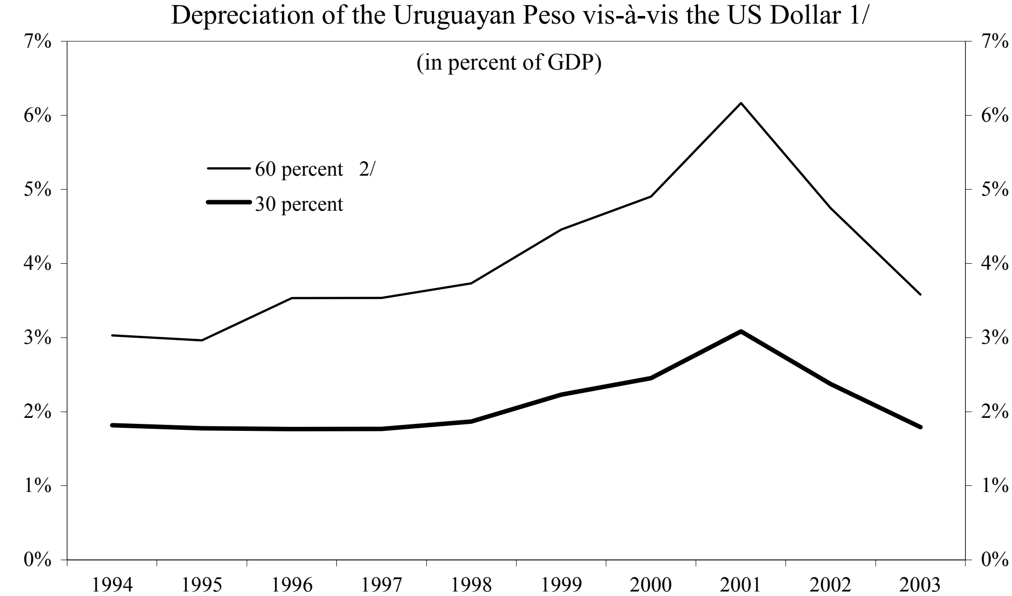

Source: Central Bank of Uruguay (BCU) and International Financial Statistics (IFS).

1/ Dollar deposits fell by 65.4 percent for non-residents and 30.1 percent for residents between January 2002 and August 2002.

2/ Gross international reserves include free reserves deposited at the central bank by commercial banks and other agents. This is therefore a considerable overestimate of the central bank's ability to direct reserves to specific banks at its own discretion.

3/ Including deposits in local currency.

Figure 4. Uruguay: Potential Losses in BHU Resulting from a Depreciation of the Uruguayan Peso vis-à-vis the US Dollar 1/




Sources: Central Bank of Uruguay; and staff estimates.

1/ Valuation loss is computed as the depreciation times the difference between liabilities and assets in US dollars. Consistent with developments observed in the 2002 financial crisis, exchange rate pass-through to salaries (to which BHU loans are indexed) is assumed to be negligible.

2/ Scenario corresponds to the depreciation that followed the peso's floating (June 2002).

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**Statement by Hector Torres, Executive Director for Uruguay
and David Vogel, Advisor to Executive Director
March 18, 2005**

**Background**

1. On behalf of the Uruguayan authorities, we would like to thank the Executive Directors, Management and the staff for their valuable assistance and support during a very difficult period. We also thank the staff for a well-written Ex-Post Assessment (EPA) report that presents a good perspective of the last 10 years and, especially, of the future challenges that Uruguay will face. The authorities believe that this report could be useful to draw helpful lessons for the country and also for the Fund's future policies and actions.

2. Before going into the staff EPA report, the Uruguayan authorities would like to reiterate their strong commitment to macroeconomic stability as the necessary condition to achieve a higher and sustainable growth, enhance the level and quality of employment, decisively mitigate poverty conditions, and boost social equity. In that vein, the authorities will promote a significant improvement in the investment climate so as to significantly increase investment rate. In this regard, the new government is fully committed to implement an ambitious agenda of structural reforms that allows the country to have stronger institutions that provide proper incentives for social and economic development.

**Policies and Reforms**

3. One of the most controversial issues in Uruguay's last decade has been the exchange rate system. Clearly, as noted by the staff, the exact rationale for the move to an exchange rate float –and especially its timeliness in the middle of a huge deposit run- does not seem to have been fully explained in subsequent reports. Looking back, it seems to be clear that the crawling band rate system was a pillar in the strategy to gradually reduce inflation. On the other hand, as pointed out in the staff report, "while the estimates support the view that the real effective exchange rate (REER) became gradually more overvalued in the 1990s, the depreciations of the Brazilian real in 1999 and the Argentine peso had a marked impact". In this respect, we note that just a few months before the real's sharp depreciation, it was noted in the staff report (EBS/98/128) that "the authorities and the staff agreed that the policy of gradually lowering the rate of adjustment in the exchange rate band in line with targeted inflation was working well, and market analysts had welcomed the narrowing of the band as a further sign of the government's commitment to bring inflation down." Meanwhile, the exchange rate system contributed to deepen financial dollarization; dollar deposits in the banking system rose from 80 percent in 1990 to 92 percent in 2002, while dollar credits increased from 58 percent to 83 percent in the same period. For instance, it established a substantial impediment for the Central Bank to act as a lender of last resort during the 2002 crisis.

4. As noted, beyond some positive developments, financial dollarization remains as one of the main vulnerabilities of the system. Clearly, dollarization involves cultural issues and, in order to diminish this vulnerability, it will be necessary not only to continue prudent monetary policies in a context of an appropriate exchange rate flexibility –progressing

toward an inflation targeting system-, but also to further strengthen institutions in the monetary area and bank supervision. In that vein, the Superintendency of Banks will remain dealing with only in regards to technical aspects. Moreover, we feel that the comments made in paragraph 57 of the staff report suggesting the central bank's ability to supervise the banking sector has been "somewhat strengthened" are not fair enough since they fail to reflect the critical changes undertaken in the last two years in this entity. While the bank supervisory is being strengthened, prudential rules will be reinforced to diminish an exposure to exchange rate risk due to loans in dollar made to the non-tradable sector. At the same time, the authorities will attempt as soon as possible to take advantage of the current external situation to further increase the Central Bank's reserve position.

5. Evidently, the 2002 crisis was triggered by severe external shocks that substantially affected many areas of the country. Nonetheless, the observations made in Box 1 of the staff report that are in general shared by the authorities show that there were many considerable internal problems and vulnerabilities, particularly in the banking sector, which amplified the effects of the crisis. It is clear that after 2002, many vulnerabilities of the financial system have been substantially mitigated. For instance, the restructuring of the Banco de la República Oriental del Uruguay (BROU) has advanced well, its asset management company has made good progress to recover the nonperforming loan portfolio, and the liquidation funds have shown considerable advances. Beyond the critical improvements, the authorities are well aware that many vulnerabilities remain, which require further substantial efforts in strengthening regulation and supervision of the financial system in general, and improving governance structure, risk management and credit policies, among other things, in the public banks.

6. The debt-exchange operation –which implied a net present value haircut of 20-30 percent discounted at 16 percent- was a milestone that dissipated substantial uncertainties and significantly contributed to overcome the financial crisis. For instance, in August 2002, the staff report (EBS/02/141) presented a debt-sustainability assessment (Table 4) in which the assumptions were a nominal exchange rate depreciation of 99 percent in 2002, 62 percent in 2003, 12 percent in 2004, and a country risk above 1,000 basis points between 2002 and 2005, and 700 basis point until 2012. Needless to say, today's situation and forecast are very different. Independent from the results, the authorities are committed to fulfill Uruguay's obligations and, more generally, to fully respect the rule of law, as has been Uruguay's tradition.

7. Notwithstanding its substantial reduction, the level of the debt to GDP ratio remains high, being a significant source of vulnerability. In that vein, ensuring sustainable debt over the medium-term is in the first order of priority for the government. Clearly, the path of the debt to GDP ratio depends on many developments –many of them from abroad- and interrelated variables, such as the conditions to access to international financial markets, and the real exchange rate –as noted by the staff, the main vulnerability with respect to the debt is related to its large foreign currency share. Likewise, the authorities would like to emphasize the utmost importance of the GDP growth to ensure debt sustainability, together with a primary surplus consistent with that objective.

8. In the same manner as in the August 2002 staff report (EBS/02/141) -and others as well- , which recalled that the average primary surplus in the period 1990-2001 was 0.3 percent of GDP, and the historical maximum had been 2.8 percent of GDP, the EPA paper noted that primary fiscal surpluses around 4 percent are unprecedented in Uruguay's own history, and have rarely been maintained in other countries for longer than a few years. In that August 2002 report the staff warned that "a necessary condition for stabilizing the debt ratio in the medium term is the maintenance of very large primary surpluses of about 4.5 percent of GDP". Even with that 4.5 percent of GDP, according to the DSA presented in August 2002, the debt to GDP ratio would have been 75 percent by 2012. Thus, whereas the Debt Sustainability Analysis is a very helpful instrument, it is worth taking into account that there are many variables playing, and so there are no fixed "magical" numbers. Moreover, each country has its own history and conditions that must be considered. As stressed in the Fund paper on Sustainability Assessments (SM/03/206), "sustainability analysis needs to place the debt dynamics implied by the framework in the particular context of the country. Some of the relevant factors relate to the country: its vulnerability to shocks, its macroeconomic management, and any prior history of debt defaults or crises". Beyond those precisions, the authorities would like to emphasize their firm conviction that fiscal discipline is key in maintaining macroeconomic stability, and thus a necessary condition to attract investment, reduce unemployment, and mitigate poverty conditions.

9. Boosting investment and higher growth rates may not be sufficient to alleviate the most extreme poverty conditions. As pointed out in the staff report, the costs of the crisis have been major, having especially severe consequences for the lowest income brackets, with poverty rates almost doubling between 2000 and late 2002. Given this ethic need, the government is going to assist the most vulnerable sectors of the population by implementing a social emergency plan, basically aimed at providing these sectors with a higher quantity and better quality of education and health. This will be carried out in a transparent manner and taking serious consideration of providing appropriate incentives. Improving the quality of life and perspectives for social insertion of the poor will be necessary to build ownership for the pending structural reforms.

10. At the same time, the authorities will aim to reorient expenditures and to improve targeting. They agree on the need to introduce adequate improvements to the budgetary process and, in this regard, assistance from Fund's staff will be welcome. In the revenue area, figures and comments shown in Box 2 of the staff report are eloquent to conclude the necessity of reforming the revenue administration in order to efficiently achieve the objectives of a comprehensive tax reform. This reform will be gradually undertaken in order not to affect the revenue performance, while it will be strongly oriented by efficiency as well as vertical and horizontal equity considerations.

11. The authorities firmly believe that it is necessary to increase the role of the private sector to have a sustainable and higher economic growth. They consider that public's reluctance to some initiatives that, for instance, proposed a greater involvement of private sector in activities traditionally carried out by the public sector could be significantly diminished by improving transparency and establishing more efficient regulations that, for instance, can promote more and better competition. Meanwhile, Uruguay's strong

commitment to the Mercosur is fully compatible with the authorities' intention to continue diversifying the country's external markets as well as its export base as an essential way to reduce Uruguay's vulnerability to external shocks.

12. Regarding the IMF's engagement in Uruguay, as noted above, it has been critical to overcome the severe crisis. However, in hindsight, this engagement has been far from perfect, to large extent due to lacks -or absence- in the Fund's facilities. For instance, the staff posed an interesting question on whether a somewhat larger package early on could have prevented panic among residents, who had not yet started withdrawing massively their deposits. The staff also rightly noted that standard IMF programs do not make sufficient funds available upfront and they make funds available even after the crisis may have subsided. Indeed, the holiday bank could be lifted only after a bridge loan provided by the U.S. government. Otherwise, the Fund's procedures for a new augmentation could have come when the crisis would have reached a dead end. Furthermore, as our Chair has stressed in many opportunities, there is a clear need to have a facility like the former Contingent Credit Lines (CCL), which had not been used not because it was not a very useful instrument, but because of significant deficiencies in its design.

**Conclusion**

13. Finally, there is no doubt about the need that Uruguay has for a successor Fund's supported program, while regaining access to the external financial markets. The Uruguayan authorities would like to emphasize that they firmly believe in the need for macroeconomic stability and structural reforms and the benefits they provide; thus they will have a full ownership of its program. They hope to have a close and fruitful cooperation with the Fund.

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# IMF Executive Board Reviews Uruguay's Performance Under Past Fund-Supported Programs

On March 18, 2005, the Executive Board of the International Monetary Fund (IMF) discussed the ex post assessment of Uruguay's longer-term involvement with Fund-supported arrangements.[1]

**Background**

Uruguay has undertaken broadly prudent macroeconomic polices over the last decade. An exchange rate-based stabilization in the 1990s successfully reduced inflation, though it resulted in some real exchange rate appreciation. The real economy has been importantly influenced by developments in the region, especially in Argentina. Since 1996, Uruguay has had a series of Stand-By Arrangements with the IMF that were treated mostly as precautionary. In 2002, Uruguay faced its most severe financial crisis, with widespread illiquidity and insolvencies in the domestic banking system, a sharp depreciation of its currency followed by high inflation, and a

[1] Ex post assessments were established by the IMF's Executive Board in 2003 to provide an opportunity for the IMF to step back from the program context in member countries with longer-term program engagement. The latter are defined as members that have spent seven or more of the last ten years under upper credit tranche arrangements (including those that have precautionary arrangements and those that have a mix of resources from the General Resources Account and the PRGF/ESAF), and members that have had two or more multiyear arrangements under concessional facilities such as the PRGF or ESAF. A team of IMF economists prepares a report on the economic problems facing the country, a critical and frank review of progress during the period of Fund-supported programs, and a forward-looking assessment that takes into account lessons learned and presents a strategy for future engagement. This report is discussed with the country's authorities and presented to the Board for discussion. 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.

doubling of the public debt-to-GDP ratio to about 100 percent. This triggered activation of purchases under the existing Fund arrangement and approval of a new one, which was augmented twice, making it the largest Fund arrangement as a share of a country's GDP. The economy has rebounded strongly since the crisis, and inflation has returned to single digits. However, substantial vulnerabilities remain, reflecting the high debt burden and widespread dollarization.

The ex post assessment concludes that continued Fund involvement will likely be needed, and that exit from Fund financial support in the future will depend on the ability to tap international capital markets, which in turn will hinge on a forceful program aimed at fiscal consolidation and fostering sustainable growth. Achieving these objectives will require a wide range of structural reforms, notably in the tax and financial sector areas.

**Executive Board Assessment**

Executive Directors considered that, on the whole, the series of precautionary arrangements had helped buttress the authorities' commitment to prudent macroeconomic policies and secure political support for difficult reforms. In retrospect, however, deep-rooted vulnerabilities—notably in the banking system and the fiscal accounts—should have been tackled more forcefully to build a larger cushion against shocks. Moreover, the gradual, consensus-building approach to structural reforms had led to slow progress in needed areas. These weaknesses constrained economic performance and the ability of the Uruguayan economy to withstand the external shocks in late 2001 and early 2002, leading to the deep financial crisis and recession of 2002. Directors regretted that the arrangements did not manage to address the vulnerabilities in the banking system in a more timely manner. Many Directors stressed, in this regard, that precautionary arrangements should be subject, to the same standards as regular arrangements, in terms of both program conditionality and compliance.

Directors noted that both the magnitude and the nature of the 2002 crisis, with large withdrawals of dollar deposits from the banking system, required a somewhat novel approach in its resolution, involving support of the central bank's lender of last resort function in a highly dollarized economy. They observed that while the strategy employed, combined with an exceptional access to the Fund's resources, had eventually halted the banking crisis, a comprehensive approach had been adopted only after a few months. Directors considered that Uruguay's experience pointed to the need for early implementation of comprehensive and strong programs, addressing simultaneously the intertwined difficulties in the banking system, the external accounts, and the fiscal position. They broadly agreed that the move to an exchange rate float—though a close call—had been a decisive and reasonable course of action, but noted that the rationale for floating should have been explained fully in subsequent staff reports. Directors acknowledged that the debt exchange, which extended bond maturities by about five years, brought welcome breathing room, although the debt remains high and will require strong fiscal policies and structural reforms to promote growth in order to bring the debt down rapidly over the medium term.

Directors agreed that Fund financial support had been instrumental in stabilizing the Uruguayan economy following the deep financial crisis, although most considered that a larger access combined with stronger measures would have been desirable at the start of the program. They commended the authorities for the successful implementation of the Fund-supported program and for the rapid economic recovery that has ensued. Directors observed that, while much progress has been made in the structural area, in particular with regard to banking resolution and restructuring, vulnerabilities remain substantial, stemming largely from the high levels of public debt and dollarization. At the same time, Directors regretted that several important fiscal reforms had not been undertaken as programmed.

Directors agreed that Uruguay still faces significant challenges in setting the economy on a durably higher growth path, which call for continued commitment by the authorities to macroeconomic stability and growth-enhancing structural reforms, as well as intensive engagement by the Fund. They considered that financial support from the Fund would remain critical, particularly in light of Uruguay's large external payment obligations coming due in the next few years, although some Directors emphasized that a successor arrangement should entail an exit strategy from Fund resources. They also pointed to the need to adhere strictly to the exceptional access framework. Directors underscored the need for a strong program to create the conditions for improved access to capital markets at reasonable spreads, and progressively reduced exposure to the Fund in tandem with Uruguay's ability to tap international financial markets.

Directors emphasized that a successor Fund-supported program should seek to further reduce the country's macroeconomic vulnerabilities and set the basis for a sustained increase in private investment and growth. This would require continued fiscal consolidation, aimed at generating sufficiently large primary surpluses to restore medium-term debt sustainability, while safeguarding social spending. To this end, Directors encouraged the authorities to undertake the necessary reforms to simplify the tax system, strengthen the tax administration, reform the special pension funds, and improve the budget framework and procedures. Directors also stressed the need to reduce the role of the state and encourage competition. Further reforms in the banking system and enhancement of prudential regulations and supervision remain immediate priorities, with a view to restoring sound credit flows and reducing vulnerabilities resulting from dollarization and nonresident deposits. Measures should also be taken to increase the independence of the central bank and of the banking supervision function, as well as to enhance flexibility in the areas of trade and labor markets. A clear communications strategy would help ensure broad-based consensus needed for moving forward with difficult reforms.

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## Uruguay: Selected Economic Indicators 1/

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | Est. 2004 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | (Percentage changes) | | | | | |
| **Output and prices** | | | | | | | | | | |
| Real GDP | -1.4 | 5.6 | 4.9 | 4.7 | -2.8 | -1.4 | -3.4 | -11.0 | 2.5 | 12.0 |
| GDP (in U.S. dollar billion) | 19.3 | 20.5 | 21.7 | 22.4 | 20.9 | 20.1 | 18.6 | 12.3 | 11.2 | 13.3 |
| Consumer prices (e.o.p.) | 35.4 | 24.3 | 15.2 | 8.6 | 4.2 | 5.1 | 3.6 | 26.0 | 10.2 | 7.6 |
| Exchange rate (Ur$/U.S.$, e.o.p.) | 27.0 | 22.5 | 15.2 | 7.7 | 7.4 | 7.7 | 18.0 | 84.2 | 7.3 | -2.8 |
| **Monetary indicators** | | | | | | | | | | |
| Currency issued | 32.5 | 26.6 | 22.0 | 13.8 | 6.9 | -3.9 | -0.2 | 5.8 | 22.4 | 15.7 |
| Credit to the private sector | | | | | | | | | | |
| (constant exchange rate) | 21.9 | 21.5 | 12.2 | 5.8 | 4.5 | 0.2 | -6.5 | -13.7 | -25.5 | -20.1 |
| | | | | | (Percent of GDP) | | | | | |
| **Public sector operations** | | | | | | | | | | |
| Revenue | 30.2 | 29.8 | 30.1 | 32.7 | 32.2 | 28.8 | 32.7 | 31.1 | 31.1 | 30.0 |
| Non-interest expenditure | 29.5 | 29.6 | 29.3 | 34.9 | 34.4 | 30.4 | 34.0 | 31.1 | 28.4 | 26.3 |
| Primary Balance | 0.7 | 0.2 | 0.9 | -2.2 | -2.1 | -1.5 | -1.2 | 0.0 | 2.7 | 3.8 |
| Interest | 2.1 | 1.9 | 2.0 | 1.9 | 2.1 | 2.6 | 2.9 | 4.7 | 6.0 | 6.0 |
| Overall balance | -1.4 | -1.8 | -1.1 | -4.1 | -4.2 | -4.1 | -4.2 | -4.6 | -3.2 | -2.2 |
| Public sector debt 2/ | 29.8 | 29.0 | 28.7 | 30.2 | 31.1 | 35.7 | 42.8 | 85.1 | 105.3 | 88.4 |
| | | | | | (U.S. dollar million) | | | | | |
| **External indicators** | | | | | | | | | | |
| Merchandise exports, f.o.b. | 2,148 | 2,449 | 2,793 | 2,829 | 2,291 | 2,384 | 2,139 | 1,922 | 2,273 | 3,025 |
| Merchandise imports, f.o.b. | 2,711 | 3,135 | 3,498 | 3,601 | 3,187 | 3,311 | 2,915 | 1,874 | 2,092 | 2,990 |
| Current account balance (in percent of GDP) | -1.1 | -1.1 | -1.3 | -2.1 | -2.4 | -2.8 | -2.6 | 3.1 | -0.3 | -0.8 |
| External debt (in percent of GDP) | 27.6 | 28.7 | 30.8 | 33.8 | 35.7 | 40.7 | 52.2 | 87.7 | 98.3 | 87.4 |
| Gross official reserves | 1,813 | 1,892 | 2,067 | 2,587 | 2,604 | 2,776 | 3,099 | 772 | 2,087 | 2,512 |
| in percent of short-term debt and FX deposits | ... | ... | ... | ... | 17.3 | 17.1 | 17.5 | 7.0 | 20.0 | 27.7 |
| REER (percentage depreciation -, e.o.p.) | 1.7 | -0.8 | 1.6 | 1.1 | 10.0 | -0.9 | -5.4 | -13.2 | -15.0 | 9.4 |

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

1/ Data reported reflect information available at the date of the issuance of the report.
2/ Includes nonfinancial public sector debt plus liabilities to the IMF.