December 2005
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Uruguay: First Review Under the Stand-By Arrangement and Request for Modification of Performance Criteria—Staff Report; Staff Statement; Press Release; and Statement by the Executive Director for Uruguay

In the context of the first review under the Stand-By Arrangement and request for modification of performance criteria, the following documents have been released and are included in this package:

- the staff report for the First Review Under the Stand-By Arrangement and Request for Modification of Performance Criteria prepared by a staff team of the IMF, following discussions that ended on August 16, 2005, with the officials of Uruguay on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 14, 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 staff statement of September 28, 2005 updating information on recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during its September 28, 2005 discussion of the staff report that completed the review.

- a statement by the Executive Director for Uruguay.

The documents listed below have been separately released.

Letter of Intent sent to the IMF by the authorities of Uruguay*
Memorandum of Economic and Financial Policies by the authorities of Uruguay*
Technical Memorandum of Understanding*
*Are also included in Staff Report

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

First Review under the Stand-By Arrangement and Request for Modification of Performance Criteria

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

Approved by Markus Rodlauer and Juha Kähkönen

September 14, 2005

Stand-By Arrangement. On June 8, 2005, the Executive Board approved a three-year Stand-By Arrangement (SDR 766.3 million, 250 percent of quota) under the Fund's exceptional access policy. SDR 735.6 million remains to be disbursed and a purchase of SDR 30.7 million will become available upon completion of this (first) review. Outstanding Fund resources as of July 31, 2005 were SDR 1,666.25 million (543.64 percent of quota).

- Recent economic developments. Growth has slowed this year, as expected, from the very strong post-crisis recovery, and inflation has remained subdued. Export growth has been strong, and while a sharp recovery in imports contributed to an increase in the external current account deficit, capital inflows have helped raise international reserves. The 2005 structural reform agenda is advancing, although continued efforts are needed to ensure its timely implementation and to address vulnerabilities in the financial system.

- Program status. End-June quantitative performance criteria (PCs) on NDA, NIR, general government non-interest expenditure, and external arrears were observed, and preliminary data suggest that the primary surplus and debt PCs were met as well (final data will be reported in a supplement).The end-August structural performance criterion on budget submission was observed, as was the June structural benchmark on strengthening social security collection.

- Review issues. Discussions centered on the need to consolidate recent gains in macroeconomic performance and implement key reforms to sustain growth and bolster Uruguay's resilience to shocks. In particular, they focused on: (i) near-term fiscal and monetary policies; (ii) the budget and structural fiscal reforms; (iii) progress with bank restructuring, particularly in the ailing BHU; and (iv) reforms to improve the business environment.

Discussions. Discussions were held in Montevideo during August 2–16. The mission met with Finance Minister Astori, Central Bank President Cancela, and other senior officials. The staff team comprised M. Piñón (Head), J. Canales-Kriljenko, S. Eble, (all WHD), A. Hajdenberg (FAD), and H. Finger (PDR), and was assisted by G. Gelos (Resident Representative). An MFD mission (S. Seelig) overlapped with the visit. M. Rodlauer (WHD) and D. Vogel (OED) participated in some of the policy discussions.

Fund relations. The last Article IV consultation was concluded on July 11, 2003, and an Ex-Post Assessment (EPA) was considered by the Board on March 18, 2005. Uruguay has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system that is free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions.

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EXECUTIVE SUMMARY

Background

Uruguay's recovery from the 2002 crisis continues to impress. Although growth has slowed from the very rapid pace of last year, it is expected to remain strong; inflation has been subdued; and the external position has strengthened further with continuing upward pressure on the peso. This performance and the favorable external environment have allowed the government to place larger international bond issues than programmed, already covering some of its 2006 external financing needs.

The program is on track, supported by strong domestic ownership. President Vázquez' government continues to enjoy strong political support, and although there have been pressures (mainly from within the governing coalition) for higher fiscal spending and more state intervention in the economy, there is broad consensus across the main parties on the key elements of the program. The fiscal program is on track, and the five-year budget submitted to Congress in August is in line with the medium-term macroframework. The structural reform agenda is advancing as planned, although key challenges remain ahead, including important fiscal reforms, reforming the ailing public housing bank, and steps to improve the investment climate.

Nonetheless, significant vulnerabilities remain. Medium-term debt sustainability depends critically on sustained growth and fiscal consolidation; weaknesses remain in the banking system; and wage and social spending pressures are strong.

Policy discussions and staff appraisal

The near-term economic outlook is favorable. The growth target of 6 percent in 2005 is well within reach. With inflation well below the central bank target band, staff supported a recent moderate easing of monetary policy. The authorities stand ready to tighten monetary policy should inflationary pressures emerge.

The 2005–09 budget submitted to Congress supports the medium-term fiscal objectives of the program. It is now important to implement it. Key to this end will be planned tax policy and administration reforms to help achieve ambitious revenue targets. On the spending side, it will be important to contain public sector wage and pension increases, and implement the social emergency program in an effective, well-focused and transitory way, as planned.

Sustained rapid growth will require improving the investment climate. The government is developing a broad agenda of growth-enhancing reforms, focused on attracting more private investment as the key engine of future growth and social progress in Uruguay.

Continued reforms of the financial system are needed to minimize contingent fiscal costs and ensure a sustainable resumption of credit. Programmed central bank and financial sector oversight reforms are progressing as planned. NBC is being privatized, and the restructuring of the public banks needs to continue, especially at the public housing bank (BHU). The upcoming FSAP should help shape the future reform agenda in this area.

I. BACKGROUND

1. **A three-year Stand-By Arrangement in the amount of SDR 766.3 million (250 percent of quota) was approved on June 8, 2005.** Executive Directors considered that the pursuit of prudent macroeconomic policies, deep structural reforms to improve the investment climate, and well-targeted social spending would help to improve social conditions by raising growth, reduce vulnerabilities from the high public debt and widespread dollarization, and lay the basis for Uruguay's exit from Fund-supported programs.

2. **Macroeconomic performance in the first half of 2005 was broadly in line with the program.**

- ***Output growth slowed in Q1 2005, but is expected to strengthen again in the course of the year.*** Seasonally adjusted GDP remained broadly constant in Q1, compared to the last quarter of 2004, but was still some 7 percent higher than in Q1 a year earlier. This reflected mainly a weakening in domestic investment. Available indicators suggest that growth strengthened considerably in Q2, owing mostly to a pick-up in private demand.

- ***Annual inflation dropped to about 3½ percent at end-August, below the central bank's target range for end-December (5½–7½ percent)***. This reflected mainly an appreciation of the peso (by 9½ percent in nominal effective terms over the past year). Inflationary expectations have dropped sharply toward the mid-point of the target range.

- ***As expected, the external current account weakened somewhat this year, mirrored by a strengthening in the capital account***. Through June, exports grew by 21 percent (y/y), while imports increased by 30 percent (y/y), reflecting a jump in capital goods imports and continued strength of consumer demand. The capital account benefited from government bond issuances and the return of private capital; as a result, gross reserves at end-June stood at US$2.5 billion, some US$150 million higher than envisaged under the program. While the real effective exchange rate has continued to appreciate, it is still some 23 percent below the pre-2002 crisis level.

- ***Financial and vulnerability indicators have strengthened further.*** Sovereign spreads have continued to fall in line with emerging market trends, and have reached their lowest level since the financial crisis. Taking advantage of this trend, the authorities have used new placements to gradually improve the public debt profile by increasing the share of long-term, fixed rate, and domestic currency debt.[1]

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[1] The government has extended the maturity of new placements of dollar-denominated treasury bills by 6 months to two years, and increased the amount of inflation-indexed debt and extended maturity on new placements from 3 to 5–10 years. Also, the government

(continued)

- ***The fiscal program is on track.*** The primary surplus of the consolidated public sector was 3.1 percent of GDP in the first half of the year, about ½ percent of GDP higher than programmed. Revenues benefited from strong collections of corporate income and property taxes, and of social security contributions. This was partly offset by weaker performance of public enterprises of some ½ percent of GDP, reflecting mainly the impact of a drought, rising oil prices combined with some delays in tariff adjustment[2] and weak domestic demand in early 2005. Noninterest expenditure were slightly below the program, owing to start-up delays of social emergency partially offset by advance oil purchases by the state-owned oil company ANCAP.

- ***The central bank (BCU) has eased monetary policy moderately***. The BCU in June raised the target range for base money by about 4 percent, while maintaining the inflation target range for June 2006 at 5–7 percent. The higher-than-programmed base money growth reflects somewhat faster-than-expected remonetization of the 2002 crisis (although currency issue is still significantly below pre-crisis-level). Credit to the private sector has remained subdued, while the market-determined peso short-term interest rates have turned negative in real terms reflecting the high liquidity in the system.

- ***Available data for end-June suggest that all quantitative performance criteria (PCs) were observed*** (final for NDA and NIR of the BCU and non-interest expenditure, and preliminary for the primary surplus and NFPS debt PCs). Staff will update the Board on the primary surplus and NFPS debt PCs. [3]

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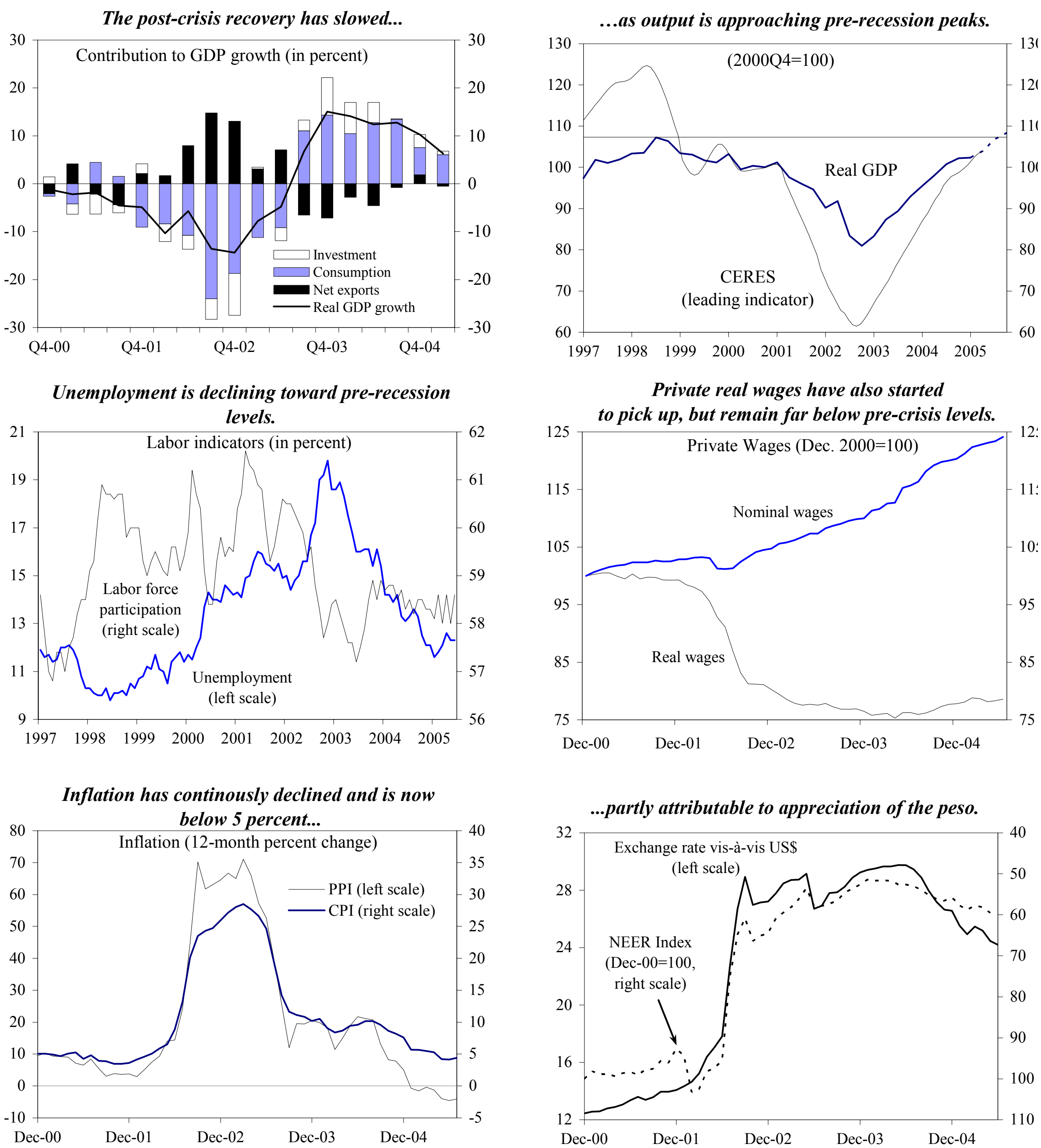
recently made three large bond issues in fixed interest rate long-term bonds (more than 10 years).

[2] Following a 7 percent increase in April, oil prices at the pump were further increased by 7 percent in July. Electricity tariffs were increased by 10 percent in April only.

[3] The attached TMU clarifies the definitions of coverage of public debt and the combined public sector balance, for the purpose of monitoring performance under the program.

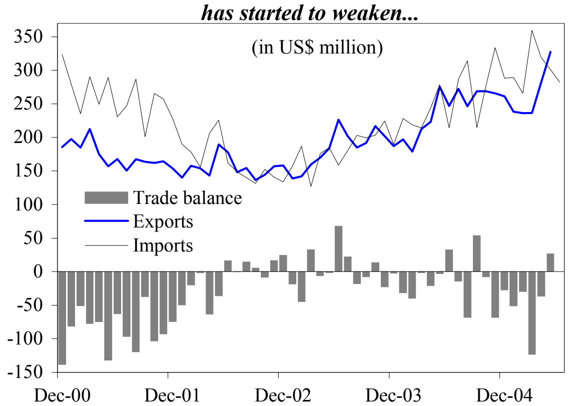
Figure 1. Uruguay: Output and Prices



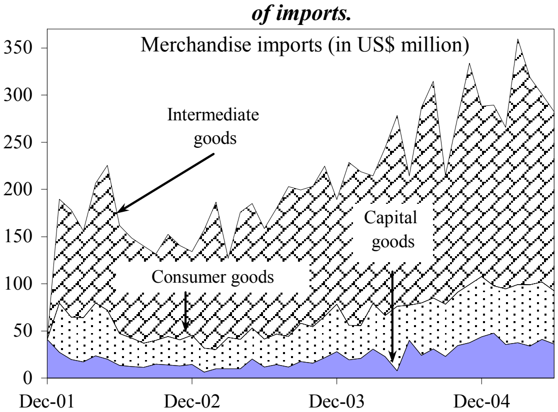
Sources: Central Bank of Uruguay; Ministry of Economy and Finance; and Fund staff estimates.

Figure 2. Uruguay: External Sector

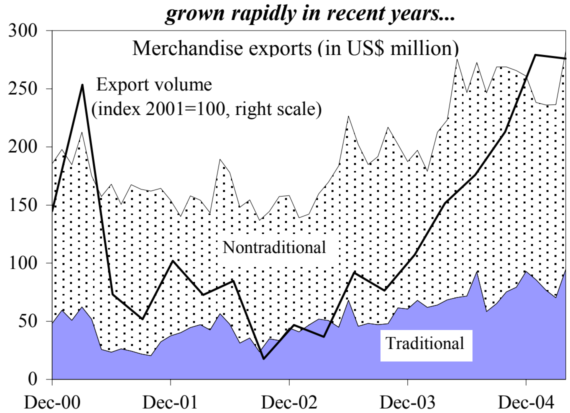
Despite strong export growth, the trade account has started to weaken...



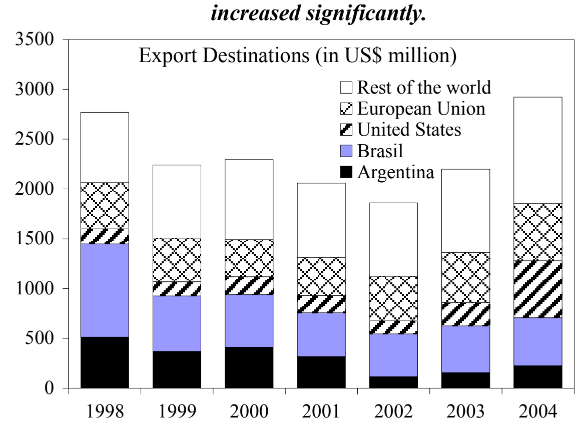
…reflecting strong growth of all categories of imports.



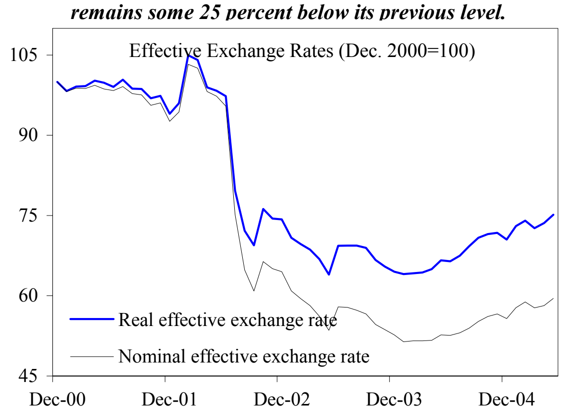
Both traditional and nontraditional exports have grown rapidly in recent years...



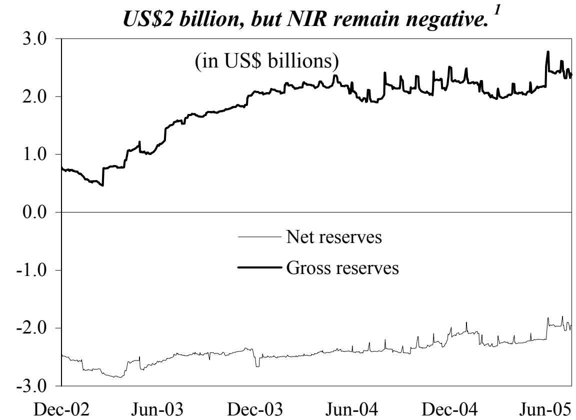
… and exports outside the region have increased significantly.



Despite the recent appreciation, the real exchange rate remains some 25 percent below its previous level.

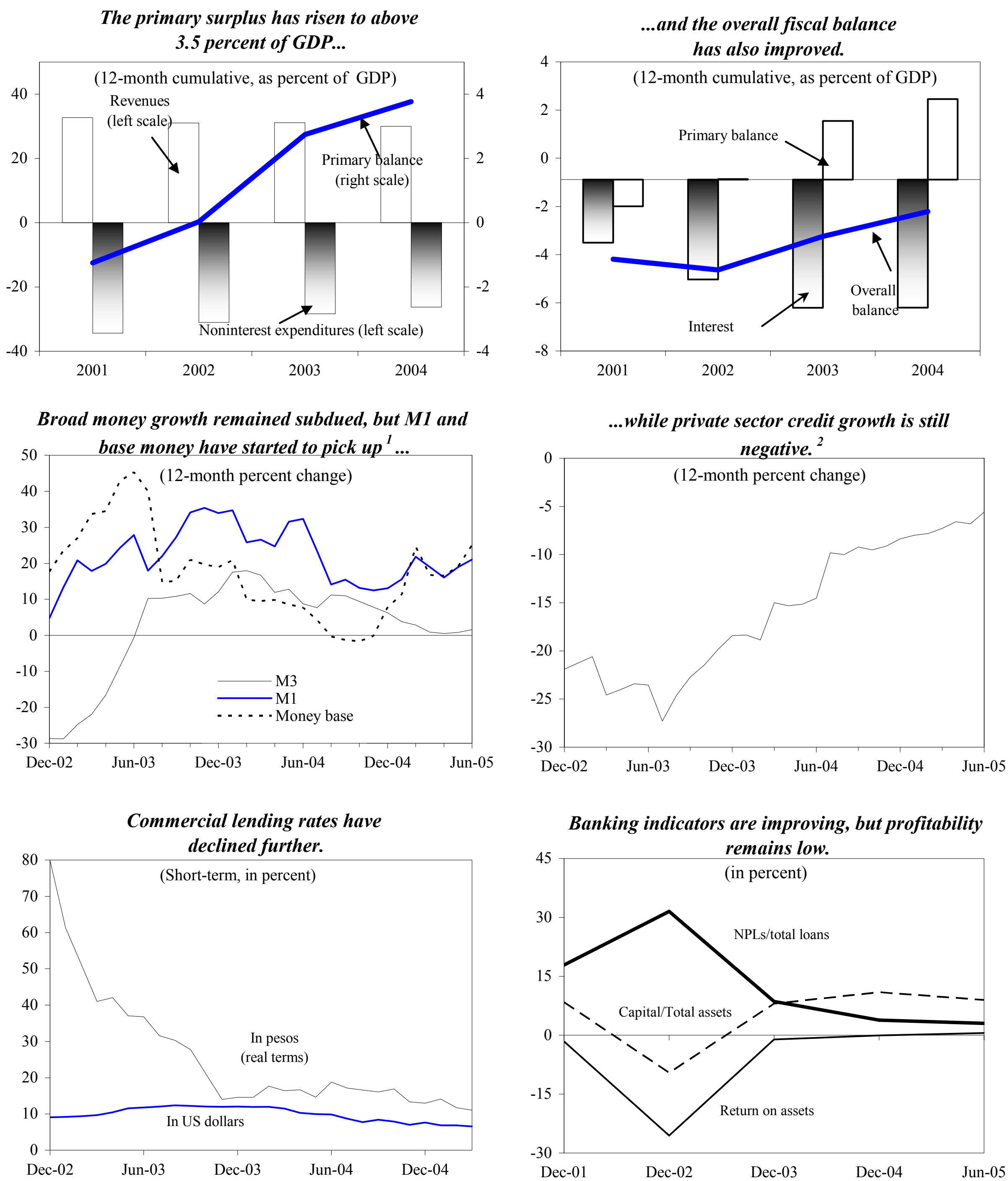


Gross reserves have increased above US$2 billion, but NIR remain negative. [1]



Sources: Central Bank of Uruguay; Ministry of Economy and Finance; and Fund staff estimates.
1/ Includes all liabilities to the Fund and short-term liabilities to resident financial institutions. Excludes proceeds of recent sovereign debt issues (about US$0.6 billion).

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



Sources: Central Bank of Uruguay; Ministry of Economy and Finance; and Fund Staff estimates.
1/ Measured at constant exchange rate.
2/ Includes impact of loan writeoffs by banks and the trust funds with the nonperforming assets formerly on the books of BROU.

3. **While implementation of structural reforms has been broadly as planned, problems in the public housing bank (BHU) remain.** The end-June benchmark on establishing revenue targets in the social security bank (BPS) and the August PC on budget submission were observed. Good progress is being made in preparing the key tax and specialized pension reforms, and legislation to strengthen central bank autonomy, financial system oversight, and the bank resolution framework. Also, the government is working on broadening the agenda for growth-enhancing reforms as described below. Reforms at BHU, however, have not produced the expected improvements in its financial situation, and more decisive actions are needed.

4. **Political support for the government has remained strong, but important risks and challenges to program implementation lie ahead.** President Vázquez's approval rating continues to be relatively high and the consensus across the political spectrum on the main elements of the program remains fairly solid. In June, Congress passed the Social Emergency Program (SEP) Law, which is designed to be transitory (2 years), and which the Administration sees as key to building political support for its reform agenda. At the same time, there have been pressures within the ruling Frente Amplio coalition for increased state intervention, especially in the labor market and the debt resolution process. While this has resulted in some measures, such as the reinstatement of tripartite wage councils, that have raised concern in the business community, it has not affected the broad direction and key elements of the program. However, the next few months will be a critical test when the five-year budget has to be passed by Congress and important parts of the government's reform agenda are to be implemented.

II. Outlook and Risks

6. **The outlook for 2005 and the medium term remains broadly as envisaged in the program (Country Report No. 05/235).** Growth in the first semester and recent data on exports and industrial production are consistent with the growth target of 6 percent for 2005. Growth objectives beyond 2005 should be attainable, helped initially by ongoing large FDI projects, although the longer-term outlook depends on a successful strategy to improve the business environment. Also, projected wage increases over the medium-term are now somewhat higher, based on recent agreements of public and private sector unions. The external current account deficit has been revised upwards to incorporate the impact of a second large-scale pulp mill project (of some 4 percent of GDP) and higher oil prices. However, the higher deficit is projected to be fully financed by higher FDI and private capital inflows, and is expected to be largely temporary until these projects generate export receipts, expected from late 2007.

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

					Projections					Country Report 05/235			
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2005	2006	2007	2008
Real GDP (percentage change)	-3.4	-11	2.2	12.3	6.0	4.0	3.5	3.0	3.0	6.0	4.0	3.5	3.0
CPI (percentage change)	4.4	14	10.2	7.6	6.5	5.5	4.5	3.5	3.5	6.5	5.5	4.5	3.5
Revenue	32.4	31.1	31.1	30.0	30.3	30.7	31.4	31.6	32.1	30.2	29.4	29.3	29.1
Non-interest expenditure	34.4	31.1	28.4	26.3	26.7	27.0	27.4	27.6	28.0	26.7	25.6	25.3	25.1
of which: wages	7.2	7.0	6.2	6.2	6.2	6.3	6.4	6.5	6.6	6.1	5.9	5.9	5.9
of which: social security benefits	16.7	16.4	14.0	12.6	12.6	12.2	12.2	12.2	12.4	12.4	11.9	11.7	11.5
of which: investment	4.3	2.5	2.5	2.5	2.3	3.0	3.4	3.4	3.5	2.5	2.4	2.7	2.8
Primary balance	-1.2	0	2.7	3.8	3.6	3.7	4.0	4.0	4.0	3.5	3.7	4.0	4.0
Overall fiscal balance	-4.1	-4.6	-3.2	-2.2	-1.3	-1.2	-0.7	-0.6	-0.9	-1.7	-1.3	-0.8	-0.8
Public sector debt 1/	46	96	104	92	73	67	64	60	57	76	70	65	62
External current account balance	-2.8	1.6	-0.5	-0.8	-2.8	-6.4	-2.8	-1.5	-1.2	-2.8	-5.3	-1.2	-0.7
excluding: pulp mill projects					-2.5	-2.4	-1.6	-1.5	-2.3	-2.0	-2.1	-1.4	-1.2
Official reserves (millions of U.S. dollars)	3099	776	2,087	2,512	2,762	2,977	3,185	3,254	3,373	2,656	2,866	3,067	3,230
As a % of ST debt + FX deposits	18.0	7.7	20.0	27.7	27.1	26.7	27.3	27.9	27.8	26.2	25.7	26.5	27.4

Sources: Uruguayan authorities; and Fund staff estimates.

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

7. **While short-term financing risks have decreased in the context of the benign external environment, important program risks and vulnerabilities remain:**

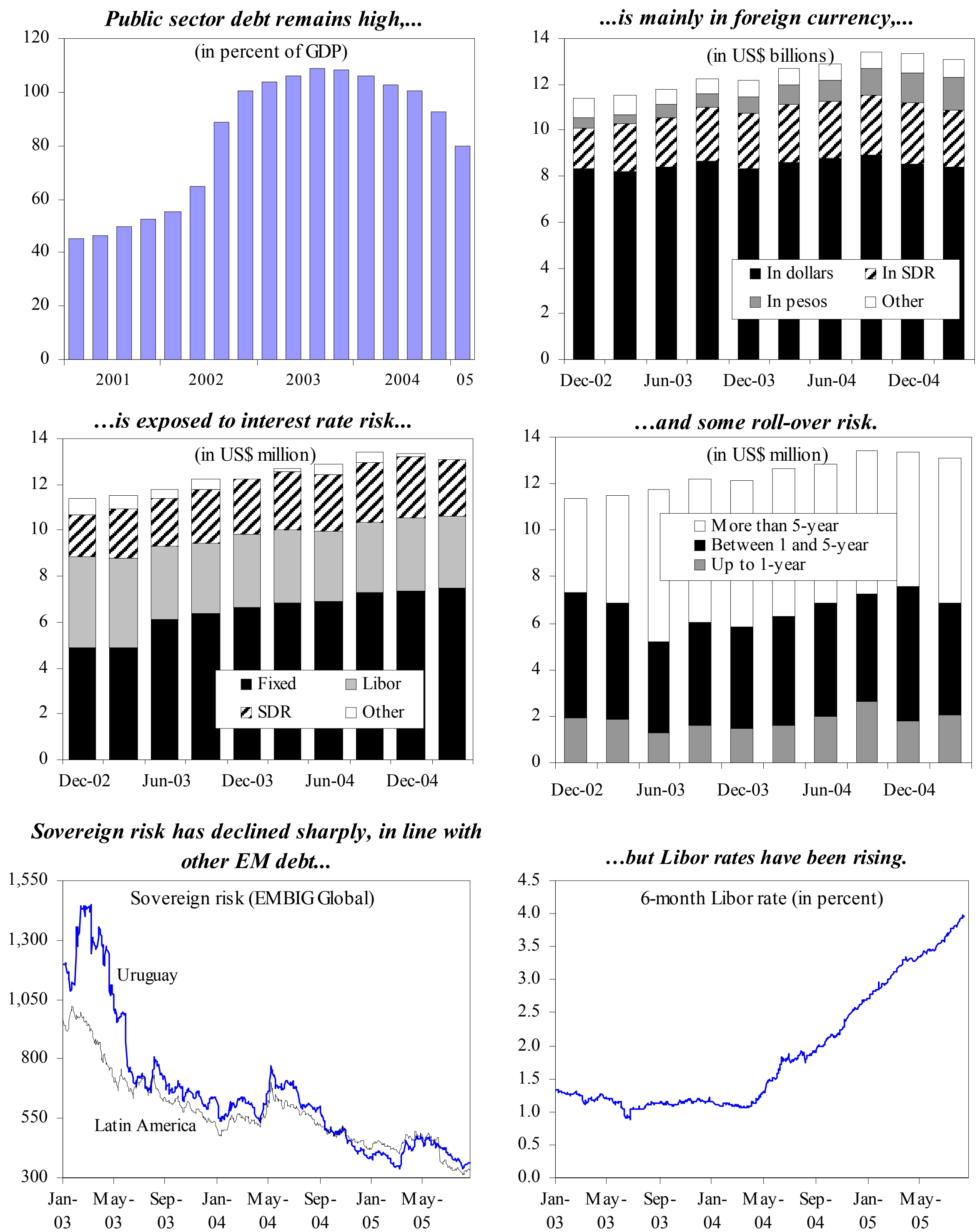
- ***Strong pressure to recover real wages and pensions and increase social spending persist***. While the recent agreement underlying the draft budget (discussed below) is consistent with the medium-term fiscal program, the changes made to the draft budget to forge consensus between cabinet highlight this risk.

- ***Sustaining growth will be critical*** for social progress and debt sustainability. However, as noted, recent mixed signals by the government, including concessions to unions, have created some uncertainty among investors about the future direction of policies, and the medium-term growth prospects depend critically on a clear and effective strategy to improve the environment for private investment.

- ***Fragilities remain in the banking system.*** Dollarization remains high, and the reserve coverage of dollar deposits and short-term debt is still significantly lower than in other dollarized economies.

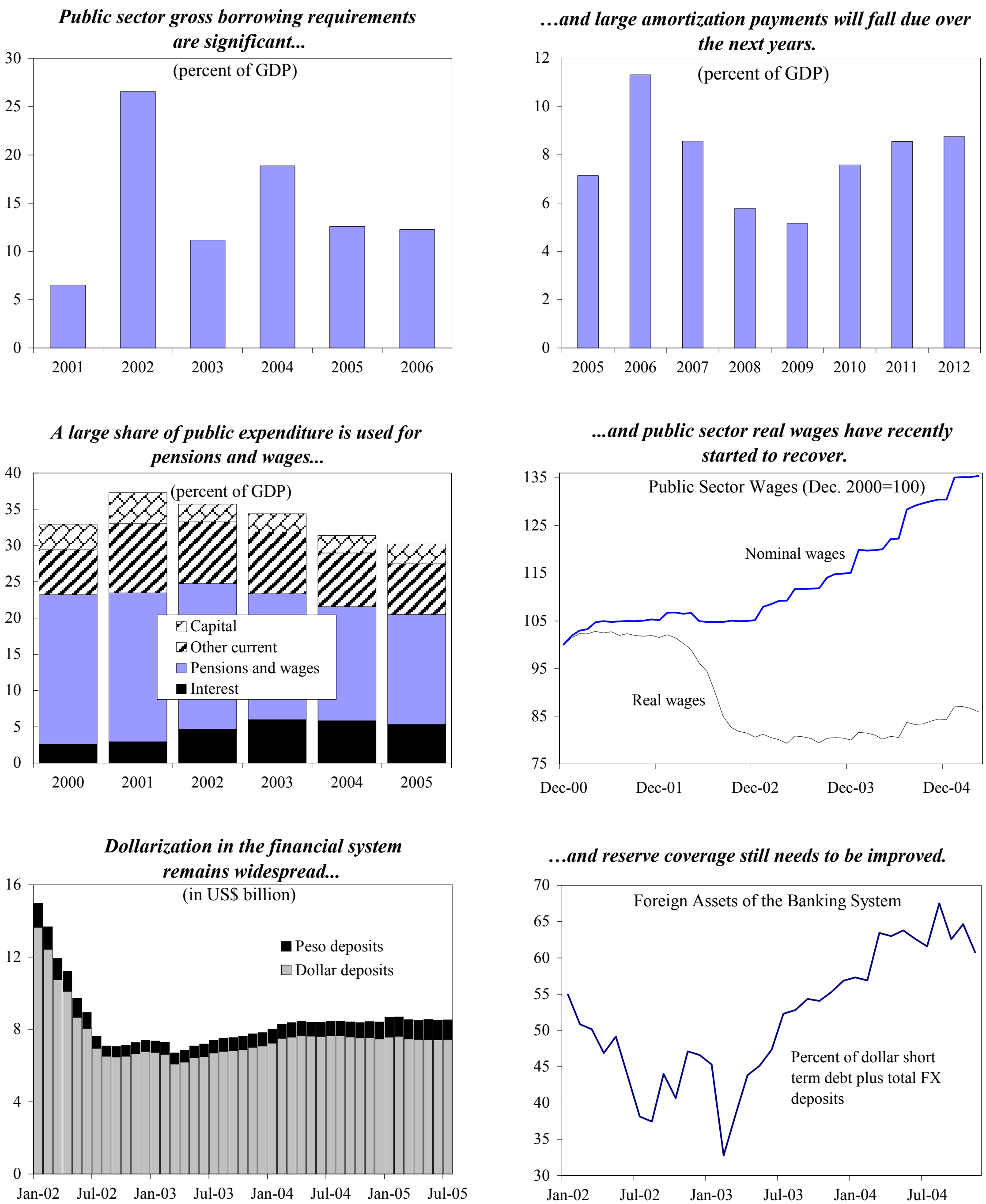
- ***The public debt is still high,*** with large debt-service payments due in the next years, including to the Fund. A reversal in emerging market sentiment, slowdown in world growth, and higher U.S. interest rates could heighten the vulnerability of Uruguay's financing outlook (see Appendix I).

Figure 4. Uruguay: Vulnerability Indicators



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

Figure 4. Uruguay: Vulnerability Indicators (concluded)



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

III. POLICY DISCUSSIONS

The first review focused on four areas: (i) near-term fiscal and monetary policies; (ii) the 2005–09 budget and fiscal reforms; (iii) financial sector restructuring; and (iv) reforms to improve the business environment and growth prospects.

8. **Discussions took place against the background of difficult budget negotiations within the ruling coalition**. While large spending requests from line ministries were essentially contained so as to meet the programmed primary surplus targets, this involved difficult discussions that seriously tested the coalition's support for the economic team. The budget submitted to Congress aims at primary surplus targets in line with the program, although it also targets somewhat higher revenues than initially (conservatively) programmed.

A. Macroeconomic Policies

Fiscal policy

9. **The authorities reiterated their commitment to save any revenue overperformance in 2005, toward a higher primary surplus.** However, they noted that part of the fiscal overperformance during the first half of 2005 was in part due to temporary factors, including seasonally strong revenue collection by local governments. They emphasized their continuous efforts to strengthen tax administration and social security collections, which are already bearing fruit, and maintain primary expenditure within program limits. They explained that slightly higher-than-programmed public sector wage increases reflect supplements to teachers and lower-wage employees.[4] While sharing staff's concerns, the authorities explained that the deterioration in the public enterprises was partly due to a drought and rising oil prices with impact throughout 2005, but that they are committed to strengthen management. They also recently announced fuel price increases, to take place by early October; current estimates point at the need of an 8 percent increase, but a possible agreement with Venezuela could lower oil import costs.

10. **Staff supported the five-year budget submitted to Congress, although higher revenue and spending targets imply somewhat heightened risks (Box 1).** While the primary fiscal surplus targets are in line with the program, projected revenues are about 1½ percent of GDP and spending levels about 1 percent of GDP higher over the medium-term relative to 2005. Staff expressed some concern that the revenue targets are ambitious and subject to downward risks. On the spending side, the budget incorporates an agreement with unions for an increase in real wages of about 3 percent per year over the next four years, in line with GDP growth, plus an additional allocation to priority sectors, which would reach

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[4] In July, public wages were increased on average by 3.7 percent, above the 2.5 percent assumed in the program.

0.4 percent of GDP in 2009. The authorities explained that the ongoing improvements in tax administration (see below) and the planned tax reform should ensure achievement of the revenue targets, which would still remain as a share of GDP below its pre-crisis level. They also stressed that the recent wage agreements help consolidate some of the sharp reduction in the wage bill and pensions as a percent of GDP achieved during 2002–05, as they are conditional on GDP growth and include safeguards for fiscal difficulties. In addition to the safeguards on salaries, they stressed their readiness to adjust spending plans, including of investment, should revenues come in lower than expected. Staff intends to discuss with the authorities appropriate contingency plans in the context of each annual budget.

Box 1. Uruguay: The 2005–09 Budget

In August, the government submitted to Congress the draft budget for the period 2005–09, which significantly improves from previous budgets in several areas. In particular, it:

- Is based on an explicit medium-term macroeconomic framework;
- Contains revenue projections, in addition to expenditure ceilings; and
- Is consistent with the program's primary surplus and overall deficit targets, instead of presenting "high" expenditure ceilings to be "underimplemented."

The primary surplus would reach 3.7 percent of GDP in 2006 and 4 percent of GDP thereafter, **with revenue measures allowing increases in investment levels**. The medium-term strategy entails:

- Increasing revenue by over 1½ percent of GDP through tax administration efforts, a comprehensive tax reform, and improved administration of public enterprises;
- Containing noninterest current spending slightly above its 2005 level, which would consolidate reductions of close to 6 percent of GDP achieved during 2002–05.
- Discontinuing the social emergency program in 2007 as originally envisaged.
- Increasing investment by over 1 percent of GDP to upgrade infrastructure, especially in the transportation and energy sectors.

Agreements with labor aim at gradually recovering public sector real wages, while containing the wage bill as a share of GDP well below pre-crisis levels. These agreements also affect pension payments, the largest spending category, which are partially determined by public sector wages. Wage increases would be based on:

- Inflation during the previous 12-month period (except in 2006, when it would be only inflation of the preceding 6 months);
- An additional 2.5 percent per year (assumed real GDP growth trend), with a symmetric adjustor for half of the deviation of actual GDP growth from 2.5 percent;
- Additional allocations reaching about 0.4 percent of GDP by 2009 for priority sectors, including health and education; and
- Fiscal objectives being met and good employee performance.

11. **Authorities and staff concurred on the need to improve the execution of the Social Emergency Program (SEP).** The authorities indicated that they had taken action to address the initial difficulties and were confident that implementation would now proceed well. Staff and the authorities agreed that any underspending on the SEP should not be substituted by other spending. The authorities reiterated their commitment to keeping the SEP within the overall budget envelope (US$200 million) as envisaged.

Monetary and exchange rate policy

12. **Staff supported the authorities' decision to ease monetary policy in June.** The faster-than-envisaged deceleration in inflation, as well as continued pressures for peso appreciation, suggest that the current (moderately eased) stance of monetary policy is consistent with the authorities' 5½–7½ inflation target range for end-2005. Staff and the authorities agreed, however, that caution was warranted given potential inflationary pressures from high oil prices and wage increases, as well as their still incomplete understanding of the monetary transmission mechanism and the exchange rate pass-through under the relatively new flexible exchange rate regime.

13. **The base money target range for the remainder of 2005 has been raised by 4 percent.** Staff recommended that as much as possible of this increase be achieved through unsterilized foreign exchange purchases (given the need to further increase international reserves). The authorities agreed with the desirability of further raising reserves, and--barring unforeseen shocks—will conduct policies aimed at maintaining overperformance in this respect. They were reluctant, however, to commit to a higher NIR floor under the program, given the risk of shocks; they also noted the benefits of reducing the outstanding stock of central bank securities, which carry high quasi-fiscal costs. On this basis, it is proposed to increase the NDA ceilings for end-September and end-December, consistent with the revised base money targets. It was agreed to reexamine the monetary program at the next review when, in the staff's view, the program should seek to lock in the overperformance. The authorities also reiterated their readiness to adjust monetary policy as necessary to achieve the inflation objectives for 2005 and 2006.

B. Fiscal Reforms and Debt Management

14. **Fiscal reforms are to bolster the public finances' resilience to shocks, improve efficiency, and ensure achievement of the medium-term fiscal targets**. Staff welcomed progress in preparing the programmed reforms of tax policy and administration, the budgetary framework, and pension schemes, noting that timely and full implementation will be important to reap benefits early on in the program.

- ***Tax reform***. A draft law is being prepared, including a new personal income tax (PIT), revamping of the corporate income tax, elimination of tax exemptions and subsidies, and unification of VAT rates. The reform is to generate increases in revenues starting in 2007 equivalent to ½ - ¾ percent of GDP. In addition, the authorities agreed with the staff that implementation will have to be carefully sequenced to make sure that the burden of indirect taxation is not reduced before the targeted revenue increases are assured. They explained that, while the draft law will be ready by year-end as previously expected, it would only be submitted after Congress returns from recess in mid-February. Implementation is still envisaged by mid-2006.

- ***Strengthening revenue administration.*** Staff welcomed recent progress, including the establishment of a large taxpayers unit, collection targets at the social security bank (BPS), and improved coordination of tax audits between collection agencies. The authorities are taking steps to implement several of the July 2005 Fund-World Bank recommendations (Box 2).

Box 2. Uruguay: Strengthening Revenue Administration

The authorities view comprehensive reforms in the revenue collecting agencies as key to their fiscal program for 2005–08. In particular:

Domestic tax collecting agency (DGI)

- **The DGI is being reformed based on a recent decree for its modernization**. Actions already taken include: (i) creation of a large taxpayers unit and an internal audit department; (ii) adoption of a new human resources policy, together with a new professional career stream; and (iii) increased funding (by some 0.15 percent of GDP). Recruitment of required personnel is ongoing.

- **A memorandum of understanding between the Ministry of Economy and Finance and the DGI is to be signed by December 2005** (structural benchmark). It should include: (i) collection goals for 2006; (ii) performance incentives; and (iii) quantitative criteria to strengthen the collection and audit functions, enhance tax services, and update information systems.

Customs agency (DNA)

- **A comprehensive strategy to transform the DNA into a modern customs service will be prepared by August 2006** (structural benchmark), with Fund TA. Recent Fund–World Bank TA has recommended: (i) revising the organizational structure; (ii) increasing human and material resources; and (iii) moving toward risk-based controls. The budget submitted to Congress proposes additional funds of some 0.15 percent of GDP for the DNA.

Social Security (BPS)

- **BPS has adopted an action plan through end-2006**, which takes into account Fund–World Bank recommendations. The plan aims to improve: (i) audit and collection functions; (ii) services to contributors; and (iii) coordination with other government entities.

- ***Reforming the budget process.*** The budget recently submitted to Congress incorporates a medium-term macroeconomic framework, expands budget coverage, and aligns appropriations with execution ceilings. Staff encouraged the authorities to move forward with the implementation of other FAD recommendations, which include introducing an organic financial management law, moving to annual budgets within a rolling five-year framework, improving budget classification and coverage, and completing tax expenditure analysis. The authorities stated that they would turn to those issues following budget approval in early 2006.

- ***Pension reform***. The authorities confirmed that the reform of the pension fund for the police would be enacted by November this year, while the reforms of other specialized funds (military and bank employees) would be implemented in 2006. Regarding the general pension system, the authorities are focusing on strengthening collection of contributions, as a key measure to improve the financial viability of the system. Staff noted that the expected recovery of real wages will add strain on the system (under the current indexation formula linking pensions to wages) and that more far-reaching reforms should be considered,[5] in the context of possible second-generation reforms being discussed with the World Bank, which would aim to improve the system's equity and generate some cost savings over the medium-term.[6] The authorities agreed, while noting that pensions are projected to decline moderately as a percent of GDP over the medium term, remaining substantially below their pre-2002 levels.

15. **The government is taking advantage of favorable financial market conditions to improve gradually the structure of public debt.** The staff welcomed the gradual extension of the maturity of dollar-denominated T-bills, and the issuance of inflation-indexed T-notes and international bond issues at longer maturities. The authorities agreed with the staff that further international bond placements to pre-finance the government's needs would help lock in current favorable market conditions. The establishment of the debt management unit in the Ministry of Finance—supported by Fund-IDB technical assistance—by end-December is on track, with the necessary appropriations made in the budget.

C. Central Bank and Financial Sector Reforms

16. **The authorities reiterated their commitment to programmed reforms of the central bank and financial sector oversight authorities.** Final decisions on the organizational structure of the financial sector supervisory agencies would be taken shortly, and legislation to increase the operational independence of the BCU would be submitted to Congress by year-end as envisaged. Work on the law clarifying the operations and funding of the deposit insurance agency is also well-advanced, and the authorities agreed with the staff that it would be preferable to place the agency outside the central bank. The staff welcomed the prudential regulation approved in August, which takes into account currency risks (to

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[5] It required treasury support of some 6½ percent of GDP in 2004.

[6] Suggested reforms include (i) increasing the retirement age to 65; (ii) shifting the indexation of pensions from wages to inflation; and (iii) calculating pensions based on lifetime earnings and taking into account interruption in labor force participation.

become effective July 2006). A first FSAP mission in October will take stock of the current financial sector framework and identify an agenda for longer-term systemic reforms and development needs.

17. **Bank restructuring is proceeding well, except in the housing bank (BHU) where stronger measures are needed.**

- ***Nuevo Banco Comercial (NBC).*** Staff welcomes the authorities' recent signature of a contract to sell 100 percent of the common equity of NBC; the deal is expect to be closed by year's end. Staff recommended to use the proceeds to retire debt.

- ***State bank (BROU)***. The authorities noted that BROU continued to be profitable in the first half of 2005, and the quality of its loan portfolio has remained consistently strong. The bank's asset management company (AMC) is making progress in the recovery of nonperforming loans (NPLs), allowing the trust funds to service the government-guaranteed note to BROU ahead of schedule.

- ***Housing bank (BHU)***. A joint Fund–World Bank mission in July 2005 found BHU to be undercapitalized and illiquid, with negative cash flows and serious governance problems. The bank's problems stem mainly from its large portfolio of nonperforming assets and high operating expenses. Unless decisive steps are taken, it may be unable to meet its government-guaranteed obligations to BROU beyond the next few months. The authorities shared the staff's concerns and stressed that a final plan for the bank aimed at minimizing potential fiscal costs would be adopted by December (proposed structural PC). In the meantime, BHU would continue to refrain from taking deposits.[7]

- ***Liquidation funds***. Collection by the private asset manager of the liquidation funds is proceeding on schedule, and recoveries for the three banks have exceeded the original business plan by about 10 percent. Staff emphasized—and the authorities agreed—that to enhance transparency, publication of semi-annual financial reports on the liquidation funds' operations should continue (see Country Report No. 05/109, para.18). The voluntary guidelines for debt restructuring issued in June have not had a notable impact on the operations of the private asset manager. The transfer of information on non-performing borrowers of the liquidation funds into the credit registry is expected to be completed by year's end.

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

D. Growth-Enhancing Structural Reforms

18. **The authorities are developing a strong pro-growth agenda, which they deem essential for the success of the program.** In addition to sound macropolicies and a strengthened financial system, improving the business environment is a key plank of this agenda. A recently established growth commission, which includes government officials and representatives of the private sector and labor, is currently designing a detailed roadmap with pro-growth reforms to be implemented over the next years, which is expected to be completed by end-March 2006 (proposed structural benchmark).

19. **In the meantime, the government is already working on several fronts to improve the business climate and reduce the costs of doing business.**

- ***Tax reform.*** The upcoming tax reform (discussed above) is expected to further stimulate consumer demand and reduce distortions across productive sectors.

- ***Reducing the cost of doing business.*** The government is streamlining business setup procedures to eliminate hurdles to starting new businesses in Uruguay. Tax and social security registration have already been simplified through one-stop windows.

- ***Creditor and debtor rights.*** A new bankruptcy law will be submitted to Congress by June 2006 (proposed structural benchmark), allowing Chapter 11-like corporate restructurings. Implementation would be expected by December 2006.

- ***Competition policy***. Legislation restricting anticompetitive practices has been submitted to Congress.

20. **Staff highlighted the need for prudent wage policies and labor market flexibility.** In response to the staff's concerns that the new wage councils might result in increases that adversely affect competitiveness and growth, the authorities explained that the wage increases agreed in the context of the councils for 2005 remained broadly in line with productivity growth. Moreover, they stressed that the new collective bargaining framework is bringing stability to labor relations by channeling demands in an orderly fashion and in an environment conducive to moderation.

21. **Public-Private Partnerships (PPPs) are expected to play a key role in raising investment and improving the efficiency of public enterprises.** The authorities explained that given fiscal constraints and society's preference for continued public involvement, private sector participation in public enterprises and infrastructure projects should play a significant role to meet the growth objectives. The staff stressed that it will be important to have a proper regulatory and legal framework for PPPs in place to maximize their benefits and minimize contingent fiscal costs. While the authorities agreed on the need to structure PPPs carefully to ensure proper accounting, risk sharing, and transparency, they explained

that they plan to move ahead on a case-by-case basis (taking into account Fund and IDB advice), building up experience and the institutional framework over time.

IV. Financing Assurances

22. **The program has adequate financing assurances in place**. Most of the government's 2005 market financing needs have been secured through placements in the domestic market and a US$500 million international bond placement in May, and some US$265 million disbursements under the World Bank and IDB lending programs are expected before year's end. In addition, taking advantage of favorable market conditions, the government already obtained part of the 2006 external financing needs through the issuance of a EUR 300 million (US$360 million) bond in July. Gross financing requirements for the remainder of the program will need to be met through sustained fiscal discipline, increasing access to domestic and international financial markets, and continued IFI support.[8]

Uruguay: Public Sector Financing Outlook 2005

(In millions of U.S. dollars)

	2005		
	Jan.-July	Report No. 05/235	Proj.
Public sector gross borrowing requirements	**1,172**	**2,044**	**2,114**
o/w: IMF repurchases	356	483	480
o/w: World Bank/IDB	142	327	354
o/w: Bond amortizations	286	619	676
Gross financing	**1,572**	**2,044**	**2,354**
o/w: IMF disbursments	252	353	342
o/w: World Bank/IDB	32	376	297
o/w: Bond placements	1,289	1,044	1,511
o/w: >10 year maturity	892	429	892
o/w: Short-term debt	63	150	124
Deposit buildup	**400**	**0**	**240**
Memorandum items:			
Fund credit outstanding	...	1,946	1,946
(as a share of quota)	...	553.7	553.7
Net World Bank/IDB	-110	49	-58
Net bond placements	1003	425	835

[8] The total gross public sector financing need (including for the programmed buildup in international reserves) will average about US$2.2 billion a year (12 percent of GDP) during 2005–08, and debt service payments will average some 15½ percent of GDP (5 percent of GDP in interest payments).

V. Program Monitoring, Statistical Issues and Safeguards

23. **Program monitoring.** Performance criteria, benchmarks, and indicative targets under the program are specified in the attached supplementary MEFP and TMU (Attachments II and III).

- **Some monetary targets for 2005 are proposed to be modified.** The indicative ceiling on base money for September and December would be raised by Ur$0.6 billion and Ur$0.7 billion, respectively, in line with the BCU's new target range. The ceiling on NDA is proposed to be adjusted upwards, accordingly (see paragraph 13). The adjustors to NIR and NFPS debt targets are also proposed to be modified to better reflect the concept of pre-financing.

- **The structural performance criterion on tax law submission** is proposed to be moved to end-February (from end-December) to better align the test date with the resumption of congressional sessions in mid-February (see paragraph 14).

- **A new structural performance criterion is proposed in the financial sector, and structural benchmarks in the growth and tax administration areas.** Adoption of a reform plan for BHU is proposed as a structural PC for end-2005. To support growth, benchmarks on the completion of an agenda of growth-enhancing reforms and on the submission of the bankruptcy law are proposed for end-March and end-June 2006, respectively. Signing a memorandum of understanding between the Ministry of Finance and the DGI, and designing an action plan to reform the customs office would be new benchmarks for December 2005 and August 2006, respectively.

- **The second review is expected to take place in December 2005.** Quantitative quarterly performance criteria and the main elements of the structural reform agenda for 2006 will be established at that time.

24. **Statistical issues**. Uruguay's statistical database has been broadly adequate for program monitoring, but provision of fiscal and public debt data still exceeds the two-month limit specified in the TMU, mainly due to reporting difficulties from BHU and BROU. Staff urged that further efforts be made to reduce the reporting lag, and welcomed recent efforts to strengthen the recording of floating debt, which will become part of the fiscal PCs beginning 2006, and the publication of the Fund's Data Template on International Reserves and Foreign Currency Liquidity on the Fund's website.

25. **Safeguards assessment**. The BCU has implemented most of the measures proposed under the safeguards assessment completed in 2003. The new safeguards assessment is near completion and found that broadly adequate mechanism are in place that safeguard the use of Fund resources and minimize the possibility of misreporting, but some vulnerabilities in the areas of external audit, financial reporting, and the legal framework remain to be addressed (see Appendix II). The authorities are reviewing the recommendations, which will be discussed at the next review.

VI. Staff Appraisal

26. **Early results of the program are encouraging and vulnerabilities, albeit still high, have declined.** Good macroeconomic policies and favorable external conditions have resulted in rapid growth, low inflation, and strong fiscal performance. Favorable financial market conditions have allowed for some buildup in reserves and enabled the government to successfully tap the international capital markets, completing already part of the external financing plan for 2006. Staff commends the authorities for their commitment to save any fiscal revenues exceeding program levels in 2005 toward achieving the medium-term primary surplus target of 4 percent of GDP as soon as possible, and stressed that tariff adjustments in public enterprises should be done promptly in line with cost developments. It also encourages the authorities to continue to take advantage of market conditions to further improve the net international reserve position and the public debt profile.

27. **Continued success of the program depends on sustaining growth and making progress in the social area.** While growth has been broadly in line with the program, downside risks remain, and the social situation is still difficult. With the output gap closing this year, and given the fiscal resource constraint, it is crucial to encourage private sector investment by improving the investment climate. Staff welcomes the establishment of a growth commission with private sector participation to define a broad-based agenda of growth-enhancing reforms, which should be implemented in close collaboration with the Word Bank and the IDB. It also encourages the authorities to continue efforts for efficient implementation of the Social Emergency Program, and ensure that it is phased out as envisaged.

28. **The recent submission to Congress of the 2005–09 budget represents a major step toward the medium-term objectives of the program**. The budget submitted contains significant improvements from previous budgets and is consistent with the program's fiscal targets. The challenge is now to approve and implement it. Key in this regard will be planned tax policy and administration reforms to help meet the ambitious revenue targets, and to contain public sector wage and pension increases, as necessary, to safeguard the program's fiscal objectives.

29. **While the recent easing of monetary policy is appropriate, the authorities need to remain vigilant against potential inflationary pressures.** In particular, the effects of recent private sector wage increases, pending utility tariff increases due to higher energy prices, and excess liquidity in banks should be monitored carefully. The staff urged the authorities to be ready to tighten policies, if needed, to safeguard the inflation objective of the program. Staff recommends that as much as possible of the targeted increase in base money be achieved through unsterilized international reserve accumulation.

30. **Fiscal reforms are on track.** On tax administration, staff commended the authorities for reforming the tax directorate and their plans to further strengthen collection agencies in line with FAD recommendations. On the budget process, staff welcomes the improvements introduced with the 2005–09 budget, and looks forward to further efforts toward annual budgets within a rolling five-year framework and improved budget

classification and coverage, including tax expenditure analysis. On debt management, staff encouraged the authorities to proceed with establishing a debt management unit at the Ministry of Finance, as planned.

31. **Pending pension reforms need to be implemented.** Preparations for the reform of the police pension funds are well advanced, and its implementation by November 2005 should ensure reductions in the fiscal burden over time. Staff urged the authorities to proceed with the reform of the military and bank employees' pension funds as soon as possible, and to consider second-generation reforms for the general pension system to improve its actuarial balance and reduce its fiscal cost, in collaboration with the World Bank.

32. **Ongoing reforms to strengthen the financial system, its supervision and regulation, and the conduct of monetary policy are well placed.** It will be important to consolidate the ongoing restructuring of the financial system by proceeding as planned with the reform of the BCU and the supervisory authority of banks, and the creation of the deposit insurance agency. The upcoming FSAP will be a good opportunity to take stock of the reform process and develop the future agenda.

33. **The restructuring of public banks must continue, with immediate attention to the situation in BHU.** The ongoing privatization of NBC is a major achievement. Progress at BROU is commendable, and should be followed up with a further strengthening of the bank's credit-granting procedures, internal controls, and risk management systems which, in due course, should allow to gradually relax liquidity requirements imposed by the BCU. Reforms at BHU, however, have stalled, with potentially serious consequences for the bank's financial situation and its burden on the budget. It is critical that an action plan, aiming at minimizing systemic risks and contingent fiscal costs, is developed and implemented promptly.

34. **Uruguay's statistical information is adequate for program and surveillance purposes, but concerns remain about the timeliness of fiscal data.** Staff urges compiling below-the-line fiscal data in a timely manner, and welcomes the authorities' efforts to increase the coverage of fiscal data to include floating debt.

35. **Staff is confident that continued implementation of the program will further reduce Uruguay's economic vulnerabilities and prepare the country for a lasting exit from Fund support.** Despite the strong results so far, important risks and vulnerabilities remain, leaving little room for policy slippages. Based on the authorities' firm commitment to continued strong program implementation, and their demonstrated readiness to adjust policies as needed to meet the program objectives, staff recommends completion of the first review under the SBA, and supports the authorities' request for modification of performance criteria.

Table 1. Uruguay: Selected Economic and Social Indicators

Population (estimate)	3.2	Physicians per 1,000	3.7
		Hospital beds per 1,000	4.4
Life expectancy at birth (years)	74.6		
Crude birth rate (per thousand)	9.7	Access to safe water (percent of population	98.0
Infant mortality rate (per thousand live births)	14.0		
Income share held by highest 10 percent of households	33.5	Adult literacy rate	97.7
Income share held by lowest 20 percent of households	4.8	Gross enrollment rate	
Gini coefficient	44.6	Primary education	108.3
Unemployment rate	11.0	Secondary education	101.5
Poverty rate	31.0	Tertiary education	37.7
GDP per capita in 2004 (in US$)	4,300		
Human Development Index Rank	46 (out of 177 countries)		

				Report 05/235	Proj.	Projections		
	2002	2003	2004	2005		2006	2007	2008
				(Percent change)				
				I. Output, prices, and employment				
Real GDP	-11.0	2.2	12.3	6.0	6.0	4.0	3.5	3.0
Real consumption	-15.7	1.1	11.4	8.2	6.8	5.3	-0.3	2.0
Real investment	-34.5	18.0	27.0	11.5	13.9	30.9	-4.7	-0.3
Contributions to real growth (percent)								
Consumption	-15.2	-1.0	9.2	7.0	6.2	4.8	-0.3	1.7
Investment	-5.0	2.7	2.9	1.5	1.9	4.6	-0.9	-0.1
Net exports	9.1	0.9	-1.2	-2.8	-2.1	-5.4	4.7	1.3
GDP (Ur$ billions)	261	315	379	418	416	461	499	533
GDP (US$ billions)	12.1	11.2	13.3	16.4	16.8	18.4	19.6	20.8
Investment	3.9	20.1	18.9	23.0	25.1	43.0	0.7	3.3
Consumption	-11.7	32.1	30.6	10.6	9.9	9.8	5.8	6.0
GDP deflator	18.7	18.4	6.9	4.1	3.5	6.6	4.6	3.7
CPI inflation (average)	14.0	19.4	9.2	5.2	5.1	6.5	4.5	3.5
CPI inflation (eop)	25.9	10.2	7.6	6.5	6.5	5.5	4.5	3.5
Exchange rate change (Ur$/US$)(average)	62.1	30.4	-10.8	...	...	...	...	...
Exchange rate change (Ur$/US$) (eop)	84.2	7.3	-2.8	...	...	...	...	...
Average public sector wage (end-of-period)	0.5	7.9	9.7	6.5	10.2	10.5	9.6	8.6
Unemployement (in percent)	17.0	16.9	13.1	...	...	...	...	...
				II. Monetary indicators 1/				
BCU monetary liabilities	-7.4	25.3	30.0	7.9	20.3	...	...	...
Currency issued	5.8	22.4	15.7	11.6	11.4	...	...	...
M-2	0.8	20.7	9.9	8.1	8.1	...	...	...
M-3	21.3	24.2	-9.5	1.5	4.0	...	...	...
Credit to the private sector (constant exch. rate) 2/	-13.7	-25.5	-20.1	8.6	0.0	...	...	...
				(Percent of GDP, unless otherwise indicated)				
				III. Public sector operations				
Revenue	31.1	31.1	30.0	30.2	30.3	30.7	31.4	31.6
Noninterest expenditure (incl. discrepancy)	31.1	28.4	26.3	26.7	26.7	27.0	27.4	27.6
Primary balance	0.0	2.7	3.8	3.5	3.6	3.7	4.0	4.0
Interest	4.7	6.0	6.0	5.2	4.9	4.8	4.7	4.6
Overall balance	-4.6	-3.2	-2.2	-1.7	-1.3	-1.2	-0.7	-0.6
Public sector debt 3/	96	104	92	76	73	67	64	60
Public debt service (as a percent of GDP)	13	14	19	16	16	16	15	12

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

	2002	2003	2004	Report 05/235 2005	Proj. 2005	Projections 2006	2007	2008
				IV. Savings and investment				
Gross domestic investment	11.5	12.6	13.3	15.3	15.5	20.0	18.4	17.8
Gross national savings	14.7	12.1	12.5	12.5	12.8	13.7	15.6	16.3
Foreign savings	-3.2	0.5	0.8	2.8	2.8	6.4	2.8	1.5
				V. External indicators				
Merchandise exports, fob (US$ millions)	1,922	2,281	3,021	3,276	3,496	3,724	4,078	4,511
Merchandise imports, fob (US$ millions)	1,874	2,098	2,990	3,713	3,852	4,878	4,724	4,961
Merchandise terms of trade (percentage change)	4.3	2.9	-3.1	-6.4	-9.6	-5.6	-0.3	0.2
Current account balance	3.2	-0.5	-0.8	-2.8	-2.8	-6.4	-2.8	-1.5
Of which: Excluding cellulose projects	3.2	-0.5	-0.8	-2.0	-2.5	-2.4	-1.6	-1.5
Foreign direct investment	1.5	3.6	2.3	2.9	2.3	6.3	4.1	2.9
Overall balance of payments (US$ millions)	-2,328	1,380	454	144	297	215	207	69
External debt 4/	87.5	98.2	87.4	70.2	69.7	62.2	57.2	52.9
Of which: External public debt	68.9	85.3	76.9	61.7	61.8	54.9	50.4	46.5
External debt service (percent of exports of goods and services)	55.0	52.3	42.9	51.7	49.4	52.2	48.5	36.1
Gross official reserves (US$ millions) 5/	776	2,087	2,512	2,656	2,762	2,977	3,185	3,254
In months of imports of goods and services	3.7	9.2	8.2	7.2	7.0	6.1	6.7	6.5
In percent of short-term debt	25.1	86.8	158.0	115.0	124.9	118.5	125.9	163.5
In percent of short-term debt plus bank non-resident deposits	14.3	45.1	61.6	54.2	58.9	58.5	61.1	68.2
In percent of short-term debt plus FX deposits	7.0	20.0	27.7	26.2	27.1	26.7	27.3	27.9
REER (percentage depreciation -, e.o.p.)	-20.3	-13.2	9.3	...	...	...	...	...

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

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

Table 2: Performance under the 2005 Economic Program 1/

	2004 Stock	June 30			
	Dec. 31	PC	PC (adjusted)	Actual	Margin (+)
A. Quantitative performance criteria					
		(In millions of Uruguayan pesos)			
1. Combined public sector primary balance (floor) 2/	...	5,471	5,372	6,489	**1,117** 4/
2. General government noninterest expenditure (ceiling) 2/	...	23,561	23,539	22,126	**1,413**
3. Net domestic assets of the BCU (ceiling) 2/	74,079	3,983	3,983	-302	**4,284**
		(In millions of U.S. dollars)			
4. Net international reserves of the BCU (floor) 2/	-2,218	-130	-130	18	**148**
5. Nonfinancial public sector gross debt (ceiling) 3/	12,189	12,510	12,517	12,368	**148** 4/
6. Accumulation of external payment arrears of the public sector (on a continuous basis) 2/	0	0	0	0	**0**
B. Indicative targets					
		(In millions of Uruguayan pesos)			
7. Combined public sector overall balance (floor) 2/	...	-5,086	-5,086	-2,708	**2,378**
8. Monetary base (ceiling) 2/	15,648	557	557	1,070	**-513**
9. Floating debt of the central government (ceiling)	3,081	3,081	3,081	2,567	**514**

PC= performance criterion; IT=Indicative target.

Table 2. Uruguay: Performance under the 2005 Economic Program (concluded) 1/

Area	Structural Conditionality	Date	Status
A. Prior actions for the approval of the Stand-by Arrangement			
Tax administration	Issue a decree to implement the DGI's modernization law.		Observed.
Tax administration	Establish a large taxpayers unit at the DGI.		Observed.
Tax administration	Formulate a plan to coordinate tax audits between the DGI, the BPS, and the Ministry of Labor.		Observed.
Financial sector	Appoint a Board of Directors for NBC with appropriate professional experience and an interim CEO with banking experience.		Observed.
B. Structural performance criteria			
Fiscal	Submit to congress a five-year spending plan, complemented with revenue projections and deficit targets consistent with the program's fiscal targets.	August 31, 2005	Observed.
BROU & BHU	Government to ensure timely service of BHU note and BROU fiduciary notes to BROU in accordance with the current payment schedules.	Continuous	Observed.
C. Structural benchmarks			
Fiscal	Establish quarterly revenue collection targets (floors) at the social security bank (BPS).	June 30, 2005	Observed.

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

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

Table 3. Uruguay: Balance of Payments

(In millions of US$, unless otherwise stated)

	2002	2003	Prel. 2004	2005 Report No. 05/235	2005 Proj.
			1. Balance of Payments		
Current account	**382**	**-56**	**-103**	**-459**	**-467**
Trade balance	48	183	31	-437	-356
Exports, f.o.b.	1,922	2,281	3,021	3,276	3,496
Imports, f.o.b.	1,874	2,098	2,990	3,713	3,852
Services	153	167	304	351	283
Income (net)	109	-489	-527	-454	-481
Transfers (net)	72	83	89	80	87
Financial and capital account	**-2,234**	**1,039**	**-22**	**603**	**454**
Foreign direct investment	180	401	300	480	381
Portfolio investment	415	-541	-187	273	274
Government securities	171	-5	217	124	380
Issues	710	613	410	381	739
Amortization 1/	539	618	193	256	358
Banks	244	-537	-404	148	-106
Other capital flows (net)	-2,828	1,179	-135	-150	-202
Loans	1,290	375	72	-202	-245
Of which: IMF (net)	883	671	152	-130	-130
Disbursements	1,989	840	552	353	348
Amortization	1,105	169	400	483	478
Deposits, net	-1,693	267	-151	0	23
Other flows, net	-2,426	537	-57	52	20
Errors and omissions 2/	-476	397	580	0	311
Overall balance	-2,328	1,380	454	144	297
Reserve assets (- increase)	**2,328**	**-1,380**	**-454**	**-144**	**-297**
			2. Reserve Adequacy and External Indicators		
Gross official reserves	**776**	**2,087**	**2,512**	**2,656**	**2,762**
In months of imports of goods and services	3.7	9.2	8.2	7.2	7.0
In percent of short-term debt excluding nonresidential deposits	25.1	86.8	158.0	115.0	124.9
In percent of short-term debt including nonresidential deposits	14.3	45.1	61.6	54.2	58.9
Net international reserves 3/	**-1,088**	**-763**	**-2,218**	**-1,938**	**-1,938**
			(As percent of GDP)		
Exports	15.9	20.3	22.8	20.0	20.8
Imports	15.5	18.7	22.5	22.6	22.9
Current account	3.2	-0.5	-0.8	-2.8	-2.8
Underlying current account 4/	3.2	-0.5	-0.8	-2.0	-2.5
Financial and capital account	-18.5	9.3	-0.2	3.7	2.7
of which: foreign direct investment (net)	1.5	3.6	2.3	2.9	2.3
of which: government securities (net)	1.4	0.0	1.6	0.8	2.3
of which: IMF (net)	7.3	6.0	1.1	-0.8	-0.8
Overall balance	-19.3	12.3	3.4	0.9	1.8
Changes in GIR	19.3	-12.3	-3.4	-0.9	-1.8
External debt	87.5	98.2	87.4	70.2	69.7
Short-term debt (residual maturity)	25.5	21.4	12.0	14.1	13.2
External public debt	68.9	85.3	76.9	61.7	61.8
External debt + NR deposits	106.8	118.1	106.1	86.0	84.5
			(As percent of annual exports of goods and services)		
Total external debt	392.8	357.1	289.3	263.8	251.4
Total external debt (including nonresidential deposits)	479.2	429.3	351.3	323.0	304.7
Debt service	55.0	52.3	42.9	51.7	49.4
of which: interest payments	24.5	19.2	18.9	16.7	18.3
			(Annual percent changes)		
Exports	-10.2	18.7	32.4	8.3	15.7
Imports	-35.7	12.0	42.5	24.2	28.8
Export prices in US$ 4/	-7.7	7.4	6.5	-1.2	4.0
Import prices in US$ 4/	-10.8	5.1	9.2	5.6	11.8
Terms of trade 4/	3.5	2.2	-2.5	-6.4	-7.0
Export volume 4/	-2.1	9.4	23.6	10.0	12.5
Import volume 4/	-26.9	6.2	29.0	12.0	12.1

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

1/ Includes secondary market transactions between residents and nonresidents.

2/ 2005: Projection is based on preliminary actual for H1 of US$311 million.

3/ Includes all liabilities to the Fund and liabilities to residents; follows respective TMU definitions.

4/ Excluding cellulose plant projects (Botnia and ENCE).

Table 4. Uruguay: Public Sector Operations
(in millions of UR peso)

					2005					
					H1		Proj.			
	2001	2002	2003	2004	Report No.05/235	Actual	Q	Q4	Report No.05/235	Proj.
Revenue	**80,866**	**81,138**	**98,180**	**113,856**	**60,646**	**61,242**	**32,083**	**32,104**	**126,304**	**126,005**
Taxes	54,007	57,832	70,096	83,002	44,552	45,838	22,249	23,671	91,070	92,255
VAT and excise taxes	29,437	29,708	37,667	47,200	26,056	25,648	13,107	14,136	53,513	52,891
On income and profits	12,719	14,302	15,621	17,683	9,598	10,449	4,655	4,864	18,864	19,968
On foreign trade	2,428	2,730	3,780	4,958	2,525	2,431	1,370	1,416	5,456	5,216
On property and other	9,424	11,091	13,028	13,161	6,373	7,311	3,117	3,256	13,237	14,181
Social security contributions 1/	14,381	12,836	11,794	13,146	7,960	8,331	4,420	3,546	15,774	16,285
Nontax revenue 2/	5,250	5,274	6,200	7,831	3,962	3,970	2,062	2,077	8,115	8,125
Current surplus of public enterprises	7,227	5,196	10,090	9,876	4,172	3,102	3,352	2,810	11,345	9,339
Noninterest expenditure	**83,954**	**81,066**	**89,529**	**99,572**	**55,174**	**54,762**	**28,276**	**28,451**	**111,657**	**111,043**
Current 2/	74,871	74,653	81,721	90,269	49,923	49,891	25,437	26,597	101,123	101,479
Wages	18,074	18,158	19,701	23,409	12,760	12,602	6,229	7,044	25,639	25,878
Goods and services	12,833	12,057	15,031	17,015	10,023	9,230	5,250	5,311	20,273	19,840
Of Which: SEP	0	0	0	0	529	28	395	600	1,812	1,023
Social security benefits	41,907	42,818	44,218	47,702	25,465	25,815	13,145	13,407	51,914	52,367
Other	2,057	1,619	2,771	2,144	1,675	2,244	813	834	3,297	3,394
Capital (Government and enterprises) 4/	9,083	6,413	7,808	9,303	5,252	4,871	2,839	1,854	10,535	9,564
Primary balance	**-3,088**	**72**	**8,651**	**14,284**	**5,471**	**6,489**	**3,807**	**3,653**	**14,647**	**14,962**
Interest	7,276	12,163	18,881	22,666	10,558	9,197	6,711	4,563	21,719	20,471
Overall balance	**-10,364**	**-12,091**	**-10,231**	**-8,382**	**-5,086**	**-2,708**	**-2,904**	**-910**	**-7,072**	**-5,510**

Table 4. Uruguay: Public Sector Operations (concluded)
(in millions of UR peso)

					2005					
					H1		Proj.			
	2001	2002	2003	2004	Report No. 05/235	Actual	Q3	Q4	Report No.05/235	Proj.
Revenue	**32.7**	**31.1**	**31.1**	**30.0**	**29.0**	**29.4**	**30.8**	**30.9**	**30.2**	**30.3**
Taxes	21.8	22.2	22.2	21.9	21.3	22.0	21.4	22.8	21.8	22.2
VAT and excise taxes	11.9	11.4	11.9	12.4	12.5	12.3	12.6	13.6	12.8	12.7
On income and profits	5.1	5.5	5.0	4.7	4.6	5.0	4.5	4.7	4.5	4.8
On foreign trade	1.0	1.0	1.2	1.3	1.2	1.2	1.3	1.4	1.3	1.3
On property and other	3.8	4.3	4.1	3.5	3.0	3.5	3.0	3.1	3.2	3.4
Social security contributions 1/	5.8	4.9	3.7	3.5	3.8	4.0	4.2	3.4	3.8	3.9
Nontax revenue 2/	2.1	2.0	2.0	2.1	1.9	1.9	2.0	2.0	1.9	2.0
Current surplus of public enterprises	2.9	2.0	3.2	2.6	2.0	1.5	3.2	2.7	2.7	2.2
Noninterest expenditure	**34.4**	**31.1**	**28.4**	**26.3**	**26.4**	**26.3**	**27.2**	**27.3**	**26.7**	**26.7**
Current 2/	30.1	28.6	25.9	23.8	23.9	24.0	24.4	25.6	24.2	24.4
Wages	7.2	7.0	6.2	6.2	6.1	6.1	6.0	6.8	6.1	6.2
Goods and services	5.5	4.6	4.8	4.5	4.8	4.4	5.0	5.1	4.8	4.8
Of Which: SEP	0.0	0.0	0.0	0.0	0.3	0.0	0.4	0.6	0.4	0.2
Social security benefits	16.7	16.4	14.0	12.6	12.2	12.4	12.6	12.9	12.4	12.6
Other	0.7	0.6	0.9	0.6	0.8	1.1	0.8	0.8	0.8	0.8
Capital (Government and enterprises) 2/	4.3	2.5	2.5	2.5	2.5	2.3	2.7	1.8	2.5	2.3
Primary balance	**-1.2**	**0.0**	**2.7**	**3.8**	**2.6**	**3.1**	**3.7**	**3.5**	**3.5**	**3.6**
Interest	2.9	4.7	6.0	6.0	5.0	4.4	6.5	4.4	5.2	4.9
Overall balance	**-4.2**	**-4.6**	**-3.2**	**-2.2**	**-2.4**	**-1.3**	**-2.8**	**-0.9**	**-1.7**	**-1.3**
Memorandum										
Augmented Balance 3/	**-10,364**	**-56,106**	**-10,231**	**-1,229**	**-5,086**	**-2,708**	**-2,904**	**-910**	**-7,072**	**-5,510**
In percent of GDP	-4.2	-21.5	-3.2	-0.3	...	...	...	...	-1.7	-1.3
GDP (billions of pesos)	247	261	315	379	...	...	...	...	**418**	**416**

Sources: Ministry of Finance; and Fund staff estimates.

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

2/ Includes extrabudgetary operations.

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

Table 5. Uruguay: Summary Accounts of the Banking System 1/
(In millions of US dollars)

				2005	
	2002	2003	2004	Report No. 05/235	Proj.
1. Banco Central del Uruguay					
Net foreign assets	-689	-52	-51	228	520
Net international reserves 2/	-1,269	-430	-164	115	218
Gross international reserves	772	2,087	2,512	2,656	2,762
Reserve liabilities 2/	-2,041	-2,517	-2,675	-2,541	-2,544
Other net foreign assets	580	378	113	113	302
Net domestic assets	1,120	553	775	577	361
Net credit to the public sector	1,541	2,464	2,626	2,391	2,418
Net credit to the financial system	-343	-2,091	-1,781	-1,826	-1,885
Credit to the private sector	80	71	62	62	59
Securities issued by the BCU	-34	-243	-563	-643	-724
Other	-124	352	431	592	493
Monetary liabilities	431	501	777	858	934
Memorandum items:					
Monetary base (average)	...	...	594	698	725
NIR program definition	...	...	-2,218	-1,938	-1,938
NDA program definition	...	...	2,811	2,636	2,663
2. Public and Private Banks 3/					
Net foreign assets	551	1,213	1,887	1,718	1,905
Net domestic assets	5,254	5,331	5,090	5,511	5,275
Net credit to the public sector 1/	399	219	437	336	-34
Net credit to the financial system	947	2,612	2,256	2,300	2,562
Credit to the private sector	6,319	4,726	4,307	4,813	4,508
Securities issued by the BCU	30	6	50	50	271
Other	-2,411	-2,226	-1,909	-1,938	-1,982
Liabilities to the private sector (residents)	5,805	6,544	6,977	7,250	7,180
Public banks	3,140	3,409	3,670	3,775	3,770
Local currency	339	394	520	574	617
Foreign currency	2,801	3,016	3,149	3,201	3,175
Private banks	2,666	3,135	3,307	3,475	3,367
Local currency	357	349	405	450	456
Foreign currency	2,309	2,785	2,902	3,025	2,911
3. Banking System					
Net foreign assets	-138	1,161	1,835	1,945	2,426
Net domestic assets	6,288	5,788	5,738	5,700	5,450
Credit to the public sector	1,940	2,684	3,063	2,728	2,384
Credit to the rest of financial system	-218	-173	-165	-165	38
Credit to the private sector	6,398	4,797	4,369	4,748	4,567
Securities issued by the BCU	...	...	...	-81	59
Other	-2,568	-2,117	-2,041	-2,041	-2,050
Broad money (M3)	6,150	6,949	7,573	7,646	7,876

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

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

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

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

Table 6. Uruguay: Vulnerability Indicators

	2002	2003	2004	Proj. 2005
(Percent change, unless otherwise indicated)				
Financial sector indicators				
Broad money	21.3	24.2	-9.5	4.0
Credit to the private sector (const. exch. rate)	-13.7	-25.5	-20.1	0.0
Share of nonperforming loans in total loans (in percent) 1/	31.5	8.6	3.8	3.0
Capital adequacy ratio (in percent) 1/	-9.6	9.2	10.9	11.9
Interbank interest rates (percent, end of period) 1/	45.0	2.5	1.3	1.0
FX deposits held by residents (in percent of total deposits)	88.3	88.8	87.6	85.0
FX loans to residents (in percent of total loans)	80.4	77.6	73.3	73.2
Public debt indicators				
Public sector gross debt (PSGD, in percent of GDP)	95.5	104.5	92.5	72.9
of which: Exposed to rollover risk (in percent of total PSGD)	17.2	12.1	13.5	...
Exposed to exchange rate risk (in percent of total PSGD)	96.0	94.3	90.2	...
Exposed to interest rate risk (in percent of total PSGD)	57.0	45.5	44.6	...
External indicators				
Merchandise exports	-10.2	18.7	32.4	15.7
Merchandise imports	-35.7	12.0	42.5	28.8
Merchandise terms of trade	4.3	2.9	-3.1	-9.6
REER appreciation (+)	-20.3	-13.2	9.3	...
(Percent of GDP, unless otherwise indicated)				
Current account balance	3.2	-0.5	-0.8	-2.8
Capital and financial account balance	-18.5	9.3	-0.2	2.7
of which : Net foreign direct investment	1.5	3.6	2.3	2.3
Government securities	1.4	0.0	1.6	2.3
Other net inflows	-21.4	5.7	-4.1	-1.8
Total gross external debt (ED) in percent of GDP	87.5	98.2	87.4	69.7
of which: Short-term ED (original maturity, in percent of total ED)	12.5	6.7	7.6	5.3
ED to foreign official sector (in percent of total ED)	44.9	51.1	50.7	48.5
External interest payments (in percent of exports of GNFS)	24.5	19.2	18.9	18.3
External amortization payments (in percent of exports of GNFS)	30.5	33.1	23.9	31.1
(U.S. million, unless otherwise indicated)				
Central Bank reserve liabilities 2/	1,786	2,407	2,675	2,541
Short term foreign assets of the banking system	3,140	4,989	5,988	6,829
Short term foreign liabilities of the banking system 2/	4,916	4,597	4,389	4,254
Gross official reserves	776	2,087	2,512	2,762
In months of imports GNFS	3.7	9.3	8.2	7.0
In percent of short-term external debt excl. nonres FX deposits	25.1	86.8	158.0	124.9
In percent of short-term external debt plus bank NR deposits	14.3	45.1	61.6	58.9
In percent of short-term debt plus FX deposits	7.0	20.0	27.7	27.1
In percent of broad money	12.2	28.7	34.3	35.1
In percent of base money	175.4	427.3	418.1	417.4
Banking system foreign assets as percent of short-term external debt plus all FX deposits 3/ 4/	46.6	56.9	68.1	73.1
Financial market indicators				
Foreign currency debt rating (Moody's) 5/	B3	B3	B3	B3
Foreign currency debt rating (S&P) 5/	B-	B-	B	B
EMBI secondary market spread (bps, end of period) 5/	1,228	624	388	376
Exchange rate (per U.S. dollar, period average)	21.6	28.2	28.6	…

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

1/ As of June 30, 2005.
2/ Includes all use of Fund credit.
3/ By remaining maturity.
4/ Excludes nonreserve assets from the BCU.
5/ As of August 31, 2005.

Table 7. Uruguay: Schedule of Purchases Under the Stand-By Arrangement, 2005–08

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

Source: Fund staff estimates.

Table 8. Uruguay: Projected Payments to the Fund
and Indicators of Capacity to Repay the Fund

	2003	2004	2005	2006	2007	2008	2009	2010
				(In SDR million)				
Fund disbursements (existing and prospective)								
Principal Disbursements	364.2	372.8	231.8	343.3	269.7	61.3	0.0	0.0
Existing	364.2	372.8	170.5	0.0	0.0	0.0	0.0	0.0
Prospective	0.0	0.0	61.3	343.3	269.7	61.3	0.0	0.0
Fund repurchases and charges (existing and prospective)								
Principal (repurchases) 1/	57.1	270.3	317.3	434.3	574.4	332.3	314.2	274.2
On existing purchases	57.1	270.3	317.3	434.3	574.4	328.4	219.2	25.1
On prospective purchases	0.0	0.0	0.0	0.0	0.0	3.8	95.0	249.0
Charges and interest 2/	45.9	64.0	78.8	86.1	68.7	53.7	37.6	23.3
On existing purchases	45.9	64.0	78.2	74.7	40.0	18.4	7.2	1.2
On prospective purchases	0.0	0.0	0.6	11.4	28.7	35.2	30.4	22.1
Total payments to Fund 1/	103.0	334.4	396.2	520.4	643.1	385.9	351.8	297.5
In millions of U.S. dollars	144.3	495.2	586.5	757.5	937.2	562.9	513.2	433.7
In percent of exports of goods and NFS	4.7	12.4	12.6	15.0	16.9	9.2	7.9	6.2
In percent of GDP	1.3	3.7	3.5	4.1	4.8	2.7	2.3	1.8
In percent of quota	33.6	109.1	129.3	169.8	209.8	125.9	114.8	97.0
In percent of overall external debt service	8.9	28.8	25.5	28.8	34.8	25.5	22.8	18.8
In percent of gross reserves	6.9	19.7	21.2	25.4	29.4	17.3	15.2	12.4
Fund credit outstanding				(End-of-period)				
In millions of SDRs	1,625.9	1,728.4	1,642.8	1,551.8	1,247.1	976.1	661.9	387.7
In millions of U.S. dollars	2,385.9	2,662.3	2,388.9	2,260.0	1,818.2	1,423.9	965.3	565.2
In percent of exports of goods and NFS	77.4	66.4	51.3	44.7	32.7	23.3	14.9	8.1
In percent of GDP	21.3	20.1	14.2	12.3	9.3	6.8	4.4	2.4
In percent of quota	530.5	563.9	536.0	506.3	406.9	318.5	216.0	126.5
In percent of public sector external debt	25.0	26.1	23.0	22.3	18.4	14.7	10.1	5.9
In percent of overall external debt	21.7	23.0	20.4	19.7	16.2	12.9	8.8	5.2
In percent of gross reserves	114.3	106.0	86.5	75.9	57.1	43.8	28.6	16.2
Memorandum items:			(In millions of U.S. dollars unless otherwise noted)					
Exports of goods and NFS	3,084	4,008	4,655	5,051	5,556	6,115	6,475	6,947
Quota (millions of SDRs)	306.5	306.5	306.5	306.5	306.5	306.5	306.5	306.5
GDP	11,211	13,267	16,791	18,435	19,630	20,801	22,107	23,504
U.S. dollar per SDR, e.o.p.	1.47	1.54	1.45	1.46	1.46	1.46	1.46	1.46
U.S. dollar per SDR, average	1.40	1.48	1.48	1.46	1.46	1.46	1.46	1.46
Public sector debt	11,705	12,272	12,248	12,405	12,499	12,599	12,697	12,775
Public sector external debt 3/	9,557	10,206	10,372	10,129	9,891	9,666	9,591	9,511
Overall external debt service	1,614	1,718	2,301	2,634	2,694	2,209	2,255	2,307
Overall external debt	11,012	11,594	11,704	11,461	11,223	10,998	10,923	10,843
Gross foreign reserves	2,087	2,512	2,762	2,977	3,185	3,254	3,373	3,491

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

1/ Projections on obligations basis.
2/ Projections are based on rate of charge of 3.71 percent plus burden-sharing of 13 basis points.
3/ Excluding public commercial banks.

URUGUAY: ASSESSING PUBLIC SECTOR DEBT SUSTAINABILITY

1. **Uruguay's public debt is still high with a large share of foreign-currency and floating rate debt.** Uruguay's public debt at end-2004 stood at 92 percent of GDP, of which 90 percent was exposed to exchange rate risk (mainly the U.S. dollar and SDR rates), 45 percent was exposed to interest rate risk, and 13 percent to rollover risk. This makes Uruguay's debt outlook highly vulnerable to movements in the real exchange rate and international interest rates.

2. **The public debt-to-GDP ratio has declined by 12 percentage points since end-2003, to 92 percent by end-2004, and continued to fall sharply in the first half of 2005 to some 80 percent of GDP.** This decline is mainly attributed to high GDP growth, a strong appreciation of the real exchange rate, and to some extent to lower domestic interest rates and continued fiscal consolidation.

3. **Under baseline assumptions, Uruguay's public sector debt should decline considerably over the medium term (Table 1).** The baseline scenario assumes a primary fiscal surplus of 4 percent of GDP over the medium term, sustained GDP growth of 3 percent a year, a gradual recovery of the real value of the peso vis-à-vis the U.S. dollar to 85 percent of its pre-crisis level (from 71 percent at end-2004)[9], and sovereign spreads remaining broadly at current levels (assuming that less favorable market conditions would be offset by the lower country risk from a declining debt ratio). Assuming no contingent liabilities from bank restructuring come due, and no possible debt reduction from privatization proceeds, public debt would decline to about 60 percent of GDP by 2008 (the end of the program period) and to just below 50 percent of GDP by 2012. With nominal debt staying broadly at the 2004 level, this reduction would be mainly achieved through strong economic growth and real appreciation of the peso.

4. **Notwithstanding, debt-service payments, albeit declining, would remain high over the next years**. While debt-service payments would decline considerably over the longer term, they would decline only moderately from 15 percent of GDP (or 50 percent of public sector revenue) in 2005 to 12 percent of GDP (or 40 percent of public sector revenue) in 2010 because of high obligations coming due. This makes the public sector debt sustainability outlook subject to roll-over and interest rate risks.

5. **Public debt remains on a declining path under the no-policy change scenario but becomes unsustainable when key economic variables are set at their historical averages (Table 2).** This is because by 2004 the primary balance had already moved close to its medium-term target of 4 percent of GDP (from a deficit of 1.1 percent of GDP in 2001 to a surplus of 3.8 percent of GDP). However, when key variables are set at their historical levels (which includes the crisis period), the debt-to-GDP ratio would increase sharply (by some

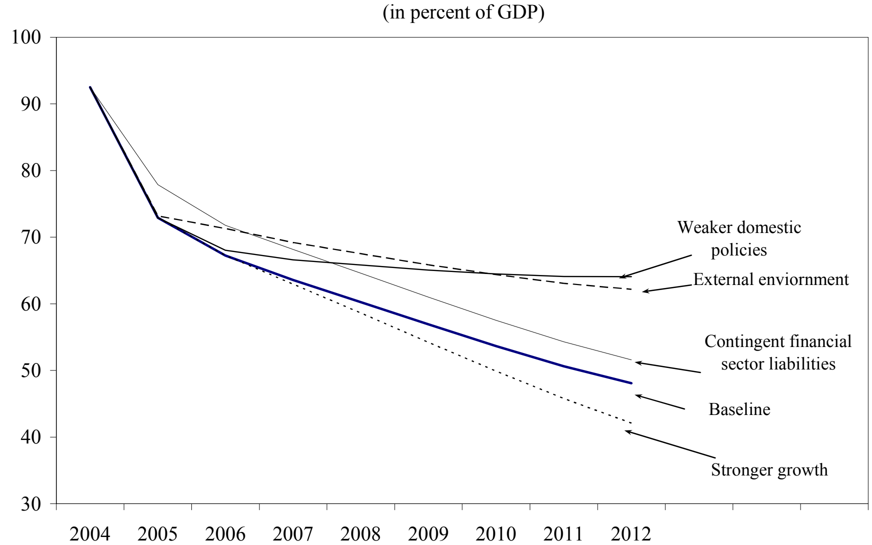
[9] As of May 2005, the REER was at 76 percent of the pre-crisis (average of 2001) level.

additional 35 percentage points at the end of the decade) reflecting the much weaker assumptions on growth (about 1 percent annually) and the primary balance (- ½ percent of GDP).

6. **Standardized bound tests show that Uruguay is vulnerable to several shocks, and particularly exposed to exchange rate risk (Figure 1)**. Assuming half a standard-deviation shocks to interest rates or growth rates, the public debt-to-GDP ratio would stay at 73–78 percent of GDP by 2010 compared to 54 percent of GDP in the baseline scenario. However, a similar shock to the primary balance would leave the public debt-to-GDP ratio at 58 percent by 2010, as the medium-term primary balance would still remain above 3 percent of GDP. If all three shocks with a ¼ standard deviation were to take place at the same time, the debt-to-GDP ratio would end up at 71 percent of GDP by 2010, raising debt sustainability concerns. Moreover, if the exchange rate were to depreciate by 30 percent, the debt-to-GDP ratio would jump up above 100 percent of GDP and only decline to about 90 percent by 2010.

7. **Tailored scenarios to assess Uruguay's specific debt vulnerabilities.** This section presents illustrative scenarios beyond the standardized tests, tailored to Uruguay's conditions.

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



- **A stronger than envisaged deterioration in the external environment.** This scenario assumes a sharper-than-currently-envisaged increase in U.S. interest rates, leading to both a slowdown in world demand and higher costs of external financing. This in turn would result in higher domestic interest rates and slower growth. This scenario also assumes that the real appreciation of some 10 percent over the medium term (expected in the baseline) will not take place. Assuming no policy response to offset the slowdown in growth, an increase in international interest rates of 100 basis points, an increase in the spread by some 50 basis points, and a reduction in annual GDP growth of ½ percent, the debt-to-GDP ratio would fall only to 62 percent of GDP in 2012, some 14 percent of GDP above baseline projections.

- **Weaker domestic policies.** This scenario assumes that the primary surplus stays at 3 percent of GDP over the medium term, instead of 4 percent GDP, while the growth-enhancing structural reforms are only partially implemented. As a result, potential growth is assumed to be on average 2 percent per year, instead of 3 percent, spreads are assumed to increase by 50 basis points as investor confidence weakens, and the real appreciation would be about 5 percent. This would leave the debt-to-GDP ratio some 16 percentage points above the baseline projections by 2012.

- **Contingent liabilities from the financial sector coming due.** This scenario explores the potential effect on the stock of debt of already identified contingent liabilities. In particular, it assumes that the government guarantee on the BHU note to BROU would be called (US$640 million), the government would take over the service of the BROU note (US$380 million during 2005–1012), the Uruguayan courts would rule in favor of the former owners of NBC (US$120 million), and the government would make an initial funding of the deposit insurance scheme of some US$40 million. Under these assumptions, the debt-to-GDP ratio would jump up by 5 percentage points and stay some 4 percentage points above baseline by 2012.

- **Growth.** This scenario assumes that the government accelerates the implementation of a comprehensive structural reform agenda, leading to substantial increases in private investment and an increase of potential growth by 1 percentage point, to 4 percent. This in turn is assumed to strengthen the primary surplus to 4¼ percent of GDP and reduce spreads by 50 basis points. As a result, the debt-to-GDP ratio would decline to 42 percent by 2012.

Table 1. Uruguay:Public Sector Debt Sustainability 1/

					Projections							
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
A. Assumptions												
Real GDP growth (percent)	-3.4	-11.0	2.2	12.3	6.0	4.0	3.5	3.0	3.0	3.0	3.0	3.0
Interest rate spread (bps)	284	1400	900	600	405	450	450	450	450	450	450	450
Real U.S. dollar exchange rate (avg.) (change in percent)	-13.7	-11.0	-22.1	-0.2	9.4	4.1	2.5	1.0	1.0	1.0	1.0	1.0
Primary balance: Consolidated public sector	**-1.2**	**0.0**	**2.7**	**3.8**	**3.6**	**3.7**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**
Non-financial public sector	-1.0	0.2	2.9	4.0	3.8	3.9	4.2	4.2	4.2	4.2	4.2	4.2
BCU	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Overall Balance: Consolidated public sector	**-4.1**	**-4.6**	**-3.2**	**-2.2**	**-1.3**	**-1.1**	**-0.7**	**-0.6**	**-0.5**	**-0.4**	**-0.3**	**-0.4**
Non-financial public sector	-3.8	-4.3	-2.9	-1.2	-0.9	-0.7	-0.2	-0.2	-0.1	0.0	0.1	0.0
BCU	-0.3	-0.3	-0.4	-1.0	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
B. Debt Dynamics (in percent of GDP)												
Gross nonfinancial public sector debt	**46**	**96**	**104**	**92**	**73**	**67**	**64**	**60**	**57**	**54**	**51**	**48**
of which:												
Contribution from REER (cum since 2004)	...	...	...	0	7	9	11	11	11	11	11	11
Contribution from Growth (cum since 2004)	...	...	...	0	13	17	20	23	27	31	34	36
C. Cash Flow (in millions of U.S. dollars)												
Gross borrowing needs	**1,210**	**3,209**	**1,251**	**2,504**	**2,114**	**2,209**	**2,090**	**1,597**	**1,786**	**1,830**	**2,406**	**1,701**
Augmented public sector deficit	707	2,524	324	161	151	129	45	33	20	5	-22	1
Public sector deficit	707	526	324	161	151	129	45	33	20	5	-22	1
Bank assistance	0	1,998	0	0	0	0	0	0	0	0	0	0
Buildup in free reserves at the central bank	-7	-364	6	631	156	61	100	100	100	100	100	100
Amortization	510	1,049	921	1,711	1,807	2,020	1,946	1,464	1,666	1,726	2,328	1,600
Long-term bonds and inflation-indexed bonds	403	349	221	29	254	603	136	184	145	259	858	341
Letras (2 years)	...	...	...	...	422	110	304	266	500	500	500	500
Peso bonds (short-term)	0	209	209	637	126	78	61	100	100	100	100	100
Commercial bank loans	0	214	217	307	89	105	119	135	162	145	149	160
Supplier credits	0	0	0	0	42	0	18	20	21	15	15	5
IDB/WB and other official debt	97	205	234	339	394	491	471	276	280	307	325	325
IMF 1/	10	72	40	400	480	632	837	485	458	400	381	168
Gross Financing 2/	**1,209**	**3,209**	**1,251**	**2,504**	**2,114**	**2,260**	**2,090**	**1,597**	**1,786**	**1,830**	**2,406**	**1,701**
Long-term bonds (external)	1,292	143	405	371	892	335	403	419	617	682	1,237	529
Inflation-indexed instruments	...	...	...	...	316	174	100	70	70	70	70	70
Letras (2 years)	...	...	...	...	304	266	500	500	500	500	500	500
Peso bonds (short-term)	-15	677	637	544	124	61	100	100	100	100	100	100
Commercial bank	33	-16	-475	365	-179	429	137	154	183	160	164	166
Use of deposits	26	-21	-543	200	244	321	0	0	0	0	0	0
Loans	7	5	68	165	142	105	137	154	183	160	164	166
IDB/WB and other official debt	198	789	461	366	317	496	458	265	316	318	335	336
IMF	0	1,603	484	552	342	500	393	89	0	0	0	0
Central bank credit (net) (net of IMF disbursments)	0	0	0	0	0	0	0	0	0	0	0	0
Other inflows (net)	-299	13	-261	307	0	0	0	0	0	0	0	0
Residual financing needs	**0**	**0**	**0**	**0**	**0**	**-52**	**0**	**0**	**0**	**0**	**0**	**0**
D. Other Indicators												
Total debt service (in percent of GDP)	5.6	13.1	14.0	18.1	15.8	16.1	14.7	11.9	12.3	12.0	13.9	10.7
Average interest rate (in percent)	12.6	5.5	5.7	6.6	6.6	7.2	7.4	7.6	7.9	8.2	8.5	9.1
Memorandum items:												
GDP (millions of dollars)	18,561	12,089	11,211	13,267	16,791	18,435	19,630	20,801	22,107	23,504	24,911	26,271
Nominal debt (millions of dollars)	8,538	11,551	11,705	12,272	12,242	12,399	12,478	12,538	12,582	12,609	12,610	12,634
Commerical bond placements (net) (millions of dollars)	889	-207	184	342	835	61	563	539	542	494	449	257
World Bank/IDB (net)	...	...	...	...	49	30	-4	-3	42	17	16	16
Rollover of Fund obligations (in percent)	...	...	...	...	71	79	47	18	0	0	0	0
Fund credit outstanding (millions of dollars)	145	1,754	2,416	2,684	2,432	2,259	1,817	1,424	966	565	184	17
Fund credit outstanding (in percent of GDP)	0.8	14.5	21.6	20.2	14.5	12.3	9.3	6.8	4.4	2.4	0.7	0.1
Fund credit outstanding (as a share of quota)	0.5	5.5	530.5	563.9	536.0	506.3	406.9	318.5	216.0	126.5	41.3	3.8

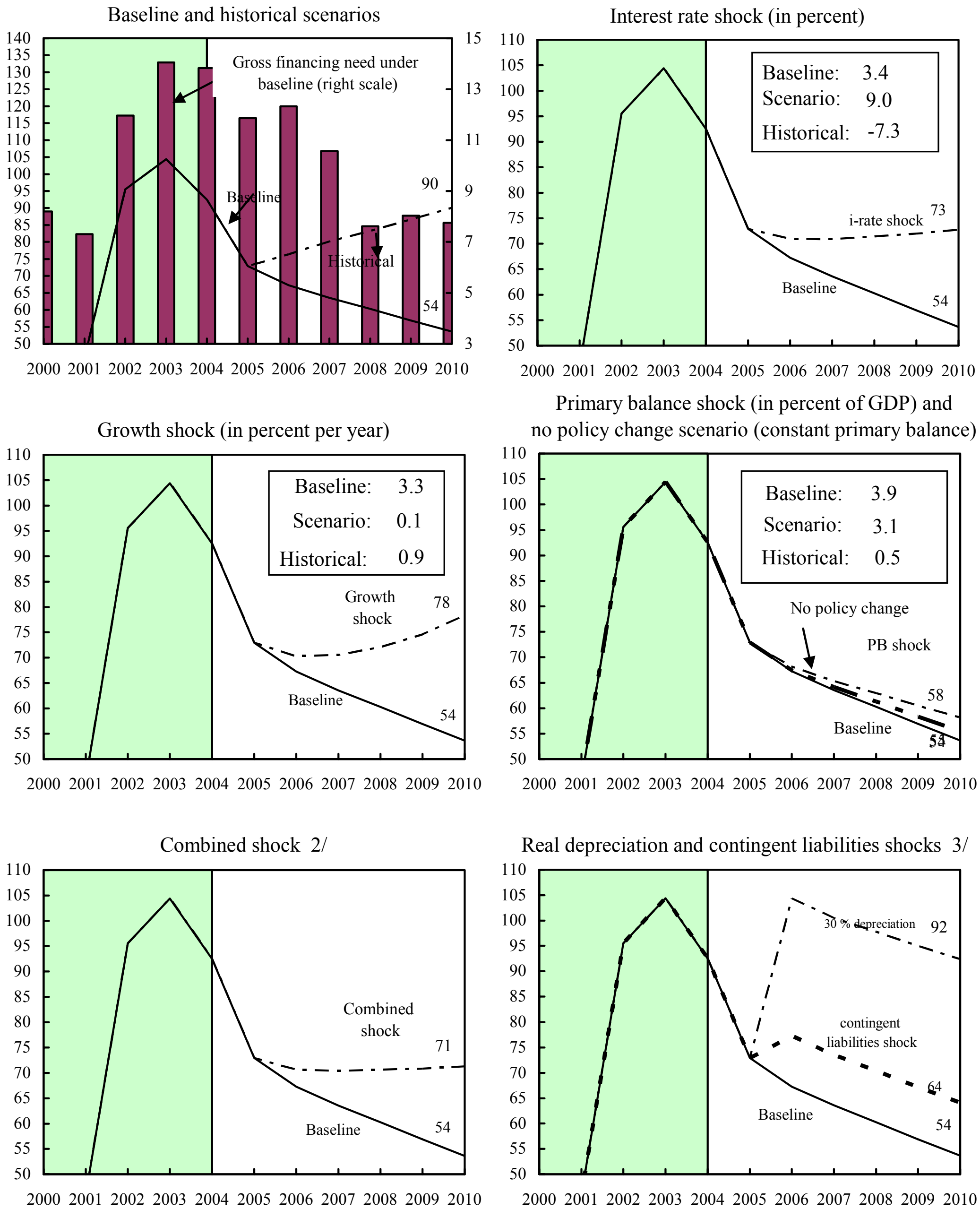
Sources: Ministry of Finance; Banco Central del Uruguay; and Fund staff estimates.
1/ Obligation basis.
2/ Net of free reserves and monetary policy instruments.

Table 2. Uruguay: Public Sector Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	primary balance 9/
Baseline: Public sector debt 1/	38.5	46.0	95.5	104.4	92.5	**72.9**	**67.3**	**63.6**	**60.3**	**56.9**	**53.6**	
o/w foreign-currency denominated	35.7	43.2	76.6	94.7	83.4	65.8	60.7	57.3	54.4	51.3	48.4	
Change in public sector debt	0.5	7.5	49.5	8.9	-11.9	-19.6	-5.7	-3.7	-3.3	-3.4	-3.3	
Identified debt-creating flows (4+7+12)	5.9	10.3	57.5	-8.3	-14.0	-6.9	-6.0	-4.5	-3.5	-3.2	-3.1	
Primary deficit	1.5	1.2	-0.1	-2.7	-3.8	-3.6	-3.7	-4.0	-4.0	-4.0	-4.0	
Revenue and grants	28.8	33.2	31.1	31.1	30.1	30.3	29.3	29.3	29.1	29.1	29.1	
Primary (noninterest) expenditure	30.4	34.4	31.1	28.4	26.3	26.7	25.6	25.3	25.1	25.1	25.1	
Automatic debt dynamics 2/	4.4	9.2	40.7	-5.6	-10.3	-3.3	-2.3	-0.5	0.5	0.8	0.9	
Contribution from interest rate/growth differential 3/	1.7	2.3	2.2	-10.7	-11.6	-3.3	-2.3	-0.5	0.5	0.8	0.9	
Of which contribution from real interest rate	1.1	1.0	-2.6	-8.9	-0.9	1.7	0.3	1.7	2.3	2.5	2.5	
Of which contribution from real GDP growth	0.5	1.3	4.8	-1.7	-10.7	-5.1	-2.6	-2.2	-1.8	-1.7	-1.6	
Contribution from exchange rate depreciation 4/	2.7	6.9	38.5	5.1	1.3	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	16.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	16.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-5.4	-2.8	-8.0	17.1	2.1	-12.7	0.4	0.8	0.2	-0.1	-0.1	
Public sector debt-to-revenue ratio 1/	133.4	138.5	306.9	336.2	307.6	240.7	229.5	216.9	207.1	195.6	184.4	
Gross financing need 6/	8.2	7.3	12.0	14.0	13.8	11.9	12.3	10.6	7.6	8.0	7.8	
in billions of U.S. dollars	1.6	1.4	1.4	1.6	1.8	1.9	2.2	2.1	1.6	1.8	1.8	
Debt service-to-GDP ratio						15.5	16.0	14.6	11.6	12.0	11.8	
Debt service-to-fiscal revenue ratio						51.0	54.7	49.7	39.9	41.3	40.4	
Scenario with key variables at their historical averages 7/						**72.9**	**76.4**	**80.2**	**83.3**	**86.6**	**90.1**	**4.3**
Debt service-to-GDP ratio						15.5	18.5	20.0	18.7	23.1	26.8	
Scenario with no policy change (constant primary balance) in 2005-2010						**72.9**	**67.4**	**64.1**	**61.3**	**58.3**	**55.5**	**1.0**
Debt service-to-GDP ratio						17.0	17.8	15.9	12.6	13.1	12.9	
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	-1.4	-3.4	-11.0	2.2	12.3	6.0	4.0	3.5	3.0	3.0	3.0	
Average nominal interest rate on public debt (in percent) 8/	7.0	7.8	10.7	7.5	6.8	5.8	7.4	7.5	7.7	7.9	8.3	
Average real interest rate	3.0	2.5	-8.0	-10.9	-0.2	2.3	0.8	2.9	4.0	4.4	4.8	
(nominal rate minus change in GDP deflator, in percent)												
Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.2	-15.3	-45.7	-6.8	-1.5	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	4.0	5.3	18.7	18.4	7.0	3.5	6.6	4.6	3.7	3.5	3.5	
Growth of real primary spending (deflated by GDP deflator, in percent)	-3.6	9.4	-19.6	-6.6	4.0	7.6	-0.3	2.3	2.2	3.0	3.0	
Primary deficit	1.5	1.2	-0.1	-2.7	-3.8	-3.6	-3.7	-4.0	-4.0	-4.0	-4.0	

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

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



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

Table 3. Uruguay: External Debt Sustainability Framework, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	44.3	48.1	87.5	98.2	87.4	**69.7**	**62.2**	**57.2**	**52.9**	**49.4**	**46.1**	**-0.8**
Change in external debt	4.8	3.9	39.4	10.7	-10.8	-17.7	-7.5	-5.0	-4.3	-3.5	-3.3	
Identified external debt-creating flows (4+8+9)	3.1	4.8	22.5	3.8	-16.6	-3.6	-2.4	-3.3	-3.0	-2.0	-2.0	
Current account deficit, excluding interest payments	1.3	0.2	-7.8	-2.6	-4.6	-1.9	1.7	-1.5	-2.6	-2.8	-2.9	
'Deficit in balance of goods and services	2.7	2.4	-1.7	-3.1	-2.5	0.4	4.2	0.8	-0.4	-0.8	-1.0	
Exports	18.2	17.6	22.3	27.5	30.2	27.7	27.4	28.3	29.4	29.3	29.6	
Imports	20.9	20.1	20.6	24.4	27.7	28.2	31.6	29.1	29.0	28.5	28.6	
Net non-debt creating capital inflows (negative)	-1.4	-1.7	-0.1	-3.6	-2.3	-2.3	-6.3	-4.1	-2.9	-1.7	-1.7	
Automatic debt dynamics 1/	3.1	6.3	30.4	9.9	-9.7	0.5	2.1	2.2	2.5	2.5	2.5	
Contribution from nominal interest rate	1.5	2.7	4.6	3.1	5.4	4.7	4.6	4.3	4.1	4.0	3.9	
'Contribution from real GDP growth	0.6	1.6	8.2	-2.1	-10.2	-4.1	-2.5	-2.0	-1.6	-1.5	-1.4	
'Contribution from price and exchange rate changes 2/	1.0	2.0	17.6	8.9	-4.9	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	1.7	-0.9	16.8	6.9	5.7	-14.1	-5.1	-1.7	-1.3	-1.5	-1.2	
External debt-to-exports ratio (in percent)	243.1	272.8	392.8	357.1	289.3	251.4	226.9	202.0	179.9	168.7	156.1	
Gross external financing need (in billions of US dollars) 4/	3.2	3.5	3.8	3.0	1.8	2.7	3.3	2.7	2.0	1.9	1.9	
in percent of GDP	15.8	19.0	31.3	26.4	13.6	16.3	17.8	14.0	9.5	8.6	8.2	
Scenario with key variables at their historical averages 5/						**69.7**	**70.5**	**73.1**	**76.3**	**79.4**	**83.1**	**5.0**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	-1.4	-3.4	-11.0	2.2	12.3	6.0	4.0	3.5	3.0	3.0	3.0	
GDP deflator in US dollars (change in percent)	-2.6	-4.4	-26.8	-9.2	5.2	19.4	5.6	2.9	2.9	3.2	3.2	
Nominal external interest rate (in percent)	3.6	5.6	6.2	3.2	6.5	6.8	7.3	7.3	7.7	8.0	8.3	
Growth of exports (US dollar terms, in percent)	5.2	-10.5	-17.8	14.5	30.0	16.1	8.5	10.0	10.1	5.9	7.3	
Growth of imports (US dollar terms, in percent)	4.9	-11.2	-33.1	9.7	34.3	28.7	23.1	-1.7	5.4	4.6	6.6	
Current account balance, excluding interest payments	-1.3	-0.2	7.8	2.6	4.6	1.9	-1.7	1.5	2.6	2.8	2.9	
Net non-debt creating capital inflows	1.4	1.7	0.1	3.6	2.3	2.3	6.3	4.1	2.9	1.7	1.7	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

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

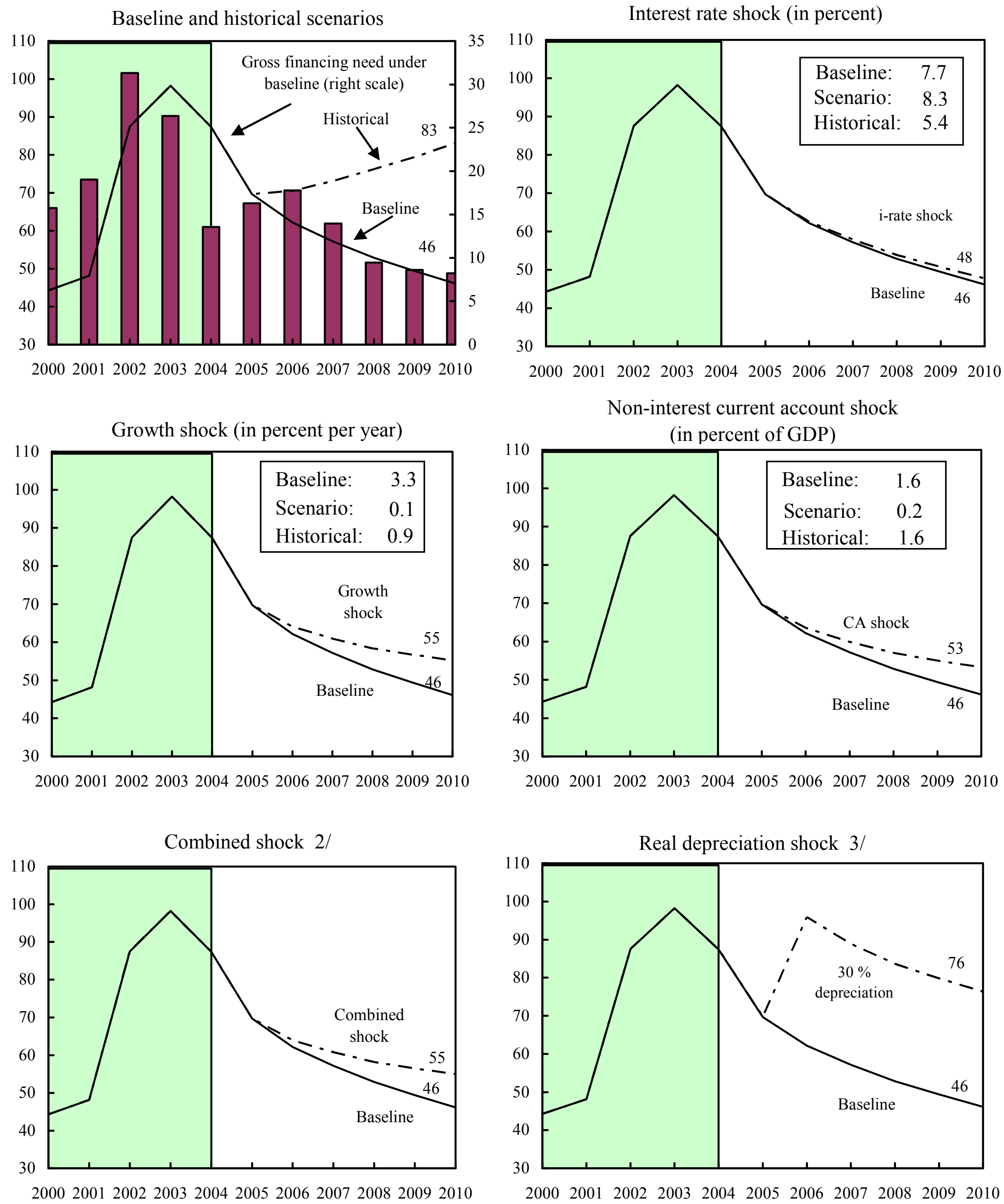
3/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

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



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

Table 4. Uruguay: Public Sector Debt Sustainability Framework--Gross Public Sector Financing Need, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Baseline Projections											
Gross financing need 1/	8.2	7.3	12.0	14.0	13.8	11.9	12.3	10.6	7.6	8.0	7.8
in billions of U.S. dollars	1.6	1.4	1.4	1.6	1.8	1.9	2.2	2.1	1.6	1.8	1.8
II. Stress Tests											
Gross financing need 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						11.9	17.3	17.5	15.0	17.1	18.3
A2. No policy change (constant primary balance) in 2006-10						11.9	12.5	11.1	8.2	8.7	8.5
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						11.9	16.6	15.6	13.1	14.6	15.3
B2. Real GDP growth is at baseline minus one-half standard deviations						11.9	13.8	13.6	12.1	14.8	16.9
B3. Primary balance is at baseline minus one-half standard deviations						11.9	13.3	11.8	8.9	9.6	9.5
B4. Combination of B1-B3 using 1/4 standard deviation shocks						11.9	15.2	14.2	11.7	13.0	13.6
B5. One time 30 percent real depreciation in 2006 5/						11.9	18.5	19.5	15.1	16.4	16.6
B6. 10 percent of GDP increase in other debt-creating flows in 2006						11.9	13.9	12.8	9.5	10.1	10.0
Gross financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						1.9	3.3	3.9	3.8	5.1	6.3
A2. No policy change (constant primary balance) in 2006-10						1.9	2.3	2.2	1.7	1.9	2.0
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						1.9	3.0	3.1	2.7	3.2	3.6
B2. Real GDP growth is at baseline minus one-half standard deviations						1.9	2.4	2.5	2.3	2.9	3.4
B3. Primary balance is at baseline minus one-half standard deviations						1.9	2.4	2.3	1.9	2.1	2.2
B4. Combination of B1-B3 using 1/4 standard deviation shocks						1.9	2.7	2.7	2.3	2.7	3.0
B5. One time 30 percent real depreciation in 2006 5/						1.9	2.1	2.4	2.0	2.3	2.5
B6. 10 percent of GDP increase in other debt-creating flows in 2006						1.9	2.5	2.5	2.0	2.2	2.3

1/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
2/ Gross financing under the stress test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.
3/ The key variables include real GDP growth; real interest rate; the primary balance in percent of GDP; inflation; and exchange rate change.
4/ The implied change in other key variables under this scenario is discussed in the text.
5/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 5. Uruguay: External Sustainability Framework–Gross External Financing Need, 2000-2010

	Actual					Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
						I. Baseline Projections					
Gross external financing need in billions of U.S. dollars 1/	3.2	3.5	3.8	3.0	1.8	2.7	3.3	2.7	2.0	1.9	1.9
(in percent of GDP)	15.8	19.0	31.3	26.4	13.6	16.3	17.8	14.0	9.5	8.6	8.2
						II. Stress Tests					
Gross external financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						2.7	2.5	2.7	2.2	2.2	2.4
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						2.7	3.4	2.8	2.1	2.0	2.1
B2. Real GDP growth is at baseline minus one-half standard deviations						2.7	3.3	2.8	2.0	2.0	2.1
B3. Non-interest current account is at baseline minus one-half standard deviations						2.7	3.6	3.1	2.4	2.4	2.6
B4. Combination of B1-B3 using 1/4 standard deviation shocks						2.7	3.5	3.0	2.3	2.3	2.4
B5. One time 30 percent nominal depreciation in 2006						2.7	3.1	2.8	2.2	2.2	2.3
Gross external financing need in percent of GDP 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						16.3	15.2	16.5	13.8	14.5	15.7
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						16.3	18.2	14.4	9.9	9.1	8.8
B2. Real GDP growth is at baseline minus one-half standard deviations						16.3	18.3	15.0	10.7	10.2	10.3
B3. Non-interest current account is at baseline minus one-half standard deviations						16.3	19.3	15.9	11.6	11.1	11.1
B4. Combination of B1-B4 using 1/4 standard deviation shocks						16.3	19.0	15.7	11.4	10.9	11.0
B5. One time 30 percent nominal depreciation in 2006						16.3	26.6	22.4	16.3	15.4	15.3

1/ Defined as non-interest current account deficit, plus interest and amortization on medium- and long-term debt, plus short-term debt at end of previous period.
2/ Gross external financing under the stress-test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.
3/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
4/ The implied change in other key variables under this scenario is discussed in the text.

I. Fund Relations

(As of July 31, 2005)

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

I. Financial Relations

II. **General Resources Account**:	In millions of SDRs	In percent of Quota
Quota	306.50	100.0
Fund holdings of currency	1,972.76	643.64
Reserve position	0.0	0.0

III. **SDR Department**:	In millions of SDRs	Percent of Allocation
Net cumulative allocation	49.98	100.0
Holdings	23.82	47.66

IV. **Outstanding Purchases and Loans**:	In millions of SDRs	In percent of quota
Stand-By Arrangements	1,666.25	543.64

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR Millions)	Amount Drawn (SDR Millions)
Stand-By	6/08/05	6/08/08	766.25	30.65
Stand-By	4/01/02	3/31/05	1,988.50	1,988.50
Of which: SRF	6/25/02	8/08/02	128.70	128.70
Stand-By	5/31/00	3/31/02	150.00	150.00
Stand-By	3/29/99	3/28/00	70.00	0.00

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

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	84.75	434.43	574.40	268.35	133.98
Charges/interest	41.13	74.67	40.00	18.42	7.22
Total	125.88	509.00	614.40	346.86	226.42

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

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	84.75	1008.73	328.44	219.20	25.14
Charges/interest	41.13	60.71	18.99	7.21	1.16
Total	125.88	1069.43	347.43	226.41	26.30

II. Nonfinancial Relations

VII. **Safeguards Assessment:** A new full safeguard assessment is near completion. The preliminary assessment found that the BCU has strengthened the safeguards framework, but vulnerabilities remain in the areas of external audit, financial reporting, and the legal framework. To this end, staff recommended, among other things, that (i) the BCU should publish the audited financial statements and audit opinions shortly after they are issued; (ii) include the BCU's obligations to the Fund it its financial statements; and (iii) periodically reviewed that data submitted to the Fund under the program is consistent with the Technical Memorandum of Understanding.

VIII. **Exchange Rate Arrangement**: The currency is the Uruguayan peso (Ur$). Uruguay has followed an independently floating exchange rate regime since July 29, 2002. On September 12, 2005, buying and selling interbank rates for the U.S. dollar, the intervention currency, were Ur$24.06 and Ur$24.11, respectively. Uruguay's exchange

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

system is free of restrictions on payments and transfers for current international transactions.

IX. **Article IV Consultation:** The 2003 Article IV consultation was concluded by the Executive Board on July 11 (Country Report No. 03/247). Uruguay is on the standard consultation cycle governed by the provisions approved by the Executive Board on July 15, 2002. The next Article IV discussions will be held in April 2006, together with the FSAP (see below).

X. **Ex Post Assessment:** The Ex Post Assessment of Longer-Term Program Engagement was considered by the Executive Board on March 18, 2005 (Country Report No. 05/202).

XI. **FSAP participation and ROSCs**: The FSAP exercise will be conducted over two missions in October 2005 and January 2006, completing an earlier exercise that was started in November 2001, but was subsequently suspended on account of the financial crisis in 2002. The ROSC-module on fiscal transparency was published on March 5, 2001. A ROSC-module on data dissemination practices was published on October 18, 2001.

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

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

RELATIONS WITH THE WORLD BANK GROUP
(As of September 12, 2005)

The World Bank Board of Executive Directors approved a new Country Assistance Strategy (CAS) on June 9, 2005. The CAS envisages a base case scenario of up to US$800 million in new lending over the period FY05–10. The lending program will be modulated on the strength of the Government's program and its ability to implement it, as well as the evolution in the country's creditworthiness.

The Bank's strategy in the new CAS is anchored around a series of programmatic development loans that are expected to be multi-sectoral in focus and support the Government in key policy areas including public sector management, financial sector reform, and reform of social programs. The CAS also proposes to rebuild the investment portfolio with new operations planned to support priority investments in infrastructure, social programs and innovation. Two investment operations for Integrated Natural Resources (not yet effective) and Transport Infrastructure and Rural Access, in the amount of US$30 million and US$70 million respectively were approved by the Board on June 9, 2005 together with the CAS.

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

In the context of the new CAS, the Government has reaffirmed its commitment to the objectives of SAL II taking into account the results of the 2003 referenda on petroleum products and water. With regard to SSAL II, the objectives of the program have been achieved and, with the immediate crisis over and the beginning of a new CAS period, the outstanding second and third tranches of this operation have been cancelled at the Government's request. The social reform agenda continues to be supported by a new development policy loan (DPL1), approved by the Board of Executive Directors together with the CAS on June 9, 2005. The DPL1 in an amount of US$75 million supports reform progress in social policies over the last two years, as well as early but important measures that the new Government has taken with respect to health, education and social protection. The DPL1 has been fully disbursed.

The current investment portfolio comprises seven projects totaling US$359.5 million in commitments, with an undisbursed amount of US$146.3 million as of September 12, 2005. The performance of the investment portfolio has improved significantly in CY04, with disbursements for investment operations aggregating to US$43.8 million. Further improvement is expected for CY05, with projected disbursements of around US$ 50 million. This is a reflection of the substantially improved economic situation, as well closer portfolio monitoring, with portfolio performance reviews being conducted every six months.

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

	Commitments (Net of Cancellations)	Disbursements	Undisbursed Amount
I. IBRD Operations (as of September 12, 2005)			
Agriculture	18.5	16.3	2.2
Central Government and Administration	151.5	51.5	100.0
Telecommunication	6.0	1.6	4.4
Education	42.0	12.5	29.5
Power	125.0	105.9	19.1
Transportation	141.0	62.4	78.6
Water Supply	27.0	14.5	12.5
Total	**511.0**	**264.7**	**246.3**

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

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

III. IBRD Loan Transactions (calendar year)

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**[1]
Disbursements	38.7	50.4	143.9	66.3	134.2	64.7	233.5	97.4	143.8	109.8
Repayments	69.7	67.9	64.1	63.2	57.9	72.5	75.3	78.2	80.2	43.3
Net Lending	**-31.0**	**-17.5**	**79.8**	**3.1**	**76.3**	**-7.8**	**158.2**	**19.2**	**63.6**	**66.5**

[1] As of August 31, 2005

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(As of August 31, 2005)

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

The Bank's new strategy proposes a target lending scenario of US$1.2 million for the five-year period 2005–2009, which together with a normal implementation of the loan portfolio, mainly investment projects, will allow for the net lending flows to remain relatively neutral. The lending program for 2005-2006 and a tentative program for the later years—2007–2009– was agreed with the new authorities during the Bank's Programming Mission on August 22nd, 2005. This program includes lending to support the Government in the key policy areas of the social sectors, competitiveness and public sector management. To this end, a social sector loan for US$250 million was approved on August 3, 2005, to support the development and implementation of Government's social policy aimed at reducing poverty, improving the human resource base among the poor, and strengthening the sector's institutional framework. A sectoral program to improve competitiveness for US$100 million is under preparation with approval expected in 2006. Within the public sector management area, a three-year programmatic loan, to support improvements in tax administration and public sector management, is under preparation, with expected approval in 2006; the estimated financing for the first year amounts to US$50 million while for the next two years is to be determined. The lending program also includes investment projects with new operations planned in support of transport infrastructure, sanitation in Montevideo and social programs such as a neighborhood improvement programs. A loan for a program to support the productivity and development of new livestock products, for US$15.8 million, was approved on July 20, 2005.

As of August 31, 2005 the Bank's current portfolio in Uruguay includes 17 loans for the financing of investment projects; two sector loans, for strengthening the banking sector and for the social sectors; and 29 nonreimbursable technical cooperation operations for US$16.7 million. The lending portfolio amounts to US$1,192.1 million, of which US$747 million are pending disbursement; this amount includes the expected US$125 million disbursement for the first tranche of the social sector loan. Portfolio performance was affected by the Government's fiscal constraint, which entailed cuts in budgetary allocations to levels below the required amounts in order to maintain a normal pace of project implementation. A main challenge ahead will be to increase the pace of project execution while setting the stage for a normal implementation of the new projects.

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

Total outstanding loans: US$2,171.8[1]

Loan transactions:

	1999	2000	2001	2002	2003	2004	2005[2]
Disbursements	358.5	162.9	214.2	558.6	373.2	57.6	259.4
Amortization	57.0	59.4	60.7	73.1	103.2	114.3	226.4
Net Loan Flows	**301.5**	**103.5**	**153.5**	**485.5**	**270.0**	**-57.3**	**33.0**

Source: Inter-American Development Bank.

[1] IDB, as of July 31, 2005.
[2] IDB, as of August 31, 2005.

September 14, 2005

Dear Mr. de Rato:

Since the approval of the three-year Stand-by Arrangement last June, the Uruguayan economy has continued to perform well, and macroeconomic and structural policies have been in line with the program. External financial markets have shown confidence in our policies, and we have successfully prefinanced an important part of our external financing needs for 2006. We have submitted to Congress our 2005–2009 budget, with primary surplus targets in line with our program.

We have made further progress in reducing vulnerabilities. Fiscal performance has been strong, with a higher-than-programmed primary surplus in the first half of the year. This outcome reflects both better revenue collections and lower non-interest spending. With a benign inflation outlook and a strengthening of the peso, we were able to bolster international reserves. The debt burden has been reduced substantially, and we are improving the structure of our debt.

Despite high and rising oil prices, economic activity remains robust, and we expect the economy to expand by 6 percent this year. Exports have continued to increase at higher-than-expected rates, and most indicators suggest solid growth. To sustain the growth performance into the medium term, we are embarking in a variety of measures to improve Uruguay’s investment climate, including the conduct of a formalized dialogue with representatives from all key economic sectors.

In the attached supplement to the memorandum of economic and financial policies of May 24, 2005 (SMEFP), we update the set of economic policies that, we believe, will ensure the continuing success of our program. In connection with this, we request: (i) completion of the first review under the Stand-By Arrangement and purchase of SDR 30.65 million; and (ii) modification of the structural performance criterion on tax reform submission, of the NDA targets for end-September and end-December 2005, and of the adjustors for the NIR and NFPS debt performance criteria.

The second review is expected to be completed by December 2005, at which time we will further our structural reform agenda for 2006/07. As usual, we will maintain a close policy dialogue with the Fund and stand ready to take additional measures as appropriate to ensure the achievement of the program's objectives.

Sincerely,

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

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

SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. This memorandum reviews the implementation of our economic and financial program supported by the SBA and lays out our policies for the rest of 2005. It supplements the Memorandum of Economic and Financial Policies (MEFP) of May 24, 2005.

A. Recent Developments and Performance under the Program

2. Developments under the program have been favorable. All monetary and structural performance criteria and benchmarks have been met. Fiscal performance through June was in line with the program objectives. Final data on noninterest expenditure of the general government, and preliminary data on the primary balance of the combined public sector and the NFPS debt stock, as specified in the attached TMU, suggest that these performance criteria were observed. We will provide final data on the primary balance of the combined public sector and the NFPS debt stock before the Executive Board meeting.

3. Leading indicators for the second quarter suggest robust growth, and the 6 percent growth objective for the year is within reach. Inflation has declined to below the central bank's (BCU) target range. The peso has strengthened significantly since the start of the year, indicative of growing demand for money and investor confidence. With a benign inflation outlook and appreciation pressures on the peso, the BCU conducted foreign exchange purchases in May and June, which were partially sterilized. In line with an increase of its commitment to the inflation target, and a lower emphasis on the monetary instrument, the BCU raised its base money target range by about 4 percent, while maintaining the inflation target range for June 2006 at 5–7 percent.

4. Fiscal performance has been strong, with a higher-than-programmed primary surplus in the first half of the year. This outcome reflects both better revenue collections and lower non-interest spending. The social emergency program (SEP) has now started to assist those in greatest need, including through direct income transfers, free preventive health care, and a temporary employment program. To further safeguard our fiscal targets, we have established quarterly revenue targets (floors) at the social security bank (BPS).

B. Macroeconomic Policies

5. We remain fully committed to the medium-term fiscal framework set out in our letter of May 24, 2005. The 2005 fiscal targets are well within reach, and the five-year expenditure plan submitted to Congress in August is consistent with the medium-term framework. The plan includes a comprehensive medium-term macroeconomic framework and explicit revenue and fiscal deficit targets for the period 2005–09, aiming at a primary surplus of 3.7 percent of GDP in 2006 and 4 percent of GDP in subsequent years. The plan entails agreement with public sector employees that allows for a gradual recovery of wages in real terms not exceeding GDP growth, and contingent on fiscal objectives being achieved. In addition, it includes additional wage allocations to priority sectors, including health and education, reaching 0.4 percent of GDP by 2009.

6. While our revenue goals for 2006 and over the medium-term are ambitious, we will closely monitor the evolution of actual revenues and have identified contingency measures for prompt adoption to ensure meeting the fiscal objectives. We reiterate our commitment to save any revenues exceeding program projections in 2005, maintain expenditure levels within program limits, and adjust public tariffs in a timely manner consistent with cost developments.

7. Reflecting the recent moderate easing of the monetary policy stance, we propose to increase the indicative target for base money for 2005 by about 4 percent, as shown in Table 1. We are monitoring carefully the inflation outlook, and will continue to timely adjust monetary policy to ensure achieving the program objectives.

C. Structural Reforms

Attracting private investment

8. We attach great importance to creating an attractive environment for private investment, which should be the main engine of growth and social progress in Uruguay. Our strategy is three-pronged: (i) firmly entrench macroeconomic stability; (ii) strengthen the legal, institutional, and financing environment for private investment: and (iii) ensure continued social peace and equitable labor relations, as a basis for productive enterprise.

9. President Vázquez launched in May a high level commission to discuss and agree on a wide agenda which includes, among others, reforms for improving the investment climate. The commission (i) is led by the Ministry of Finance and the Ministry of Labor and Social Security and is composed by representatives of all key sectors of the business community and labor unions; (ii) will build on important reforms, most of them already described in our letter of May 24, 2005, and identified by the IDB and the World Bank; and (iii) will publish its proposed reform agenda with a timetable by March 2006 (new structural benchmark). In the meantime, we are pursuing several near term priority reforms. We simplified tax and social security registration through the establishment of one-stop windows, and submitted legislation to Congress restricting anticompetitive practices. We will also submit to Congress by June 2006 a modernized bankruptcy legislation (new structural benchmark), and expect approval by end-2006.

10. We are considering public-private partnerships (PPPs) to help close the investment gap and improve efficiency of public enterprises. We will coordinate closely with the Fund to ensure that any potential investment is properly reflected in the fiscal accounts, including its actual and contingent costs, and consistent with the program's fiscal objectives.

Fiscal reforms

11. **Tax reform.** We are advancing in the preparation of draft legislation on a comprehensive tax reform, including a new personal income tax, revamping the corporate income tax, and eliminating tax exemptions and subsidies. We are looking forward to the

suggestions from an FAD mission later this year. While we expect the bill to be ready by end-2005, with Congress in recess until mid-February 2006, we now propose submission by end-February 2006, for implementation by June 2006. The reform is expected to result in higher revenues starting in 2007. However, we are committed not to reduce the burden of indirect taxes until the revenue gains from the reform materialize, ensuring that the revenue goals in the medium-term budgets are met.

12. **Revenue administration.** We have begun to implement reforms, based in part on the recommendations of a recent FAD/World Bank technical assistance (TA) mission. Regarding the DGI (domestic tax administration), the Ministry of Economy and Finance and the DGI will sign a memorandum of understanding agreeing on quantifiable targets and indicators for 2006 on tax collections, audit coverage, tax services, and information systems (new benchmark for end-December 2005). We will also strengthen the auditing and collection functions of the social security bank (BPS). In addition, by August 2006 we will finalize the design of a comprehensive plan to transform the customs authority (DNA) into a modern customs service (new structural benchmark). As part of the plan, we will introduce risk-based controls and setup simplified procedures based on the existing information technology systems.

13. **Budget process.** We will intensify work to improve budgetary management during 2006. We will request Fund TA to assist in preparing an organic financial management legal framework and improving budget classification and coverage.

14. **Pension reform.** We remain committed to reducing the fiscal burden of the pension system, starting with implementation of the reform of the fund for the police by end-November, 2005. Reforms for the pension funds of the military and the banking sector are envisaged for 2006. In the case of the general public plan, our efforts have already resulted in increased contributions, and we expect further increases by implementing recommendations by a recent Fund mission on tax administration. In addition, to improve the actuarial fairness of the general public plan, we are currently assessing recommendations by a recent World Bank mission and will formulate our reform agenda in 2006.

15. **Debt management.** Preparations for the creation of a debt management unit at the Ministry of Finance are well advanced, and its establishment is expected by year-end. This effort is assisted by the Fund and the IDB. In addition, we have started to work on the design of a debt management strategy to lengthen average maturity and reduce the share of foreign currency-denominated debt.

Monetary and financial system reforms

16. We are preparing legislation aimed at improving the operational framework of the financial system for submission to Congress by end-December (performance criterion). A new law on bank resolution will allow for resolution techniques that are less disruptive to the financial system than outright liquidation. The law will also clarify coverage and operations of the deposit insurance scheme, which was introduced by decree in March. In addition, we

are preparing legislation to strengthen financial sector supervision and to amend the central bank law to bolster BCU independence. We have requested Fund TA to study strategies for strengthening the BCU's financial position.

17. Regarding the public bank BROU, credit granting controls are being strengthened, there has not been politically-directed lending, and credit subsidies are not being granted. In line with our previous commitments, any credit subsidies would be made explicit in the budget. The trust managing BROU's nonperforming loans continues to service its debt to BROU; if the trust is unable to service the debt, the government will honor its guarantee of these notes.

18. The restructuring of the state housing bank, BHU, has not fully progressed in line with the plans developed in 2003. We therefore recognize the desirability of an updated restructuring strategy, which we intend to adopt before end-2005 (new structural PC). In the meantime, BHU will continue its practice of not accepting new deposits from the public except pre-savings schemes. The government will, if necessary, honor its guarantee of the note to BROU to assure its timely servicing.

19. We have signed a contract for the sale of NBC (the bank formed with the consolidated good assets from 3 banks) and expect the sale to be completed by year-end. Collection efforts by the asset manager for the liquidation funds for the bad assets is proceeding on schedule and semi-annual financial statements are being published and audited annually.

Financing Assurances and Program Monitoring

20. The government has been successful in funding itself on the domestic market as well as in placing bonds in international financial markets. As a result, the program's financing for 2005 is well in hand. We also remain strongly committed to the reforms supported by lending programs from the IDB and the World Bank, and expect timely disbursements in support of program implementation.

21. We request the following modifications to the performance criteria set out in the MEFP of May 24, 2005: We request modification of (i) the monetary targets noted in paragraph 7; (ii) the adjustors to the NFPS debt and NIR targets to better reflect the concept of pre-financing; and (iii) the structural PC on tax reform. We further request that an additional structural performance criterion on BHU for end-December be set, as well as structural benchmarks on growth-enhancing reforms (paragraph 9) and revenue administration (paragraph 12), as presented in Tables 1 and 2.

Table 1: Quantitative Performance Criteria and Indicative Targets under the 2005-08 Program 1/

	2004 Stock	PC	PC (adjusted	Actual	Margin (+)	2005 PC		2006 IT			2007 IT
	Dec. 31	June 30				Sept. 30	Dec. 31	March 30	June 30	Dec. 31	Dec. 31
A. Quantitative performance criteria											
	(In millions of Uruguayan pesos)										
1. Combined public sector primary balance (floor) 2/	...	5,471	5,372	6,489	**1,117** 4/	9,687	14,647	2,382	7,995	17,011	19,966
2. General government noninterest expenditure (ceiling) 2/	...	23,561	23,539	22,126	**1,413**	34,643	46,561	13,286	26,572	53,144	58,039
3. Net domestic assets of the BCU (ceiling) 2/	74,079	3,983	3,983	-302	**4,284**	4,572	-3,910	5,143	-1,612	-4,580	-13,369
	(In millions of U.S. dollars)										
4. Net international reserves of the BCU (floor) 2/	-2,218	-130	-130	18	**148**	-110	280	-226	50	241	580
5. Nonfinancial public sector gross debt (ceiling) 3/	12,189	12,510	12,517	12,368	**148** 4/	12,575	12,550	12,775	12,740	12,775	12,925
6. Accumulation of external payment arrears of the public sector (on a continuous basis) 2/	0	0	0	0	**0**	0	0	0	0	0	0
B. Indicative targets											
	(In millions of Uruguayan pesos)										
7. Combined public sector overall balance (floor) 2/	...	-5,086	-5,086	-2,708	**2,378**	-7,459	-7,072	-3,204	-3,176	-5,332	-3,338
8. Monetary base (ceiling) 2/	15,648	557	557	1,070	**-513**	1,673	3,468	-824	-294	1,770	1,914
9. Floating debt of the central government (ceiling)	3,081	3,081	3,081	2,567	**514**	3,081	3,081	...	...	...	...

PC= performance criterion; IT=Indicative target.

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

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

Table 2. Uruguay: Structural Conditionality under the June 2005-June 2006 Program 1/

Area	Structural Conditionality	Date	Status
A. Structural performance criteria			
Fiscal	Submit to congress a five-year spending plan, complemented with revenue projections and deficit targets consistent with the program's fiscal targets.	August 31, 2005	Observed.
Fiscal	Have in place a five-year spending plan, complemented with revenue projections and deficit targets consistent with the program's fiscal targets.	February 28, 2006	
Pension	Begin to implement reform of the pension fund for the police.	November 30, 2005	
Tax reform	Submit to congress a comprehensive tax reform as described in paragraph 7 of the MEFP.	February 28, 2006	
Tax reform	Begin to implement the comprehensive tax reform.	June 30, 2006	
Central Bank	Submit simultaneously three laws to congress to: (i) give appropriate autonomy to the central bank (as described in paragraph 12 of the MEFP); (ii) strengthen the regulation of the financial system (as described in paragraph 13 of the MEFP); and (iii) provide a suitable bank resolution framework (as described in paragraph 14 of the MEFP).	December 31, 2005	
Central Bank	Begin to implement these laws.	June 30, 2006	
BROU & BHU	Government to ensure timely service of BHU note and BROU fiduciary notes to BROU in accordance with the current payment schedules.	Continuous	
BHU	Adopt action plan to address the financial situation of BHU consistent with minimizing systemic risks and contingent fiscal costs.	December 31, 2005	
B. Structural benchmarks			
Fiscal	Establish quarterly revenue collection targets (floors) at the social security bank (BPS).	June 30, 2005	Observed.
Tax administration	Sign a memorandum of understanding between the Ministry of Finance and the DGI agreeing on quantitative targets and indicators for 2006 on tax collections, audit coverage, tax services, and information systems.	December 31, 2005	
Tax administration	Finalize the design of a comprehensive reform plan for the customs agency (including establishing collection targets consistent with the program).	August 31, 2006	
Debt management	Create a debt management unit at the Ministry of Finance.	December 31, 2005	
Growth	Publish agenda of growth-enhancing reforms (including timetable for implementation) prepared by the business environment commission.	March 31, 2006	
Growth	Submit to Congress bankruptcy law (to include Chapter-11 type corporate restructuring).	June 30, 2006	
Financial sector	Sell shares of NBC in amounts that yield managerial control to the private sector.	June 30, 2006	

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

TECHNICAL MEMORANDUM OF UNDERSTANDING

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

1. **Cumulative floor on the overall balance of the combined public sector (indicative target).** The combined public sector comprises the non-financial public sector (NFPS) and the Central Bank (BCU). The NFPS comprises the central government,[1] the social security system (*Banco de Previsión Social, Caja Militar,* and *Caja Policial*), the local governments (*Intendencias*), the public enterprises (AFE, ANCAP, ANCO, ANP, ANTEL, INC, OSE, and UTE (including Salto Grande)). The below-the-line overall balance will be measured as the negative of the *sum* of: (a) the net financing of the NFPS[2] minus (b) the operating balance of the BCU.

(a) The net financing of the NFPS would include the *sum* of: (i) increase in net claims of the domestic financial system on the NFPS (excluding government bonds and treasury bills); (ii) the increase in the net amount of NFPS bonds and treasury bills held outside the NFPS (excluding any debt issued for the recapitalization of BCU and debt issued to finance the capitalization of the deposit insurance scheme up to a limit of US$20 million); plus (iii) external bank loans and external[3] supplier credits to the NFPS; plus (iv) the net increase in liabilities arising from the forward sale of NFPS assets; plus (v) the increase in net non-bank loans[4]; *minus* (vi) the net increase of NFPS financial assets held by the NFPS outside the domestic financial system (including the loan component of the deposit insurance scheme); plus (vii) gross revenues from the sale of public assets (net of associated fees and commissions); plus (viii) all upfront payments related to future concessions (including the sale of mobile phone licenses); plus (ix) recoveries of financial assistance provided to the banking system.

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

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

[3] Based on the residency principle.

[4] Nonbank loans are defined in accordance with point No. 9 (a) (i) of the Fund's Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 6230-(79/140, August 3, 1979), as amended in 2000, but exclude those instruments listed in paragraph 1 (a) (i), (ii), (iii) and (iv) of this memorandum, and cover loans of the central government and public enterprises only.

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

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

Schedule A
(In millions of Uruguay pesos, cumulative basis)

	Jun-05	Sep-05	Dec-05
Projected social security contributions	1,798	2,712	3,587

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

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

3. **Cumulative ceiling on general government expenditure** applies to total (current and capital) non-interest expenditure of the central administration and the social security system (BPS) as recorded in the accounting system at the time that checks are delivered, a bank transfer is made, or the BCU notifies the receipt of a payment order.[5]

- The non-interest expenditure of BPS exclude benefit payments. The non-interest expenditure of the central administration includes *Fondos de Libre Disponibilidad* but excludes transfers to the social security system, automatic transfers to the private pension funds (AFAPs), and earmarked revenue as of December 31, 2004.

[5] Expenditures by local governments are not included.

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

Schedule B
(In millions of Uruguayan pesos, cumulative basis)

	Jun-05	Sep-05	Dec-05
Projected revenues from the FLD	3,044	4,664	6,277

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

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

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

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

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

- The NIR floor will be adjusted upward by any "excess" net financing of the NFPS defined as the difference between the stock of debt of the NFPS, as defined in para. 7 but excluding central government foreign currency deposits in domestic commercial banks, and schedule C below, and which is not explained by the adjustments specified in para. 7, bullet 1 (i-v).

Schedule C
(In millions of US dollars)

	Dec-04	Sep-05	Dec-05
Stock of debt of the NFPS, excl. CG FX deposits in domestic commercial banks	12,316	12,715	12,690

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

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

7. **The overall nonfinancial public sector gross debt ceiling** refers to the outstanding stock of external debt[6] and domestic debt[7] measured on a *gross* basis[8] in domestic and foreign currency *owed or guaranteed by the NFPS*, valued in U.S. dollars at the accounting rates of Ur$26.35 per U.S. dollar, U.S. dollar 1.3637 per Euro, U.S. dollar 0.0097 per Yen, U.S. dollar 1.54784 per SDR, and Ur$1.4345 per UI. If the Ur$ to UI rate exceeds 1.5420 the UI debt will be valued at Ur$ 1.4345 plus the difference between the actual rate and Ur$1.5420. The debt ceiling will exclude (i) the government guaranteed BHU note (with outstanding obligations estimated at US$624 million at end-December 2004) and the government guaranteed notes issued by the fiduciary trusts associated with the transfer of BROU's nonperforming loans (with outstanding obligations estimated at US$429 million at end-December 2004); and (ii) net debt of the NFPS with the BCU. It will include the total stock of Fund credit outstanding to Uruguay.

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

[6] For the definition of external debt the term "debt" has the meaning set forth in point No. 9 of the Fund's Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 6230-(79/140, August 3, 1979), as amended in 2000), and the term "external" is defined on the residency principle. The suppliers' contracts of ANTEL with equipment providers Ericsson and NEC are expensed under goods and services as rental outlays and, therefore, excluded from the definition of nonfinancial public sector gross debt for program purposes.

[7] Domestic debt covers net claims of the domestic financial system on the NFPS; NFPS bonds and treasury bills held outside the NFPS and the domestic financial system; non-bank loans as defined in footnote 4; and lease arrangements of the central government and public enterprises, as defined in point No. 9 (a) (iii) of the Fund's Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 6230-(79/140, August 3, 1979), as amended in 2000.

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

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

9. **Floating debt of the central government** is defined as expenditures from the general treasury account ("*Rentas Generales*" only) that are registered in the integrated information system (SIIF), and that have been authorized for execution and confirmed by the respective central accountants, and for which no checks for payment have yet been issued. Excluded are obligations for utilities, obligations related to subsidies, judgment debt and obligations falling under "*Inciso 24"* of the accounting plan of the *"Contaduria General de la Nacion" international organizations and other credit)*, and domestic suppliers' credits of the Ministry of Housing. The ceiling on floating debt will be adjusted upward (*downward*) by revisions made to the actual stock of floating debt at end-2004. This indicative target will apply through December 31, 2005; and afterwards—once approved in the 2006 budget—monitored by including the floating debt in the definition of the combined public sector overall balance measured from below the line, general government expenditure, and in the stock of the NFPS debt.

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

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

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

1/ Fiduciary trusts that own and manage the debt formerly on the books of BROU.
2/ Estimated balance of outstanding principal and interest obligations.
3/ Estimate. The contractual floating interest rate depends on that for BROU deposits.

Statement by the IMF Staff Representative
September 28, 2005

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

Performance criteria. The authorities have provided final data confirming that the end-June 2005 performance criteria for the primary surplus and the nonfinancial public sector debt were observed. The primary surplus of the combined public sector amounted to Ur$6,425 million, exceeding the corresponding adjusted PC by a margin of Ur$1,053 million. In turn, the nonfinancial public sector debt reached US$12,383 million, meeting the corresponding adjusted PC with a margin of US$142 million.

Recent economic developments

- Real GDP in the second quarter increased by 3.0 percent (seasonally adjusted, quarter-to-quarter), or 7.5 percent year-on-year, led by consumption and export growth. This is in line with the program's growth projection of 6 percent for 2005.

- Fuel prices at the pump were raised by 6.25 percent on average on September 15, to reflect the increase in international oil prices.

Press Release No. 05/217
FOR IMMEDIATE RELEASE
September 28, 2005

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First Review of Uruguay's Stand-By Arrangement

The Executive Board of the International Monetary Fund (IMF) completed today the first review under the SDR 766.3 million (US$1.11 billion) Stand-By Arrangement for Uruguay. Completion of this first review makes SDR 30.7 million (about US$44.4 million) immediately available to Uruguay.

In completing the review, the Board also approved the modification of the structural performance criterion on the timeframe for submission of a comprehensive tax reform, of the net domestic assets of the central bank for end-September and end-December 2005, and of the adjustors for the net international reserves and nonfinancial public sector debt performance criteria.
The Stand-By Arrangement was approved on June 8, 2005 for a three-year period, under the Fund's exceptional access policy (see Press Release No. 05/136). [1]

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

"Uruguay's economic program, supported by a new Stand-By Arrangement, is off to a good start. The authorities' strong macroeconomic policies, together with generally favorable external conditions, have resulted in rapid growth, low inflation, and renewed access to international capital markets. As a result, economic vulnerabilities have been reduced significantly, although important risks remain. In particular, the still high public debt, weaknesses in the banking system, and pressures to raise fiscal spending continue to pose important challenges to the government's reform program.

"The five-year budget submitted to Congress in August reaffirms the government's commitment to strong macroeconomic policies through its term in office. It is now important to implement the budget and associated fiscal reforms. In particular, the authorities' plans for comprehensive tax reform, improving revenue administration, and reforms of specialized pension funds are well placed.

"Uruguay's progressive return to international capital markets is an important achievement that, together with continued sound macroeconomic policies, underpins prospects for a lasting exit

[1] The staff report for the First Review of the Stand-By Arrangement with Uruguay may be made available at a later stage if the authorities consent.

from Fund financial support. Uruguay has taken advantage of favorable external conditions to improve the structure of public debt. Debt management will be further improved through the establishment of a specialized unit at the Ministry of Finance.

"Monetary policy has been successful in bringing down inflation. However, potential inflationary pressures need to be monitored carefully, to make sure monetary policy can react if necessary to safeguard the inflation objective.

"The restructuring of the banking system has progressed well, but risks remain. The ongoing divestment of NBC, the bank created out of the good assets of the failed banks, is welcome, as is the progress made in strengthening the largest state bank and its asset resolution efforts. Key remaining challenges include stepping up reforms at the state mortgage bank and reducing high financial dollarization, which remains a major vulnerability. The authorities' plans for strengthening the central bank, the supervisory authority of banks, and the deposit insurance framework are important milestones ahead.

"Continued success of the program depends on sustaining rapid growth and social progress. The authorities' strategy for achieving these goals rightly focuses on raising private sector investment, while supporting vulnerable groups through well-targeted social assistance. Developing a clear action plan to improve the investment climate and effective implementation of the two-year Social Emergency Program are important planks of this strategy, complementing the authorities' commitment to sustained fiscal consolidation and financial stability. The good start made in implementing the government's program harbors favorable prospects for achieving the overarching goals of sustained growth, debt sustainability, and social progress," Mr. Cartsens said.

Statement by Hector Torres, Executive Director for Uruguay
and David Vogel, Advisor to Executive Director
September 28, 2005

The Uruguayan authorities' goals

1. During 2005, Uruguay has been growing robustly, in a context of the lowest inflation rate in about six years, fiscal performance in line with the program's targets, and improving market conditions reflected in decreasing sovereign spreads. Under this scenario, the Uruguayan authorities are addressing the country's many substantial challenges. In particular, Uruguay's potential growth needs to be impelled. To do this, domestic and foreign investment must be encouraged by further improving the business environment which, given Uruguay's democratic tradition, requires respecting people's entitlement to participate in the country's growth by enhancing the level and quality of employment. Hence, in Uruguay, sustainable economic growth and improvements in human development go hand-in-hand.

Macrostability as a necessary condition for meeting the authorities' goals

2. Uruguay's satisfactory economic performance during 2005 is noticeable in many areas. In the first half of the year, economic activity increased at about 7 percent, led by exports, which, at the same time increased by 18 percent (compared to the same period last year) in real terms. Moreover, export diversification continues, with a higher participation of NAFTA countries (29 percent of the total exports in the last twelve months to June), while exports to Mercosur and Europe represent other important parts of Uruguay' external sales (23 percent and 20 percent, respectively). This increasing diversification makes the country more resilient to external shocks. Meanwhile, imports have also been rising at high rates (15 percent in real terms in the first half of the year compared to the same period last year), with a prominent surge in capital good imports.

3. Fiscal discipline is essential to achieve the authorities' objectives. As noted in the staff report, the fiscal program is on track. Meanwhile, the revenue collecting agencies (DGI, DNA, and BPS) have been showing a significant increase in their revenue collection over the year, and, in this month the government decreed gas price increases in order to be more in line with cost developments. Furthermore, critical fiscal reforms are already being introduced, while others will be implemented as scheduled. All of these measures and reforms will allow the government to achieve the medium-term primary surplus target of 4 percent of GDP by 2007 and a downward trend in the overall fiscal deficit. Both achievements will result in a substantial reduction in debt-to-GDP ratio. It is important to note that the authorities have already obtained part of the 2006 external financing needs. Meanwhile, they are undertaking the needed steps, including the Fund's advice, to create a debt-management unit within the Ministry of Finance.

4. By the end of August, our authorities submitted to Congress a five-year spending plan, complemented with revenue projections. This plan, beyond reflecting the government's priorities, has been oriented by four criteria. First, fiscal responsibility and, in this regard, it

is worthy to note that the budget is fully consistent with primary fiscal surplus and overall fiscal targets. Second, the plan aims at improving the administration's performance by starting to link efficiency with remuneration, as is the case of DGI officials (the national tax collection agency). The third criterion attempts to encourage a more efficient use of the resources in the administration[1], while the fourth aims at improving transparency, both in terms of tax revenue sources and use of public moneys.[2]

5. As underscored by the staff, annual inflation has been below the Central Bank's target range. Whereas maintaining the current framework of monetary indicative targets in a context of a flexible exchange rate, the authorities are preparing a legislation to bolster BCU independence and to improve institutional framework. Furthermore, the authorities have already appointed the Board of the Deposit Insurance Agency, while working on a law that will clarify its coverage and operations, together with a bank resolution framework that is being prepared. In doing so, the authorities intend to increase confidence in the monetary and financial policies, which in turn will facilitate de-dolarizing the economy.

6. The important progress made in the banking area is noteworthy. The state bank (BROU) continues to improve its performance and procedures, and its trust fund continues to recover nonperforming loans. The Nuevo Banco Comercial (NBC) was sold to a private partnership of foreign financial institutions, in a very convenient operation for the country not only because of the price of the transaction is considered fair, but more importantly because of the buyers' excellent reputation. As regards the state mortgage bank's (BHU) vulnerabilities, the authorities are strongly committed to adopt a comprehensive strategy to address the institution's problems.

The indissoluble link between investment and growth

7. Enhancing the availability of credit and reducing its costs are critical to increase Uruguay's investment rates. The authorities consider that the measures and reforms in the financial system will result in a strengthened system with positive consequences in terms of confidence. This should encourage depositors to invest in longer-maturity instruments, driving banks to flexibilize their lending policies. At the same time, the authorities are committed to developing an efficient capital market that allows firms to have more credit source alternatives.

8. The authorities have taken into account that public investment in infrastructure has substantially decreased since the 2002 economic crisis, and that it is crucial to boost it in order to support private investment. In consideration of the latter, the authorities, aware of the country's fiscal constraints, are considering introducing a Public-Private Partnership

[1] The budget would allow different entities to use the money that has not been used in current expenditure for investment during the following year.

[2] The five-year plan submitted to Congress, including its priorities and criterion for this elaboration, can be found on the Uruguayan Presidency's web site (www.presidencia.gub.uy/_Web/proyectos/2005/08/cm117.pdf)

(PPP) window. In this respect, the authorities will seek advice from the IMF and other IFIs to ensure its efficiency, transparency and accountability.

9. As noted in a business environment survey from the World Bank[3], inappropriately designed or administered taxes may impose direct or indirect costs on firms, and this seems to be one of the main explanations for disappointing investment rates in Latin America. Acknowledging that Uruguay is not an exception, our authorities have implemented a critical reform at the national revenue-collecting agency (DGI). Since the reform, DGI officials must work exclusively for this entity –or abandon it- in sharp contrast with the former system that allowed employees to work simultaneously at the revenue administration and at the private sector. Clearly, the former system gave an unfair edge to firms that employed revenue administration's workers. This very much-needed reform will improve transparency and accountability in the government and reduce rent-seeking activities in the private sector.

10. The authorities continue to work with the assistance of FAD on a comprehensive tax reform that will be fully consistent with the authorities' objective of boosting private investment. This reform will introduce a new personal income tax, will broaden the tax base, and eliminate tax exemptions and subsidies, making room to lower the current rates on indirect taxes. The aforementioned reforms seek to establish a more equitable system, with a better distribution of the tax burden. In this respect, we would like to reiterate our authorities' commitment that the total burden of indirect taxes will not be reduced until the revenue gains from the reform materialize, ensuring that the revenue goals in the medium-term are met.

11. The quality of business regulations constitutes a key element to attract -or obstruct-investment and to encourage the creation and development of business. In this regard, the authorities are undertaking critical steps to enhance regulations aimed at encouraging investment and business. Among them, the authorities have already submitted to Congress a law that restricts anticompetitive practices, while preparing a new bankruptcy law that includes Chapter XI type corporate restructuring. The authorities are also working in cooperation with the IDB and the World Bank to facilitate the creation of new businesses in Uruguay and make it less costly.

Better distribution and more beneficiaries from stronger growth

12. At the same time, as noted in the last issue of "Doing Business" from the World Bank[4], "less costly does not mean less protection" as the ease of doing business does not appear to be linked to low levels of social protection or lack of government regulations. Our authorities agree with this observation, and the new labor framework (with tripartite wage councils), which aims at improving the investment climate by tempering the normal distributional tensions, should be read in this context. Beyond possible improvements that

[3] Batra, Geeta, Daniel Kaufman, and Andrew Stone, 2003, "Investment Climate around the World", The World Bank.

[4] "Doing Business in 2006: Creating jobs". The World Bank, 2005.

will be introduced to the aforementioned wage negotiating framework, it is worth noting that nearly 80 percent of the activity sectors have already reached agreements without the government's arbitration. More generally, the framework of the national agreement on employment, income, and responsibilities (*Compromiso Nacional para el Empleo, los Ingresos y las Responsabilidades*) that includes the participation of employers, trade unions, and other social actors, will help to make the different goals prevailing in the Uruguayan society compatible. Precisely, in a further attempt to improve business climate and social cohesion, the government is committed to publish in early 2006 an agenda of growth-enhancing reforms (including timetable for implementation) that will be prepared by a business-environment commission.

13. While agreeing with the staff that the Social Emergency program is key to building ownership for the government's reform agenda, our authorities would like to point out that this program's main objective is to meet an imperious and ethic need of mitigating poverty conditions. Our authorities would like to underscore that this program has progressed slower than expected, due to a large extent to the government's commitment to implement the plan with precision and transparency.

Uruguay and the Fund

14. Once again, the Uruguayan authorities would like to thank the Fund's Management, the staff, and the Executive Directors for their fruitful recommendations and constant support. Furthermore, the authorities are considering making advance repurchases to the Fund, which would benefit the IMF –to the extent that it will collaborate with the revolving of Fund resources- and also to the country, since it would send a clear message about the Uruguayan government's strong commitment to fiscal discipline, and, in general, to its program.