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# Uruguay: Ex Post Evaluation of Exceptional Access Under the 2005 Stand-By Arrangement

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URUGUAY

# Ex Post Evaluation of Exceptional Access under the 2005 Stand-By Arrangement

Prepared by a Staff Team from FAD, PDR, and WHD[1]

Approved by the Western Hemisphere
and Policy Development and Review Departments

August 9, 2007

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[1] The team comprised Thanos Arvanitis (head, PDR), Serkan Arslanalp (FAD), Stephanie Eble (WHD), and Jun Il Kim (PDR).

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## Executive Summary

Over the past five years, Uruguay has undertaken a remarkable effort to recover from the deep economic and financial crisis of 2002. Crucial steps were taken under the 2002-05 stand by arrangement (SBA) toward stabilizing the banking system, consolidating the fiscal and debt positions, and restoring strong economic growth. However, in early 2005 important vulnerabilities remained. The public debt was sustainable only under stringent conditions, requiring fiscal surpluses significantly above historical levels. Confidence in the banking system was tenuous, in light of the widespread dollarization and balance sheet mismatches. The social situation remained difficult. And sufficient access to market financing to ensure an exit from Fund financing at the end of a successor arrangement was not secured.

Against this, the 2005 SBA—which is the main focus of this report—aimed to provide a coherent macroeconomic policy framework to further reduce vulnerabilities, boost growth, and improve social conditions. Considerable progress was made on all fronts. A strong economic expansion closed the large output gap, and confidence strengthened on the back of stronger bank balance sheets, public finances, and international reserves position. With rapidly increasing incomes and drop in unemployment, social conditions improved and poverty rates are returning to precrisis levels. Sovereign risk spreads declined sharply and Uruguay deepened its access to the international financial markets, allowing it to repay all outstanding Fund obligations half way through the arrangement.

The steadfast pursuit of sound macroeconomic policies and reforms in a broadly supportive external environment played a pivotal role to place Uruguay in this stronger position. From its perspective, the Fund helped formulate a program that was well designed and instilled market confidence. The large access under this successor SBA provided assurance that the program would remain financed against a less favorable external environment. It also gave the authorities more time to bolster market access, wind down Fund exposure, and exit from Fund financing under favorable conditions. In this context, the early termination of the SBA should be seen as a sign of the program's success.

Nonetheless, further progress could have been made in some key areas. The program's implementation could have attached higher priority to saving revenue overperformance, addressing fiscal rigidities, and creating space for public investment. Earlier progress on the transparency of the monetary policy framework and enhancing the central bank's operational autonomy and accountability, as envisaged under the program, would have helped better consolidate lower inflation. Finally, key reforms of the financial system could have been completed to further entrench financial stability.

Uruguay's transition to safer grounds is not yet complete and vulnerabilities from high dollarization and debt remain. Maintaining the general direction of policies under the 2005 SBA remains important to place the economy on a sounder footing and protect it against abrupt market reversals.

## I. INTRODUCTION

1. **Five years after the severe economic and financial crisis of 2002, Uruguay is experiencing a remarkable recovery**. Output has rebounded to well above pre-crisis levels, public debt has declined sharply from over 100 percent of GDP in 2002–03 to about 66 percent of GDP in 2006, bank balance sheets have become stronger, and market access has been restored. Within a supportive external financial environment, these results reflect the authorities' determined implementation of policies to overcome the 2002 crisis and rebuild a more resilient and buoyant economy. The international community supported these efforts with exceptionally large financing for the size of Uruguay's economy, predominantly through the Fund (Box 1).[2]

2. **The effort set in train in 2002 was expected to be completed through the 2005 SBA**. Under the 2002–05 program, Uruguay made considerable progress toward stabilizing the banking system, consolidating the fiscal and debt positions, and restoring strong economic growth. A successor three-year SBA, approved in June 2005, aimed at building on this progress, further strengthening the economy and paving the way for Uruguay's lasting exit from Fund financial support. Half way through the program and benefiting from a stronger-than-expected external position, the authorities repaid all outstanding Fund obligations (SDR 726.7 million) in late November 2006, and cancelled the arrangement shortly thereafter, upon completing the pending reviews. At end–2006, Uruguay's economy was undoubtedly on a firmer footing than in late 2004, however, some important reforms under the program remained to be implemented.

3. **This report assesses the effectiveness of Fund's involvement in the context of the 2005 SBA, responding to the requirement for an evaluation of exceptional access arrangements after their termination or expiration**.[3] It focuses on two key questions: (i) were the macroeconomic strategy, program design and financing appropriate and consistent with Fund policies; and (ii) did outcomes meet program objectives.

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[2] Over the 2002–04 period, the Fund provided about ¾ of the total multilateral support, raising the Fund's credit to 20 percent of Uruguay's GDP at end–2004, its largest exposure to a single member (relative to its GDP).

[3] See *Ex Post Evaluations of Exceptional Access Arrangements—Guidance Note*, available at http://www.imf.org/external/np/pp/eng/2005/080805.htm.

## Box 1. The 2002 Crisis—A Brief Overview

**A severe financial crisis shook Uruguay's economy in 2002**. Uruguay enjoyed relatively strong economic performance throughout most of the 1990s. Underlying vulnerabilities, however, heightened Uruguay's exposure to regional volatility and exchange rate shocks. These included a highly dollarized and weakly regulated and supervised banking system, and corporate and household sectors that held large and unhedged foreign currency liabilities. The presence of large nonresident deposits and Uruguay's status as an offshore financial center for the region were seen as a sign of strength. However, in early 2002, they were a key channel through which the Argentine crisis spread to Uruguay, when Argentine depositors began to withdraw their deposits en masse. Problems in banks with large exposure to Argentina soon spilled over to other banks in the midst of a generalized confidence crisis.

**Stopping the bank run proved challenging**. The initial policy reaction, including early support from the Fund in March 2002 (SDR 549.1 million, 194 percent of quota) failed to stem liquidity pressures in the banking system. After a small hiatus, outflows spread to resident depositors and the acceleration of the bank run led to a first augmentation of the SBA in June 2002 (SDR 1,158.2 million, 378 percent of quota). The program focused on enhancing the central bank's lender of last resort functions through the creation of a specialized fund, allowing it to extend dollar liquidity to a group of core banks. This scheme failed to restore confidence, as dollar deposits far exceeded the resources available in the fund, and the crisis deepened. With dwindling reserves, the exchange rate was allowed to float in June, losing 60 percent of its value against the US dollar in the following two months. Worsening debt dynamics and weakened bank balance sheets raised doubts about the government's capacity to service its own debt and meet its obligations to the banking system. By mid-summer, most domestic banks had become illiquid and a bank holiday was declared in late-July. In August, the Fund approved a second augmentation of the SBA (SDR 376.0 million, 123 percent of quota). The strategy shifted to creating a new fund with enough resources to fully cover sight and savings deposits of a core group of domestic banks, and partially reprogramming dollar time deposits with a maturity extension. Outflows gradually halted and a measure of stability returned.

**The financial crisis spread, imposing severe economic and social costs**. The withdrawal of nonresident deposits cascaded into full blown banking, currency, and debt crises. The output loss was considerable, with real GDP declining by 11 percent in 2002. Banks lost about 45 percent of their deposits and central bank reserves declined by nearly 80 percent. NPLs increased to 37 percent of total loans. Social indicators worsened, with unemployment up to double digits, and poverty rates above 30 percent. Public debt escalated to about 100 percent of GDP (of which, 20 percent to the IMF and 22 percent to other multilaterals), with considerable debt service obligations falling due in 2003–04. To alleviate the cash flow pressures, the authorities launched a voluntary sovereign debt exchange in April-May 2003 that was successful in lengthening maturities and reducing gross financing requirements over the 2003–07 period. Public debt, however, remained fairly high as the nominal principal reduction involved was very small (1 percent of the exchanged bonds).

## II. Overview of Developments, 2005–06[4]

### A. Discussions on the 2005–08 Program

4. **Program discussions took place against a promising economic environment**. Several factors augured well for Uruguay's economic prospects.

- The 2002–05 program was successful in helping Uruguay to overcome the financial crisis and bring about a measure of stability. By late 2004, when discussions on a successor arrangement started, the economic and financial situation had noticeably improved and the outlook was favorable. Considerable fiscal consolidation had been achieved, and a competitive exchange rate supported the recovery. The external position had strengthened, and international reserves stood at US$2.5 billion, compared to US$0.8 billion in 2002.

- Sound policies and good economic performance had helped improve sectoral balance sheets. The banking system was smaller and more liquid than before the crisis, and banks were returning to profitability. The fiscal adjustment together with high growth and peso appreciation helped put public debt firmly on a downward path.

- The global macroeconomic environment was favorable, characterized by rising growth rates, contained inflation, and low global interest rates, and the region enjoyed a strong upswing, supported by booming commodity prices. Demand for emerging market assets was strong, and gross bond issuance by these countries reached a record high in 2004.

5. **Risks and challenges, however, remained, exposing Uruguay to sudden shifts in market confidence**. The banking system was highly dollarized (dollar deposits accounted for about 90 percent of total deposits, the bulk of which was in sight deposits), and banks faced difficulties in developing their lending activities.[5] The external financing needs were still very large (averaging 12 percent of GDP a year in 2005–08) and Uruguay's capacity to tap international markets in substantial amounts was not secured. Moderate shocks threatened the sustainability of public finances and public confidence in banks, not least because of the constraints on the central bank's ability to act as a lender of last resort.[6]

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[4] Developments and policies under the 2002–05 SBA have been covered in detail by the Ex Post Assessment considered by the Board in March 2005. See *Uruguay—Ex Post Assessment of Longer-Term Engagement*, Country Report No. 05/202.

[5] Bank credit to the private sector was just 24 percent of GDP in 2004, half its pre-crisis level, and most of it was in dollars.

[6] Central bank reserves covered just 28 percent of short-term debt and foreign currency deposits.

6. **The new government was ready to support further reforms**. For the first time in Uruguay's history, a moderate left wing coalition came to power in March 2005, ending the dominance of the two traditional political parties (the Colorado and Nacional parties). The initial political uncertainty surrounding the direction of policies was gradually dispelled as the new government emphasized sound macroeconomic management, including many important structural measures that had stalled in the past. This provided an upside potential to advance reforms, in view of the government's majority in both chambers of Congress and the broader political support that key areas of the government's agenda enjoyed. The challenge remained to ensure the continuous support of the various forces within the coalition for this more center-oriented policies.

7. **Aligned interests by the authorities and the Fund facilitated program discussions**.

- The new authorities viewed continued Fund support critical to signal policy continuity to markets and reduce risks of a financing shortfall.

- The Fund had an important stake in Uruguay as it had invested considerable resources under the previous SBA. External viability was not assured without a successor Fund-supported program, and moderate shocks threatened debt sustainability, including Uruguay's capacity to repay the Fund.

- Frequent contacts by staff and management with the incoming authorities were essential in forging a common strategy. Meetings in late 2004 and early 2005, including a workshop held in Montevideo in January 2005, were key to building trust between the two sides, and forming an ambitious program that the Fund could support.

8. **Against this background, in June 2005 the Fund approved the authorities' request for a three-year SBA with access of SDR 766 million (250 percent of quota)**. The program focused on five key areas:

➢ A disciplined fiscal stance to reduce sharply public debt, supported by measures to ensure the durability of public finances while making room for a temporary social emergency program;

➢ Strengthening the conduct of monetary policy, including enhancing central bank independence, to maintain low inflation and dedollarize the economy;

➢ Institutional reforms to address financial system weaknesses and ensure the resumption of sound credit flows by strengthening the supervisory framework, improving the bank resolution framework, establishing a deposit insurance scheme, and continuing the restructuring of state banks;

- Creating a favorable environment for private investment and growth, necessary for improving social conditions; and

- Providing sufficient access to Fund resources to minimize risks of financing shortfalls which, combined with sound macro policies, was expected to enhance market access and facilitate Uruguay's lasting exit from Fund financial support.

## B. Macroeconomic Achievements and Remaining Challenges

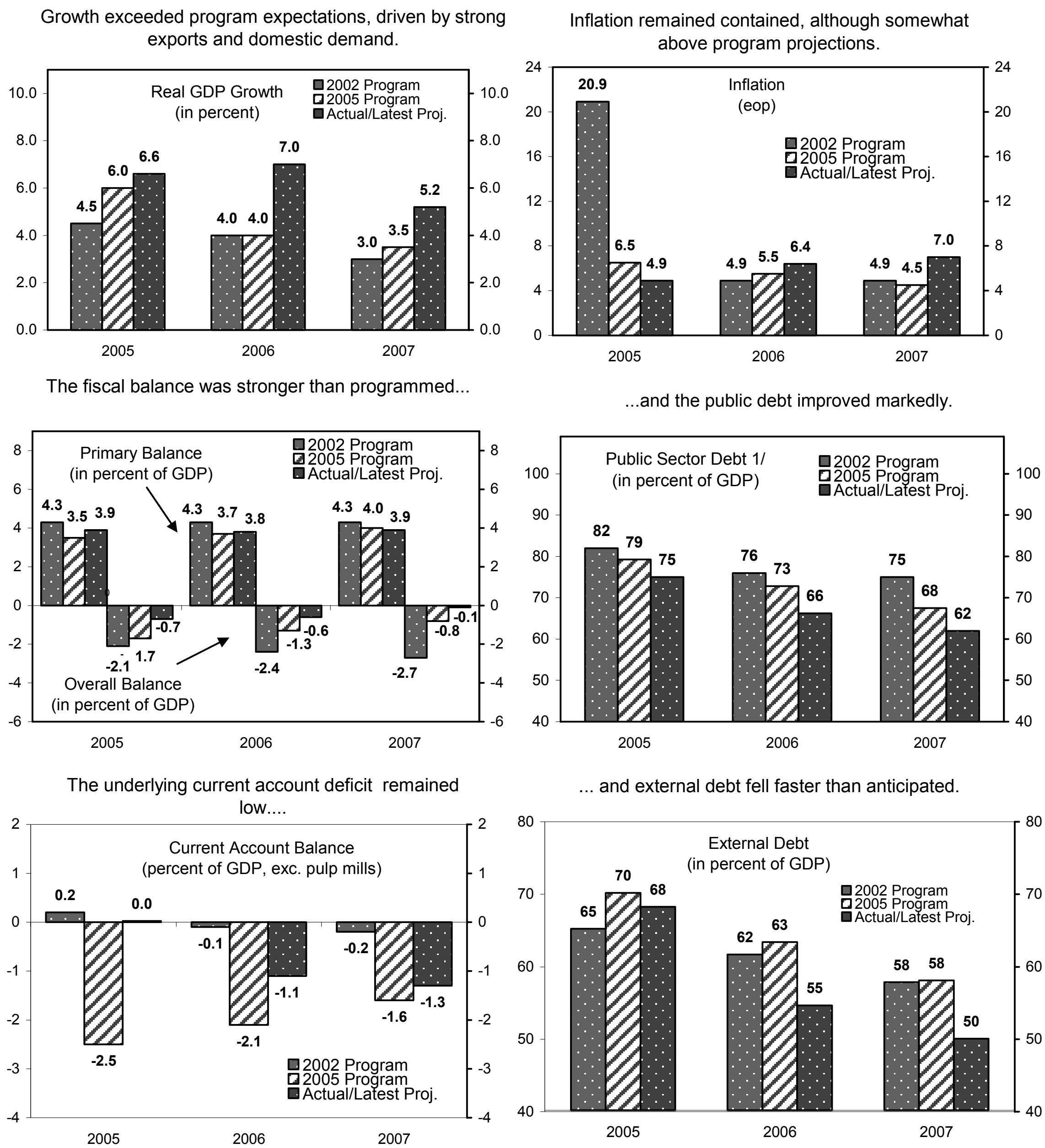
9. **Most macroeconomic targets under the program were comfortably met (Figure 1)**. The recovery that started in 2003–04 continued in 2005 and 2006, with growth rates much stronger than expected by either the Fund or market analysts.[7] Large capital inflows, dominated by FDI and portfolio investment, facilitated the build up of the central bank's reserves, which, at end–2006, were well above the level envisaged for the end of the arrangement, despite the advance repayment of all obligations to the Fund. Inflation remained contained, at the upper end of the authorities' 4½–6½ percent range, although capital inflows and rising demand challenged the conduct of monetary policy in 2006. Fiscal overperformance led to a faster-than-projected decline in public debt ratio, which also benefited from strong GDP growth and peso appreciation. With rapidly increasing incomes and drop in unemployment to just over 10 percent, social conditions improved and poverty declined to 25 percent.

10. **Overall, Uruguay's recovery shares broad similarities with the experience of other post-capital account crisis countries (Figure 2)**. With the caveat that direct cross country comparisons are difficult in view of diverse country circumstances and external conditions, Uruguay's growth performance is in line with the experience of other countries that witnessed V-shaped recoveries after sharp output losses. The real exchange rate has recovered gradually from the crisis. Inflation was quickly brought down to single digits, and large fiscal consolidation led to a quick reduction of public debt, which still remains high relative to other countries.

11. **Domestic demand was the main driver of growth, particularly in 2006**. The pace of the recovery was largely unforeseen, reflecting, inter alia, improving incomes and the return of consumer and business confidence. Net exports detracted from growth in 2006,

[7] Market projections (consensus forecasts) were somewhat more pessimistic than the Fund's regarding the pace of economic activity in 2005 (5.4 percent compared to 6.0 percent under the program) and in line with the Fund's for 2006 (4.1 percent compared to 4.0 percent under the program). Actual GDP growth reached 6.6 percent and 7.0 percent in 2005 and 2006, respectively.

Figure 1. Program Performance

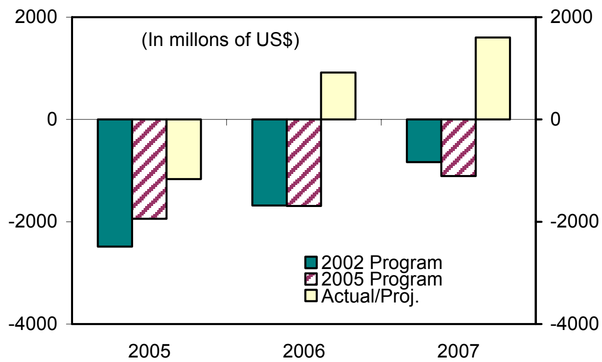



Sources: Central Bank of Uruguay, Ministry of Finance; and Fund staff estimates and projections.

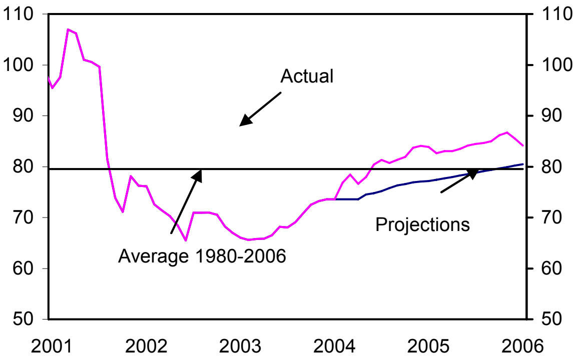
1/ Revised consistent with the definition in Uruguay-Staff Report for the 2007 Article IV Consultation. See also Public Information Notice (PIN) No. 07/111.

Figure 1 (continued). Program Performance

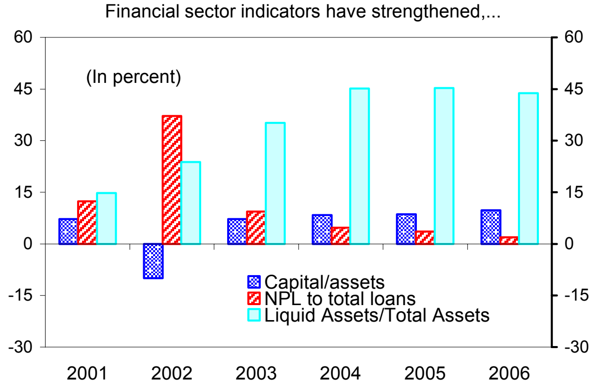
Strong capital inflows led to significant NIR accumulation...



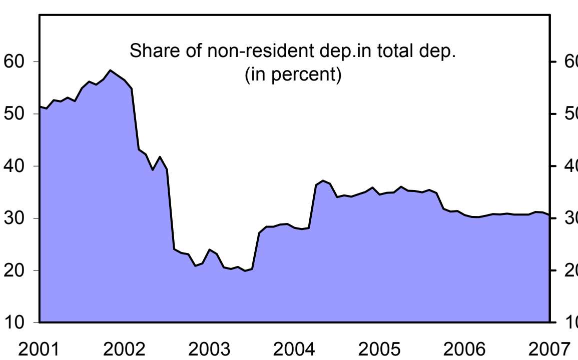

...,and the real peso-dollar rate appreciated somewhat faster than expected.




Financial sector indicators have strengthened,...

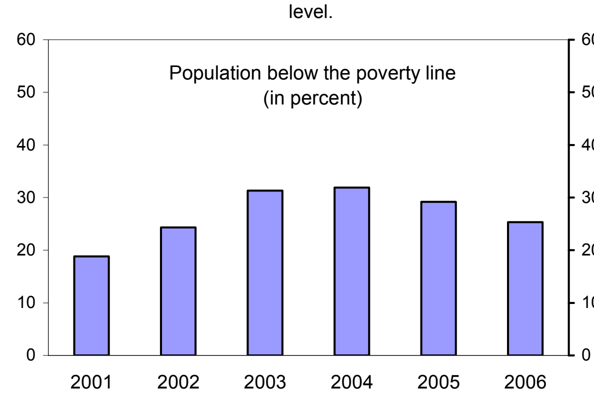



...and non-resident deposits have declined.



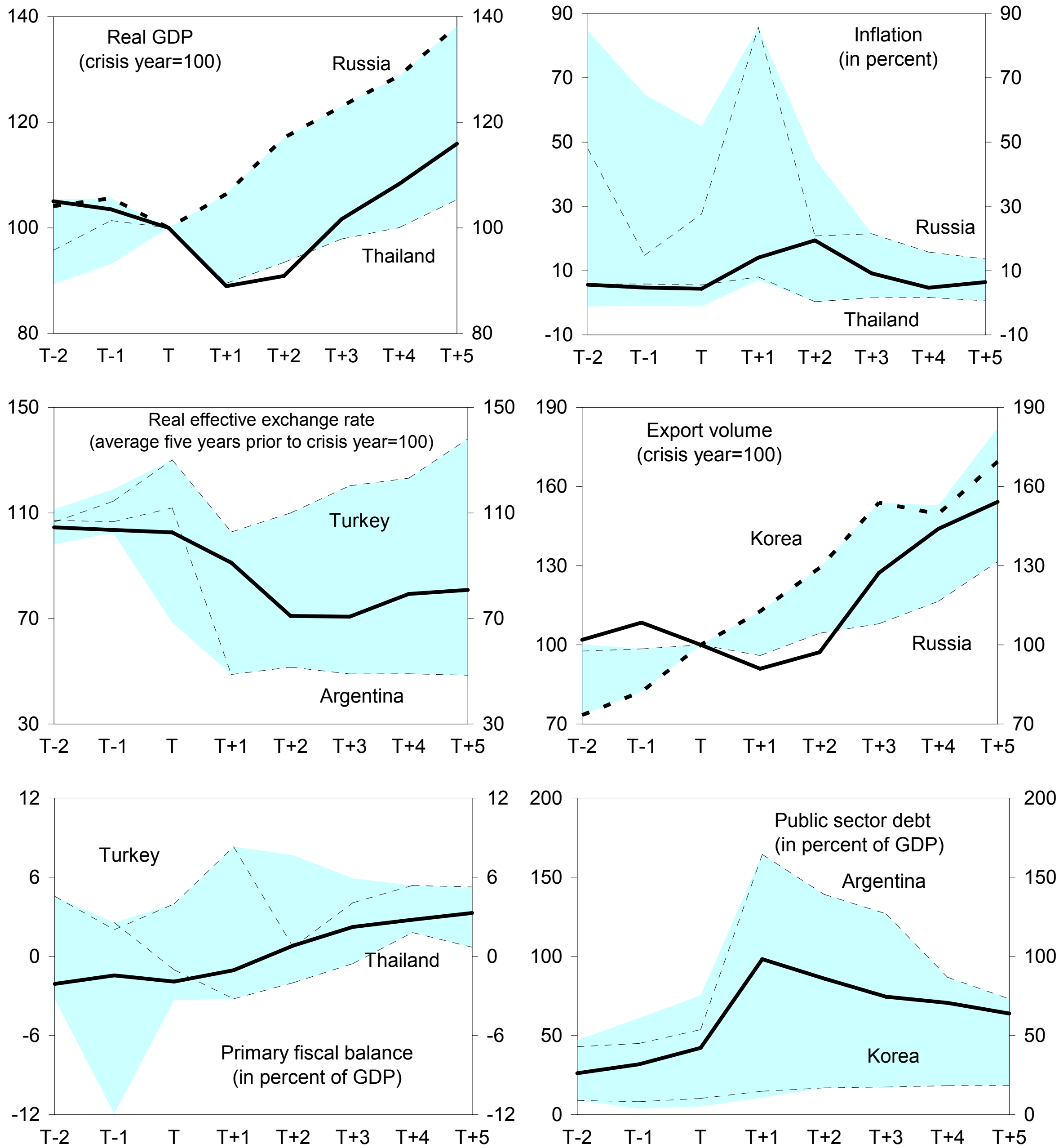

Unemployment has fallen to historical lows,...


...and poverty rates are returning back to pre-crisis level.




Source:Central Bank of Uruguay; Statistics Office; and Fund staff estimates.

Figure 2. Cross-Country Comparison of Selected Indicators 1/




1/ The solid line is for Uruguay, and band represents the minimum and maximum values during the year for Argentina (2001), Brazil (1999), Korea (1997), Russia (1998), Thailand (1997), and Turkey (2000).
Sources: WEO database, and IMF staff estimates.

mainly due to the large FDI financed imports for the pulp mills projects. Private investment increased, although still remains low, at 14 percent of GDP. Going forward, expanding productive capacity and exports will be important to sustain the growth momentum as domestic consumption returns to its trend levels.

Contributions to GDP growth

| | 2005 | | 2006 | |
|---|---|---|---|---|
| | Prg | Act | Prg | Act |
| Real GDP growth | 6.0 | 6.6 | 4.0 | 7.0 |
| Contributions to growth (percent) | | | | |
| Consumption | 5.7 | 2.5 | 2.1 | 7.4 |
| Investment | 8.0 | 1.7 | 2.3 | 3.5 |
| Net exports | -0.9 | 2.4 | -0.6 | -3.9 |

Source: Country Report No. 05/235 and staff estimates.

12. **The economy's capacity to weather external shocks has improved considerably, but risks remain (Figure 3)**. The elimination of all vulnerabilities was not expected—nor would it have been possible during the timeframe of this arrangement. As envisaged, progress was made across a range of fronts.

- Financial soundness indicators showed considerable improvement, including a stronger and more liquid banking system, declining NPLs, and lower exposure to non-resident deposits. Banks, however, continue to be highly exposed to foreign currency risk, primarily because of balance sheet mismatches at the corporate sector.

- Dollarization, although lower than in 2004, is still widespread, increasing liquidity and solvency risks, and limiting the scope for an independent monetary policy.

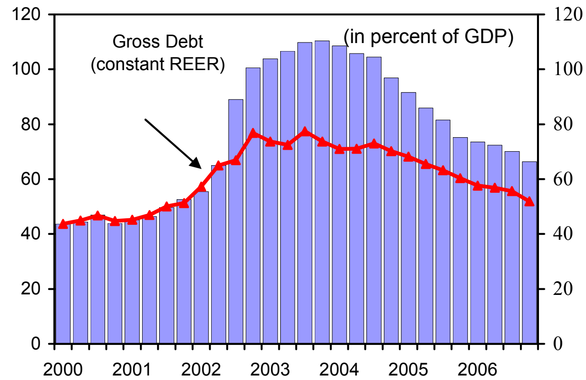
- Central bank reserves have increased considerably, but remain low for a highly dollarized economy.

- Public debt has declined sharply and the debt structure has improved, but debt still remains high and is primarily in foreign currency.

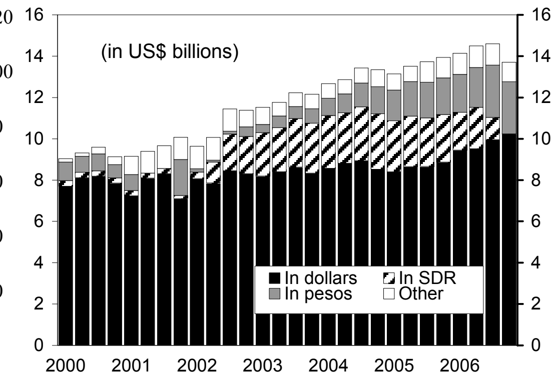
- Financial intermediation is weaker than expected, as banks have been cautious in extending credit to the private sector and borrowers have been careful in seeking credit.

Figure 3. Remaining Challenges

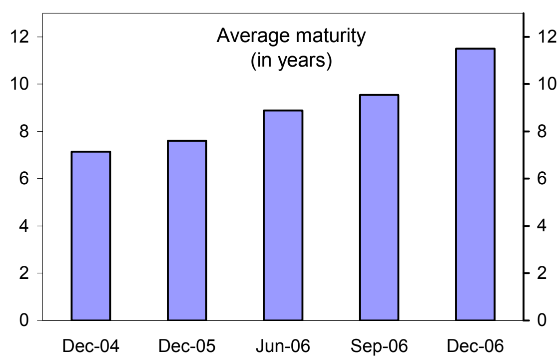
Public debt has declined markedly as the real exchange rate has been recovering, but remains above pre-crisis level,....



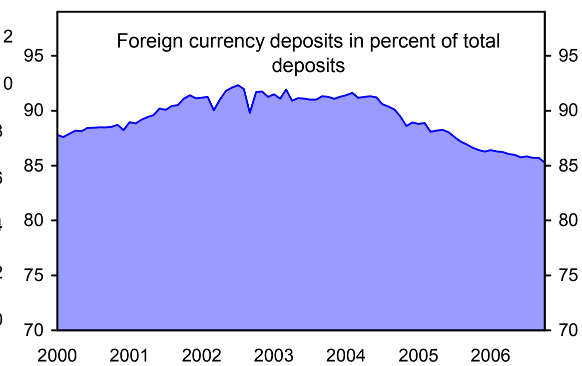

…and is mainly denominated in foreign currency,...



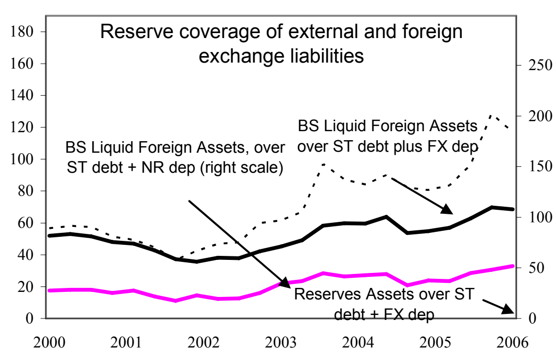

... but its maturity structure has strengthened significantly.



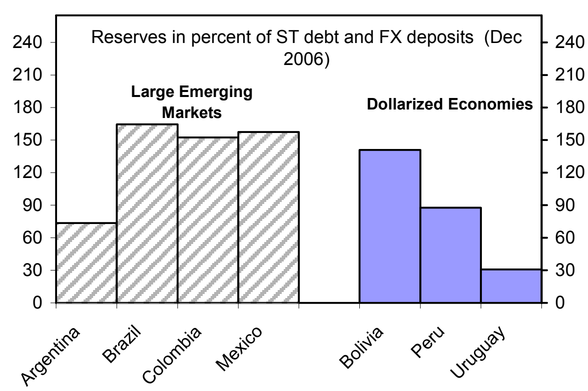

Financial dollarization has returned to pre-crisis level, but remains very high.




Even though the reserve coverage has strengthened,...

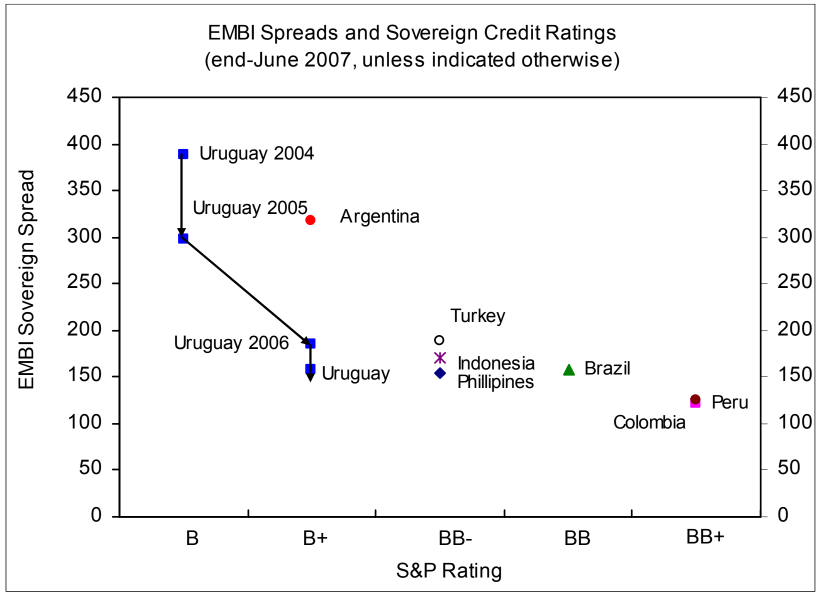



...it still compares low to other dollarized economies.




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

13. **Market confidence rose steadily; however, vulnerabilities weigh on Uruguay's credit rating**. Continued target overperformance and improved balance sheets helped to further strengthen market confidence. Spreads have declined significantly and Uruguay has been able to issue sizeable amounts of bonds in international capital markets, at long maturities.[8] Credit agencies have upgraded Uruguay's ratings, although they are still below its pre-crisis investment grade, as Uruguay's vulnerabilities from large external financing needs and dollarization, and its dependence on regional developments are now weighted more heavily than before.




## III. Program Design and Policy Implementation

14. **In light of the program's objectives, this section seeks to address the following four questions**: (i) were public finances consolidated effectively? (ii) was a credible monetary framework put in place? (iii) has progress been made to address financial system weaknesses as envisaged? and (iv) was the Fund's financing strategy right?

### A. Strengthening Public Finances

15. **Uruguay's debt level required large primary surpluses to put public debt firmly on a declining path, anchor market expectations, and ensure access to market financing**. With the debt burden exceeding 90 percent of GDP at end–2004 and high rollover risks, Uruguay was bound to stay vulnerable for an extended period. While there is no definite threshold for debt sustainability, emerging market experience over the past 30 years indicates that debt-to-GDP ratios in excess of 50 percent of GDP are associated with higher incidence of crisis.[9] [10] Uruguay needed a policy framework to deliver a large debt reduction.

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[8] Uruguay placed US$1.1 billion and US$2.6 billion in international capital markets in 2005 and 2006, respectively, well above the US$500-600 million projected under the program.

[9] *Public Debt in Emerging Markets: Is it Too High*? Chapter III, WEO, September 2003. See also, *Sustainability Assessments—Review of Application and Methodological Refinements*, available at http://www.imf.org/external/np/pdr/sustain/2003/061003.htm.

A clear lesson from past episodes of large fiscal consolidation was that budgetary surpluses needed to be pursued in a sustainable manner, consistent with the growth objectives.[11]

16. **Against this, the design of the fiscal program prompts two questions**. Was the fiscal effort sufficiently ambitious to secure debt sustainability, and was it of sufficient quality and, therefore, likely to be sustainable?

17. **The medium-term target of 4 percent of GDP balanced the need for effective debt reduction against an effort that the authorities could realistically deliver**. Within the required strong fiscal-cum-growth framework, the program envisaged feasible, although historically unprecedented primary surpluses to be sustained over the medium term.[12] The targets exceeded the surplus required to stabilize the debt-to-GDP ratio providing reasonable comfort that the debt ratio would decline steadily, even under moderate deviations from the baseline macro assumptions**.** This was of first order importance, as the debt dynamics were highly sensitive to the underlying macro environment, particularly to growth and exchange rate shocks. Finally, financing needs were expected to be met with moderate market borrowing ($500–600 million a year), reducing rollover risks.[13]

Robustness to Shocks (in percent of GDP)

| | Primary surplus |
|---|---|
| Program | 4.0 |
| Debt stabilizing primary surplus under: | |
| Baseline assumptions | 1.1 |
| Interest rate shock | 1.5 |
| Growth shock | 2.6 |
| Combined shock | 1.7 |
| Real depreciation shock | 2.0 |

Source: Country Report No. 05/235

18. **A calculated risk was taken by accepting lower primary targets in 2005 and 2006 (3.5 percent and 3.7 percent of GDP, respectively)**. The program made room for the Social Emergency Plan (SEP), a two year pro-poor program designed to alleviate the social impact of the 2002 crisis. There were strong arguments for surpluses of 4 percent of GDP in 2005 and 2006: (i) these levels were required for debt sustainability and were feasible given performance in 2004; (ii) lower targets when growth was above trend, weakened the credibility of the authorities' commitment to tighten the fiscal stance when growth returned

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[10] Reinhart, Rogoff, and Savastano estimate that safe debt levels for a typical emerging market may only be levels under 30–35 percent of GDP. See, *Debt Intolerance*, NBER working paper No 9908 (2003).

[11] See, *Experience With Large Fiscal Adjustment*, Ocassional Paper 246.

[12] Much of the fiscal adjustment had taken place in 2003–04; nonetheless, the primary targets implied an adjustment of over 5 percent of GDP relative to the 1999–2002 period, and 3 percent of GDP relative to the 1990–98 years.

[13] The fiscal targets were consistent with the EPA that suggested primary surpluses in the order of 4 percent over the medium term.

to trend; and (iii) with social challenges expected to last for a number of years, it was far from certain that the SEP would be phased out as planned and not become a permanent transfer scheme. In hindsight, accommodating the lower targets was justified. It gave the new government a strong sense of ownership of the program, as the SEP was a key promise during the election campaign, without jeopardizing market confidence. In fact, markets reacted positively to the announcement of the overall fiscal effort. At the end, with buoyant tax revenue, the fiscal targets were exceeded both in 2005 and 2006, and the fiscal outturns (3.9 percent of GDP in 2005 and 3.8 percent in 2006) were close to the medium-term target. Regarding the SEP, spending advanced gradually, owing to initial delays in implementing the program, and was executed in line with expectations in 2006 (Table 1). The strong recovery and improvements in social conditions support the elimination of the SEP as originally envisaged.[14]

19. **Strong macro and fiscal performance led to a sharp decline in debt ratios, while skillful liability management improved its structure**. The debt-to-GDP ratio fell to 66 percent at end–2006, a level that was expected to be reached in 2008. Although the strong fiscal stance contributed to falling debt, three-fourths of the debt overperformance was due to better-than-projected growth and a more appreciated exchange rate. In addition to reducing the debt burden, the authorities took advantage of the favorable financial market conditions and through successive liability management operations extended maturities, increased the shares of long-term and fixed-interest rate debt, and began to issue inflation-indexed, local currency bonds in international markets. While the effort toward debt sustainability needs to continue to make the economy less vulnerable to market volatility, the results are no small feat in view of the initial conditions and the substantial concerns about debt sustainability only a few years ago.

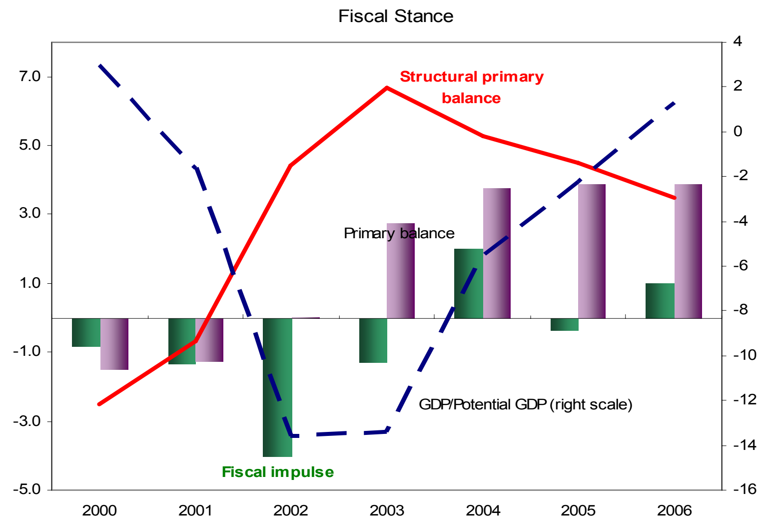
Uruguay: Decomposition of Debt Overperformance 1/
(in percent of GDP)

| | 2004 | 2006 |
|---|---|---|
| Public debt, actual | 96.9 | 66.4 |
| Original program projection 2/ | | 72.9 |
| Projection error | | -6.5 |
| Fiscal deficit | | -1.5 |
| Primary deficit | | -0.8 |
| Interest spending | | -0.7 |
| Real exchange rate | | -2.3 |
| Real GDP growth | | -2.4 |
| Other, incl. asset changes | | -0.3 |

1/ The decomposition formula is explained in the *Design of IMF-Supported Programs* OP 241.
2/ Revised consistent with the definition of public debt in Uruguay--Staff Report for the 2007 Article IV Consultation; see also PIN No 07/111.

[14] The SEP is expected to be discontinued in September 2007. Although there is not enough information at this stage, parts of it are expected to be carried out by the *Plan de Equidad* (Equity Plan).

20. **However, on a cyclically adjusted basis, the fiscal effort was less demanding than targeted**. While the program envisaged a small stimulus in 2005 and a relative tightening in 2006–07, standard statistical analysis suggests that the strong economic momentum turned the fiscal stance procyclical in 2006.[15] In retrospect, a stronger fiscal performance in 2006 would have been in order, in view of the overall macro stance and the need to contain emerging inflationary pressures (see section IIIB).




21. **Fiscal policy could have given more priority to saving revenue overperformance and emphasizing investment over current spending**. Expenditure consolidation appears to offer the best likelihood of success in terms of durability of adjustment and favorable macroeconomic impact.[16] In view of this and the need to reduce debt faster if possible, the authorities had committed to tight expenditure policies and saving any revenue overperformance. At the end, only part of the revenue overperformance was saved, as the original spending program targets proved unduly tight, particularly in 2006 where they envisaged zero growth in real terms (Table 1). Containing current spending growth and addressing rigidities remains important to support the medium-term primary targets and create fiscal space, particularly for capital investment which remain low, at about 2½ percent of GDP.[17]

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[15] The analysis is sensitive to the accuracy of potential output estimates.

[16] A staff study of 300 episodes of consolidation in excess of 5 percent over the past 30 years indicates that durable adjustments relied primarily on expenditure reduction. There were also cases of durable adjustment based on revenue enhancement, but mostly in countries with low revenue to GDP ratios. See, *Experience With Large Fiscal Adjustment*, Ocassional Paper 246.

[17] The program included adjustors for specific investment projects. While, this enhanced the authorities ownership of the program and at the same time retained the headline primary targets, it reduced transparency.

Table 1. Summary Fiscal Indicators

| | 2004 | 2005 | | 2006 | |
|---|---|---|---|---|---|
| | | Prog 1/ | Act. | Prog 1/ | Act. |
| | | (in billions of pesos) | | | |
| Revenues | 117 | 130 | 131 | 138 | 148 |
| Expenditure | 126 | 137 | 134 | 144 | 151 |
| Primary expenditure | 103 | 115 | 115 | 121 | 130 |
| Current | 71 | 105 | 105 | 110 | 118 |
| *Of which: wages and pensions* | 71 | 78 | 79 | 82 | 88 |
| *Of which: SEP* | 0 | 2 | 1 | 3 | 3 |
| Capital | 32 | 11 | 10 | 11 | 12 |
| Interest | 23 | 22 | 19 | 23 | 21 |
| Overall balance | -8 | -7 | -3 | -6 | -3 |
| Primary balance | 14 | 15 | 16 | 17 | 18 |
| | | (in percent of GDP) | | | |
| Revenue | 30.9 | 31.0 | 31.8 | 30.2 | 31.8 |
| Expenditure | 33.2 | 32.7 | 32.5 | 31.4 | 32.5 |
| Primary expenditure | 27.2 | 27.5 | 27.9 | 26.4 | 28.0 |
| Current | 24.7 | 25.0 | 25.6 | 24.1 | 25.4 |
| *Of which: wages and pensions* | 18.7 | 18.5 | 19.1 | 17.9 | 18.8 |
| *Of which: SEP* | 0.0 | 0.4 | 0.2 | 0.6 | 0.5 |
| Capital | 2.5 | 2.5 | 2.3 | 2.4 | 2.6 |
| Interest | 6.0 | 5.2 | 4.6 | 5.0 | 4.4 |
| Overall balance | -2.2 | -1.7 | -0.7 | -1.3 | -0.6 |
| Primary balance, cash basis | 3.8 | 3.5 | 3.9 | 3.7 | 3.8 |

Sources: Ministry of Finance; and Fund staff estimates
1/ Program figures, including the revision made during the 2nd review.

22. **Structural reforms placed emphasis on improving the efficiency and effectiveness of the tax system and controlling expenditure**. On the revenue side, Uruguay had a complex tax system and the tax burden was unevenly distributed across the economy. On the spending side, wages and social security transfers absorbed 75 percent of primary spending, leaving little room for other spending. Against this, the program's structural conditionality rightly focused on measures to strengthen the tax system and administration, enhancing the budget process, and reform the specialized pension funds.[18]

[18] Measures under the program included (i) the introduction of PIT, rationalization of CIT, streamlining of exemptions to broaden tax base and enhance revenue; (ii) modernizing domestic revenue service and establishing a LTU to improve tax administration; (iii) advancing the budget process; and (iv) reform of specialized pension funds.

23. **The implementation of structural measures was satisfactory in most areas**.

- The approval of the tax reform law is one of the key achievements of this program.[19] While this was expected by June 2006, building support for this reform was more challenging than expected. In view of its importance, this measure was rightly elevated to a prior action for the completion of the fifth and sixth reviews. The reform was passed in December 2006, becoming effective in July 2007.

- Considerable progress was made with improving revenue administration and strengthening the operations, collection, and enforcement capacity of the collection agencies. However, the ambitious fiscal targets over the medium-term require continued efforts to help further prepare for the administration of the reformed tax system.

- Actions to improve public financial management were largely observed, although the reform fell short of recommendations. However, the authorities were not convinced of the need to introduce some key reforms recommended by staff, such as moving to annual budgets and introducing an organic budget law, viewing the existing system of 5-year budgets with annual amendments as serving them well.

24. **Little progress, however, was made towards improving the weak financial position of the specialized pension funds**. The program focused on the long overdue reforms of the specialized funds, which remained incomplete under previous arrangements. Notwithstanding the importance of moving ahead with these reforms, progress was disappointing as they proved politically difficult. The reform of the banking employees' fund, which is most urgent, has stalled due to strong opposition from stakeholders.[20] The police fund reform has yet to be discussed, one year after the draft law was submitted to Congress. And the reform of the military pension was postponed to 2007. Conditionality for these measures was repeatedly reset, and the reforms remain to be implemented.

## B. Restoring Confidence in the Peso and the Banking System

### Monetary and exchange rate policies

25. **The monetary policy framework aimed at a steady lowering of inflation in the context of a flexible exchange rate regime, consolidating gains achieved under the previous program**. Monetary targets provided a nominal anchor, and one-year ahead

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[19] The tax bill introduces a personal income tax, reduces the corporate income tax rate from 30 to 25 percent, and broadens the VAT tax base, while reducing the current VAT rates from 23 to 22 percent and from 14 to 10 percent. It allows for further reduction of tax rates conditional on revenue objectives being achieved.

[20] The banking employees fund had a deficit of ½ percent of GDP in 2006. If reforms are not adopted its reserves are projected to expire in 2008.

inflation objectives were announced to help guide public expectations. The monetary framework was perhaps the only realistic option available to the monetary authorities at the time, in light of incomplete understanding of the transmission mechanism, the shallow peso money market, and underdeveloped policy instruments. The objective to bring inflation close to “industrial country levels” (2½–4½ percent by 2008) was ambitious, given expected pressures from wages (recovering from the compressed levels of recent years) and the recovery in non-traded goods prices as the output gap closed.

26. **Stronger-than-expected remonetization and capital inflows challenged the conduct of monetary policy**.

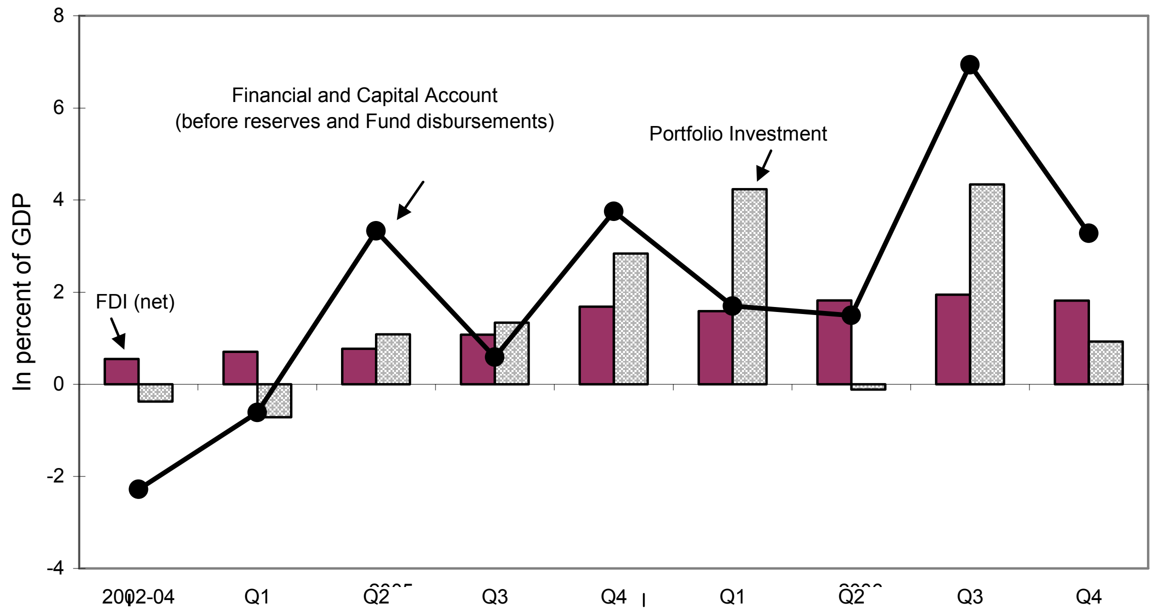
- In the second half of 2005, inflation declined quickly, reflecting stronger–than-projected money demand and peso appreciation, ending the year at 4.9 percent, below the authorities’ target range of 5½–7½ percent. Although the inflation deceleration was welcome from a macro standpoint, the central bank was criticized in Uruguay for monetary overtightening. However, predicting the pace of remonetization in the aftermath of a crisis is inherently difficult, and international experience is ambiguous regarding the behavior of money demand in disinflation periods.[21]

- In 2006, an opportunity was missed to consolidate the better-than-programmed inflation outcome and the monetary stance turned accommodative against a closing output gap. Confronted with strong capital inflows and pressures from the export sector against a stronger peso, the central bank resorted to heavy and partially unsterilized foreign exchange intervention to keep the exchange rate broadly stable (Figure 4). Core inflation (excluding energy and food) jumped to 6–6½ percent in summer 2006, forcing a reversal of the earlier easing.

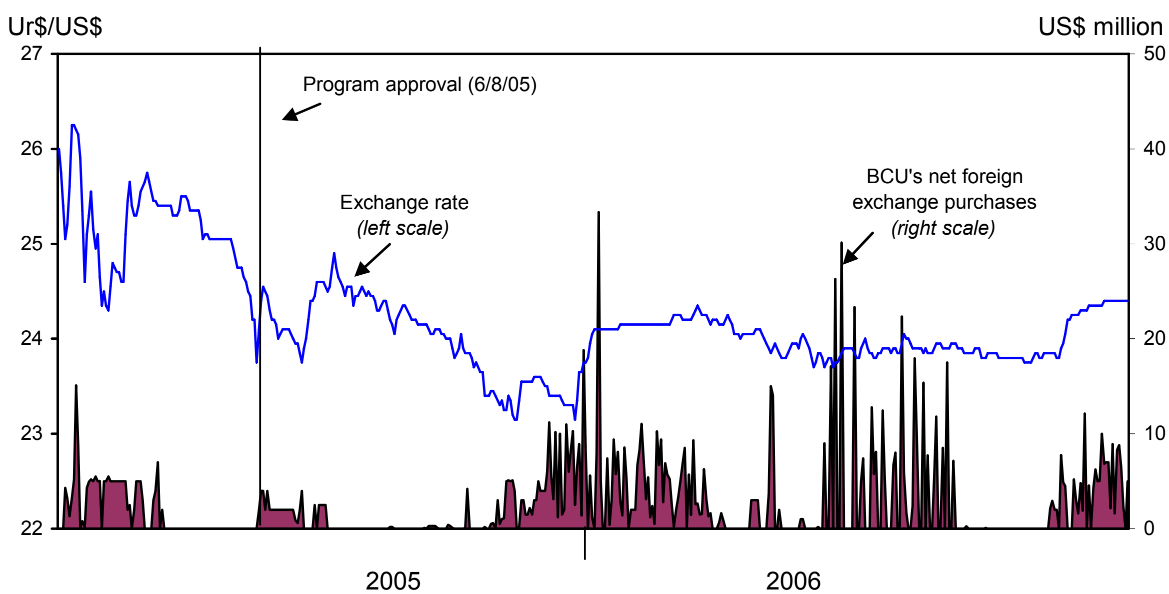
[21] Empirical evidence on the relationship between remonetization and inflation suggests a ratchet effect on money demand, namely higher inflation increases velocity, but a decrease in inflation does not lead to corresponding decrease in velocity; see *The Design of IMF Programs*, Ocassional Paper 241.

Figure 4. Capital Flows and Foreign Exchange Intervention

A. Capital flows




B. Foreign exchange intervention and nominal exchange rate



27. **While inflation remained relatively well contained, there were some ambiguities in the monetary policy framework**. In late 2006, inflation stabilized near the top of the authorities' announced range, international reserves were much higher than programmed, and external competitiveness remained broadly appropriate.[22] These achievements are commendable. However, the transparency of the monetary framework was weakened by insufficient clarity about the objectives of monetary policy. Large, persistent, and one-sided central bank foreign exchange intervention and the resulting exchange rate stickiness gave rise to perceptions that policies were geared toward resisting a nominal appreciation. These continued even when inflation expectations moved to the top end of the target range in 2006 or outside the target range in early-mid 2007.[23] In retrospect:

- The commitment to low inflation should have been strengthened, including through enhancing the central bank's operational autonomy and accountability early on in the program.
- While a stronger reserves position was a high priority, a transparent communication of how the interventions were linked to the inflation objective would have helped establish a clearer policy framework.[24]

**Banking strategy**

28. **Strengthening the banking system was essential to reduce risks and restore sound credit flows**. Reforms were already in train under the previous SBA: insolvent banks were closed and put under liquidation, risk management and internal control systems were strengthened across financial institutions, and the BROU's restructuring was under way. However, additional reforms were needed. The existing legal framework hindered the effective supervision of state banks. A new clear and transparent banking resolution framework was needed—as underscored by the difficulties experienced in the suspension of COFAC—including a well designed deposit insurance scheme.[25] The reforms of the state banks needed to be carried forward to strengthen their governance and performance. Finally,

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[22] Staff's analysis suggested that the real effective exchange rate was broadly aligned with fundamentals; see, *Assessing Competitiveness in Uruguay*, Country Report No. 06/427.

[23] The rekindling of inflationary pressures in early 2007 cast doubt about the feasibility of the original inflation objectives for end–2008. Recognizing this, the authorities extended their inflation target range of 4½–6½ percent through mid–2008.

[24] Transparency in intervention objectives can enhance the credibility of the central bank by holding it accountable for its record of policy implementation. See Ishii et al, *Official Foreign Exchange Intervention*, Occasional Paper 249.

[25] In 2005, in response to COFAC's insolvency, the government introduced by decree a limited deposit insurance scheme.

as discussed above, strengthening the central bank's legal and operational autonomy was important for the credibility of its commitment to price stability.

29. **The reform agenda rightly aimed at overhauling the institutional framework of the financial system; however, it remained unfinished**. New legislation was envisaged to: (i) strengthen central bank legal independence and finances; (ii) upgrade the regulatory and supervisory framework; and (iii) improve the bank resolution framework and create an adequate deposit insurance scheme. While the authorities submitted the draft law to Congress in late 2005, it has yet to be approved. To some extent the law became hostage to the delay in passing the tax reforms for which the authorities placed higher priority, and without the necessary congressional support, the program's strategy in this area did not advance as planned.

30. **The banking strategy put less emphasis on conditionality for the reform of the two state banks**. Regarding BROU, maintaining the momentum on its restructuring was important, given its systemic nature as it accounted for about half of the banking system and deposits at BROU enjoyed an explicit government guarantee. However, BROU had made significant improvements in cleaning up its books, as well as in disclosure, risk management, and internal controls, and its profitability had considerably improved. Staff monitored BROU's developments closely, and the program carried forward the continuous performance criterion on the timely service of government guaranteed notes to BROU issued in the bank resolution process from the previous SBA. Additional conditionality was not necessary.

31. **Regarding the housing bank, BHU, measures were added at the time of program reviews to accelerate its restructuring.** The bank remained in a weak financial position—undercapitalized and not complying with prudential regulations, with large NPLs on its portfolio and high operating costs. Given its financial conditions, the BHU was prevented from taking deposits, thus containing the risks to the banking system. The bank constituted, however, a risk to the budget as its debt service was guaranteed by the government. By mid-2005, the restructuring of the BHU was off track and measures were added at the time of the first and third program reviews.[26] While progress was made towards moving the nonperforming loans out of the BHU, key steps to convert it to a mortgage company that operates on commercial terms, including the approval of a viable business plan within a strong regulatory framework, are still pending.

32. **Overall, measures to strengthen the banking system advanced, but important institutional reforms remain to be completed**. In addition to measures noted above, the NBC, which was formed with the good assets of the failed banks during the 2002 crisis, was privatized as planned, reducing the share of the state in the banking system. Also, outside the

[26] The formulation of an action plan to address the situation was set as a performance criterion for end–December 2005. The implementation of the plan to transform BHU to a viable, commercially run bank was added as a performance criterion for end–November 2006.

context of program conditionality, the authorities tightened prudential requirements to reduce risks from high dollarization and nonresident deposits. At end 2006, the banks were stronger and more liquid than in 2004, reducing short-term risks, and bank lending was starting to resume, albeit gradually. However, strengthening the institutional framework of the financial system and tightening prudential policies in line with the 2006 FSAP recommendations remain important to reduce Uruguay's vulnerability to macroeconomic risks.[27]

### C. Access Issues–Financing a Lasting Exit from Use of Fund Resources

33. **At the start of the program, Uruguay faced exceptional fiscal and balance of payments financing needs**. A hump in public debt service payments in 2006-07 arising from maturing debt issued after the 2002 financial crisis and repayments to multilateral institutions, including to the Fund, created large financing needs.[28] Debt service to the Fund alone accounted for about one third of total external debt service and over a quarter of public debt service.

34. **Access under the SBA (SDR 766 million, 250 percent of quota) reflected the need to ensure that the program was adequately financed, while Fund exposure declined to levels that facilitated Uruguay's lasting exit from Fund financing**. Fund financing was essentially a gap filler, after a reasonable level of reserves was established and other sources of financing were taken into consideration (Table 2).[29] Purchases were somewhat front-loaded in line with the pattern of the financing needs, temporarily increasing net exposure to the Fund during the first year of the arrangement (Figure 5).[30] Overall, access covered about 60 percent of the repurchases falling due during the program period, reducing Fund's exposure to 370 percent of quota at the end of the arrangement.

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[27] Several of the FSAP's recommendations were already part of the program's reform agenda and the remaining were expected to inform future conditionality. In the event, this did not occur as the arrangement was cancelled shortly after the completion of the FSAP.

[28] Fiscal and external gross financing needs averaged 12 percent and 14 percent of GDP per year, respectively.

[29] Public and private borrowing as well as FDI were projected to fill about two-thirds of the financing needs. The World Bank and IaDB covered almost fully amortizations due to them. The remainder, about a sixth of the gross financing needs, was financed by the Fund.

[30] About 75 percent of access to be disbursed in the first two years, and with the bulk of financing becoming available in 2006.

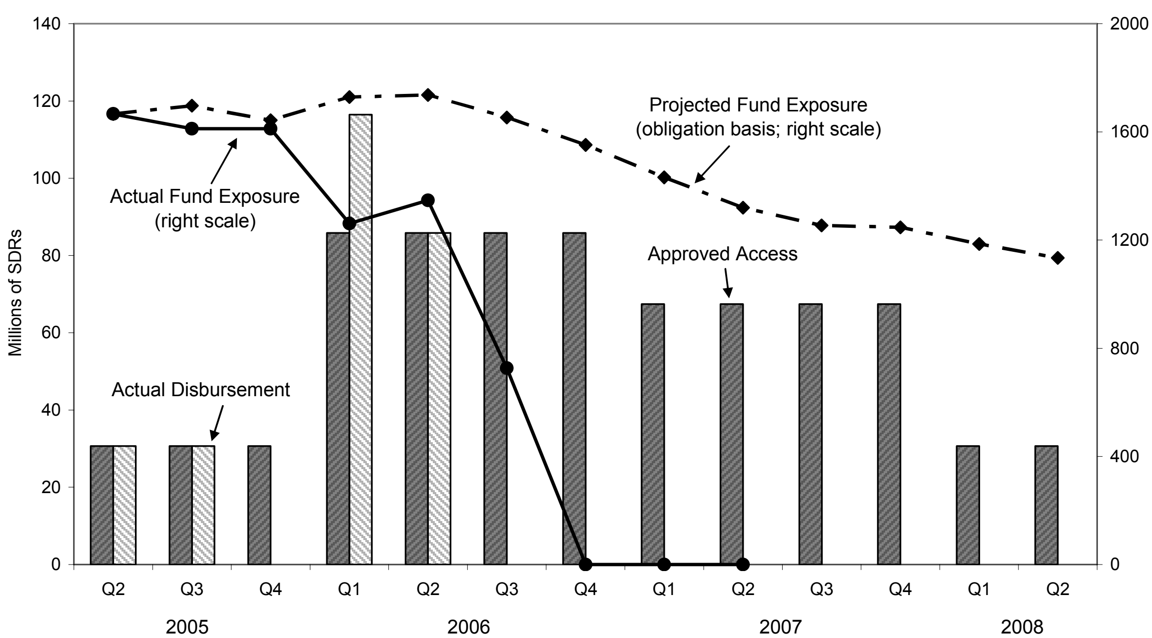
# Table 2. External Financing Requirements and Available Financing
(In billions of U.S. dollars)

| | 2005 | | 2006 | |
|---|---|---|---|---|
| | Projection 1/ | Actual | Projection 1/ | Actual |
| A. Gross Financing Requirements | 1.9 | 2.6 | 2.8 | 4.2 |
| External current account deficit | 0.5 | 0.0 | 1.0 | 0.5 |
| Public sector debt amortization | 1.3 | 1.6 | 1.6 | 4.1 |
| NFPS amortization | 1.3 | 1.1 | 1.6 | 1.4 |
| IMF repurchases | 0.5 | 0.5 | 0.7 | 2.7 |
| Gross international reserves (+: increase) | 0.1 | 1.0 | 0.2 | -0.3 |
| B. Gross Financing | 1.9 | 2.6 | 2.8 | 4.2 |
| Public sector | 1.2 | 2.1 | 1.5 | 3.1 |
| Official creditors (excludes IMF) | 0.3 | 0.4 | 0.5 | 0.1 |
| Private creditors | 0.6 | 1.4 | 0.5 | 2.7 |
| IMF disbursements | 0.4 | 0.3 | 0.5 | 0.3 |
| Private sector, net | 0.7 | 0.5 | 1.3 | 1.1 |
| *Memorandum items:* | | | | |
| Gross international reserves | 2.7 | 3.4 | 2.9 | 3.1 |
| Fund credit outstanding (SDR billion) | 1.6 | 1.6 | 1.6 | 0.0 |

Sources: IMF country documents and Fund staff estimates.

1/ Projections at the time of program approval.

Figure 5. Purchases Under the SBA and Fund Credit Outstanding



35. **The early exit from the Fund-supported program was largely unforeseen.** In fact, at the start of the program, the level and phasing of access raised concerns about Uruguay's capacity to repay the Fund without a successor arrangement. In hindsight, two questions arise: Was access under the arrangement too high and was adjustment greater than necessary?

36. **The financing assumptions were cautiously optimistic, balancing risks that the program would be underfinanced against an upside potential for market access**. Market access projections are very difficult in cases where there is a structural change.[31] The program assumed market access in line with Uruguay's access in the pre-crisis period (US$500–600 million a year). But the pre-crisis period provided limited guidance as Uruguay enjoyed an investment credit rating and its financing needs were much smaller. At the same time, a number of other factors argued for more optimistic market access assumptions. Emerging market sovereign borrowers enjoyed much-improved financing conditions in 2004, and spreads had narrowed across the board reaching near record lows in early 2005. The low interest rates in mature markets and the still favorable risk-adjusted returns in emerging markets attracted new investment inflows and a wider investor base to these countries. FDI had increased significantly, including to the region.

37. **Against this, the scale of Fund financing provided a degree of insurance against a less benign external environment, while program design tried to capture the upside potential**. One of the suggestions from the 2005 EPA was that the Fund should not be overly cautious in gauging Uruguay's market access in the medium term. While in hindsight staff may have erred on the side of caution, the upside potential was recognized and the program included a commitment to turn the SBA precautionary or to make repurchases on expectations basis if the external and market conditions turned out better than expected. Against improving financing conditions, the authorities combined purchases with early repayments, making opportunistic use of higher-than-expected capital inflows and financing.[32] While the authorities justified this on the basis that the financing outlook was unclear, this gave the impression that their operations vis-à-vis the Fund were driven by interest savings considerations. By mid–2006 (fourth program review), there was strong evidence that the program was overfinanced, and the SBA could have started to be treated as precautionary at that stage. In the event, by late 2006, Uruguay's market access and international reserves already exceeded the level programmed for the end of the arrangement, and the authorities canceled the arrangement with repayment of all outstanding obligations to the Fund.

[31] See, *Assessing the Determinants and Prospects for the Pace of Market Access by Countries Emerging from Crisis—Further Considerations*, available at http://www.imf.org/external/np/pp/eng/2005/030105a.htm.

[32] Uruguay made three early repayments between September 2005 and August 2006 amounting to SDR 1.14 billion.

38. **More available market financing, however, does not mean that the adjustment could have been less ambitious**. Uruguay's (approved) access to Fund resources was very high, indeed somewhat larger than in other post-crisis programs if measured relative to the programmed financing needs (Table 3). However, large access was not a substitute for, but rather it was a complement to, strong policies. Ambitious fiscal targets and reforms were necessary in light of Uruguay's vulnerabilities, which reinforced market confidence and resulted in higher private capital inflows.

Table 3. Access Indicators: Uruguay, Argentina, Brazil and Turkey

| | Uruguay | Argentina | Brazil 1/ | Turkey |
|---|---|---|---|---|
| | 2005-08 | 2003-06 | 2003-05 | 2005-08 |
| Access | | | | |
| In billions of SDRs | 0.8 | 9.0 | 4.6 | 6.7 |
| In billions of U.S. dollars | 1.2 | 12.5 | 6.7 | 9.1 |
| Total access in percent of: | | | | |
| Actual quota | 250 | 424 | 150 | 691 |
| Gross domestic product 2/ | 7.2 | 10.0 | 1.3 | 3.0 |
| Gross financing need 3/ | 14.3 | 11.6 | 13.4 | 3.1 |
| Gross international reserves 2/ | 44.7 | 91.6 | 14.0 | 22.9 |

Sources: IMF country documents and Fund staff estimates.

1/ Extension and augmentation of the 2002-03 SBA; treated as a separate program for comparison.

2/ Projection at the time of program approval for the year in which the program was approved.

3/ Projection at the time of program approval for cumulative total over the program period.

## Procedures

39. **Uruguay did not face a capital account crisis in early 2005, but in line with the procedures for exceptional access, the request was judged in light of the four criteria.**[33] Overall, the exceptional access criteria were adequately assessed in the note attached to the staff report:

- The paper recognized that the first criterion—exceptional balance of payments pressure in the capital account resulting in a need for Fund financing that cannot be met within normal limits—was not met. Uruguay was, nonetheless, facing substantial financing needs and had a need for Fund financing that could not be met within the normal limits (in addition to a preexisting high Fund exposure which at over 500 percent of quota in early 2005, exceeded the cumulative limit).

[33] Exceptional access was granted under the exceptional circumstances clause.

- The second criterion—rigorous and systematic analysis indicating that there is high probability that debt will remain sustainable—was adequately assessed in the report. The debt sustainability analysis was centered around the baseline scenario under which public debt was on a firmly downward path. Downside risks, however, were considerable. Although pointed out only in passing in the note evaluating the criteria, the report provided a candid assessment of the DSA's sensitivity to growth assumptions and to interest rate and exchange rate shocks.

- Regarding the third criterion—good prospects of regaining market access within the time that Fund resources would be outstanding—Uruguay had already regained such access. In fact, Uruguay returned to the capital markets in October 2003 for the first time since the 2002 crisis. Subsequently, it tapped international markets three times before the 2005 SBA (in February and September 2004 and in May 2005).

- The fourth criterion—policy program provides a reasonably strong prospect of success, including the institutional and political capacity to deliver the necessary adjustment—were based on program's reform agenda and the authorities' commitment to strong program implementation. The new government's capacity to implement the agreed measures, however, remained to be tested.

40. **As called for under the policy, there was early Board involvement in the period leading to the consideration of the request for the 2005 SBA and the Board was provided with the necessary information.** There were two Board meetings (January 31, 2005 and April 19, 2005) that discussed the need for an exceptional access program, and concise notes were circulated in advance of each meeting. The Board was provided with additional information, including a report assessing the financing risks to the Fund and the Fund's liquidity position. All documents and staff reports have been published.

## D. Scope and Focus of Structural Conditionality

41. **Structural reforms were a critical part of the program aiming to entrench macrostability and support a lasting exit from Fund financial support**. However, the implementation of the structural agenda was slower than expected (Table 4), and ten waivers were required to complete program reviews. Moreover, the authorities' decision to end the arrangement reflected, inter alia, their preference for a more flexible timetable of reforms.[34] This performance raises two questions: (i) was the scope and pacing of structural measures under the program appropriate; and (ii) was ownership of the reform agenda sufficiently strong?

[34] See, Uruguay—Fifth and Sixth Reviews Under the SBA, Country Report No. 07/146.

Table 4. Compliance with Structural Conditionality

| Area | Conditionality | Date | Status |
| --- | --- | --- | --- |
| | **A. Performance Criteria** | | |
| **Fiscal sector** | | | |
| A. Budget | | | |
| | 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. |
| | Have in place a five-year spending plan, complemented with revenue projections and deficit targets consistent with the program's fiscal targets. | February 28, 2006 | Observed. |
| B. Tax policy | | | |
| | Submit to congress a comprehensive tax reform. | Original: Dec. 31, 2005<br>Modified: Feb. 28, 2006 | Modified date not observed. Delayed and done as prior action for third review. |
| | Begin to implement the comprehensive tax reform. | Original: June 30, 2006<br>Modified: Oct. 31, 2006<br>Modified: Sept. 15, 2006 | Modified dates not observed. Delayed and done as prior action for 5th and 6th review. |
| C. Pensions | | | |
| | Begin to implement reform of the pension fund for the police. | Original: Nov. 30, 2005<br>Reset: May 31, 2006<br>Reset: Oct. 31, 2006 | Nov. date not observed. Waived and reset for May and Oct. 2006. New dates not observed, waived, to be implemented in 2007. |
| | Submit to congress reform of the pension fund for the military and bank employees. | November 30, 2006 | Not observed. Waived, to be implemented in 2007. |
| | Begin to implement the reform of the pension fund for the military and bank employees. | May 31, 2007 | |
| **Financial sector** | | | |
| D. Central bank | | | |
| | Submit simultaneously three laws to congress to: (i) give appropriate autonomy to the central bank; (ii) strengthen the regulation of the financial system ; and (iii) provide a suitable bank resolution framework. | December 31, 2005 | Mostly done. Waiver granted. |
| | Begin to implement these laws. | Original: June 30, 2006<br>Modified: Nov. 30, 2006 | Modified date not observed. Waived, to be implemented in 2007. |
| E. Bank restructuring | | | |
| | Government to ensure timely service of BHU note and BROU fiduciary notes to BROU in accordance with the current payment schedules. | Continuous | Observed. |
| | Adopt action plan to address the financial situation of BHU consistent with minimizing systemic risks and contingent fiscal costs. | December 31, 2005 | Observed. |
| | Move nonperforming loans into a fideicomiso and adequately capitalize BHU. | August 31, 2006 | Not observed. Remedial actions were taken. |
| | Transform BHU into an institution with a viable business plan and a strong regulatory framework. | November 30, 2006 | Not observed. Waived, to be implemented in 2007. |
| | **B. Benchmarks** | | |
| **Fiscal sector** | | | |
| A. Tax administration | | | |
| | Establish quarterly revenue collection targets (floors) at the social security bank (BPS). | June 30, 2005 | Observed. |
| | Sign a memorandum of understanding between the Ministry of Finance and the DGI agreeing on quantitative targets and indicators for 2006 on tax collections, audit coverage, tax services, and information systems. | December 31, 2005 | Observed. |
| | Formulate a plan to strengthen the auditing and enforced collection functions of the BPS. | June 30, 2006 | Not observed. Done with small delay. |
| | Finalize the design of a comprehensive reform plan for the customs agency (including establishing collection targets consistent with the program). | August 31, 2006 | Not observed. Largely done. |
| B. Debt management | | | |
| | Create a debt management unit at the Ministry of Finance. | December 31, 2005 | Observed. |
| C. Budget | | | |
| | Prepare recommendations, with a timetable, to improve legislation, coverage, classification, formulation, controls, and transparency of the budget process. | August 31, 2006 | Not observed. Done with small delay. |
| **Financial sector** | | | |
| D. Central bank | | | |
| | Adopt plan to strengthen the central bank finances (outright capitalization or interest payment on government paper). | Original: Sept. 30, 2006<br>Modified: Nov. 30, 2006 | Modified date not observed. To be implemented in 2007. |
| E. Bank restructuring | | | |
| | Adopt a detailed schedule for the implementation of the BHU action plan. | February 28, 2006 | Observed. |
| | Sell shares of NBC in amounts that yield managerial control to the private sector. | June 30, 2006 | Observed. |
| **Pro-growth reforms** | | | |
| | Publish agenda of growth-enhancing reforms (including timetable for implementation) prepared by the business environment commission. | March 31, 2006 | Not observed. Done with small delay. |
| | Submit to Congress bankruptcy law (to include Chapter-11 type corporate restructuring). | June 30, 2006 | Not observed. Done with small delay. |
| | Establish a private sector relations office at the MEF. | August 31, 2006 | Observed. |
| | Adoption of a detailed plan to strengthen government procurement procedures. | July 31, 2007 | |

Sources: IMF staff reports

42. **The use of conditions was in line with the general move towards streamlining conditionality**. Conditionality generally focused on macrocritical areas (in particular, the fiscal and financial sectors) and there is no evidence of misguided conditionality. Collaboration with other multilateral development banks was also very good, particularly in the area of growth-enhancing reforms (Box 2). The use of prior actions, structural performance criteria and benchmarks was in line with other exceptional access arrangements, although numerical comparisons should be interpreted with caution as they provide limited information about the relative importance of individual measures (Table 5). Overall, there is no evidence that the choice and scope of conditionality overburdened the authorities' administrative capacity.[35]

Table 5. Structural Conditionality

| GRA-supported Program | Number of Conditions 1/ | | | |
|---|---|---|---|---|
| | Total Measures | Prior Actions | Structural Benchmarks | Performance Criteria |
| Uruguay (2005-06) | 18.0 | 2.6 | 7.7 | 7.7 |
| GRA-supported program (2001-06) | 18.9 | 4.9 | 10.2 | 3.8 |
| Exceptional access 2/ | 21.0 | 3.3 | 11.5 | 6.3 |
| Non-exceptional access | 18.9 | 5.2 | 10.3 | 3.4 |

Source: MONA database and Fund staff estimates.

1/ Average number of conditions per program year.
2/ Includes Brazil (2001-02, 2002-05), Argentina (2003, 2003-06), Turkey (2002-05, 2005-08), and Uruguay (2002-05, 2005-06).

[35] The Fund also provided significant technical assistance to support these reforms, including FAD missions on tax and customs administration (March 2006 and June 2005), tax policy (October 2005), and public financial management (March 2005). MFD provided continuous support since 2002, and an FSAP was completed in June 2006. ICM provided assistance on debt management (July 2005).

**Box 2. Pro-Growth Agenda—An Area of Close Collaboration with Other Multilateral Institutions**

Sustaining high growth rates was a key objective of the authorities' program and this was critical both for debt sustainability and improving social conditions. Uruguay needed to improve its growth potential relative to its performance over the last half century, when real per capita growth averaged less than 1 percent.[1] A comprehensive World Bank study (2005) identified three pillars for higher growth in Uruguay; (i) macroeconomic and financial stability; (ii) a favorable investment climate;[2] and (iii) private entrepreneurship.[3]

The division of labor between the multilateral institutions was in line with their respective areas of expertise. The World Bank and the IDB efforts supported the authorities' micro reform program focusing, inter alia, on improving the investment climate, increasing competitiveness, improving infrastructure, developing domestic capital markets, enhancing the effectiveness of social spending, and reforming state enterprises. The SBA supported this agenda through prudent macropolicies, a more effective and efficient tax system, and stronger banks intermediating flows to the private sector. Conditionality was attached to measures to strengthen the bankruptcy framework and the development of a pro-growth agenda.

A combination of macro- and micro-oriented reforms remains essential to sustain high growth rates, now that the output gap is closed. Rapid growth rates over the last 3 years have helped a quick recovery from to the crisis. Similar to the experience in other countries emerging from crisis, this recovery has taken place without commensurate recovery in credit.[4] However, private investment remains low at around 14 percent of GDP. Sustaining growth above historic averages would require continued efforts to boost productivity and encourage entrepreneurship within a stable macro environment.

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[1] Average growth was explained mostly by TFP (about 1 percent per year) with slightly negative contribution from capital accumulation, see Country Report No. 06/427.

[2] Uruguay ranked 70th among 175 countries in 2005 by the World Bank index of ease of doing business.

[3] This included measures to promote deregulation, a legal bankruptcy framework, public enterprise reform, and measures to foster innovation.

[4] Calvo et al. "Phoenix Miracles in Emerging Markets with Credit in Systemic Financial Crises", 2006.

43. **The design and sequencing of measures provided adequate policy space to the authorities**. The measures were largely drawn from the authorities' program. In line with the authorities' agenda, the SBA placed emphasis on some important measures during the first program year (tax reforms and financial sector laws) in view of the perceived domestic political support, but also because decisive action was important to increase the economy's resilience to shocks and strengthen market confidence, reduce country risk, and enhance Uruguay's market access.

44. **The government undertook some important reforms; however, strong ownership did not ensure timely and full implementation of the reform agenda**. Good progress was made across a number of areas: the long-awaited tax reform was approved and the

government implemented measures to bolster public finances and strengthening revenue administration. A new debt management unit was established, taking the important task of improving the debt structure. In the financial sector, prudential requirements were tightened to reduce risks from high dollarization and nonresident deposits. Finally, a bankruptcy framework was submitted to Congress and the bank formed with the performing assets of three failed banks was privatized. However, delays plagued measures aiming to enhance central bank independence, upgrade institutional and supervisory frameworks, safeguard public finances by putting specialized pension funds on a sound footing, and reducing contingent liabilities by restructuring the BHU.

45. **Although the government had secured majority in both houses of congress, reforms that required parliamentary approval proved difficult**. While ownership was high among the government's economic team, the broader support for these measures within Congress was weaker than expected and draft laws have not yet been approved, several months after their submission to Congress. In retrospect and despite the criticality of the measures, the authorities were not able to leverage their majority in Congress as well as the good economic performance to expedite discussion and gain approval of the delayed measures.

46. **Although delays were regrettable, macro overperformance and the concomitant decline in vulnerabilities supported waivers for temporary deviations from the program**. During the June 2005–June 2006 period, conditions were modified or waived, and were reset during the period of the arrangement. Some flexibility regarding the implementation timetable of structural measures was justified, as the authorities continued to be committed and, indeed, were making progress toward meeting the program's objectives, especially on the macro front. In addition, most of the delayed measures related to systemic reforms and their specific timing was less important than the reforms being implemented appropriately.

47. **The last program review—after repayment of all obligations to the Fund—was the final chapter of a multiyear, and largely successful cooperation**. Completion of the combined fifth and sixth reviews required waivers for six missed structural performance criteria. While remedial action was taken for two of the measures (which were implemented with delay), actions on the remaining four measures rested on the authorities' commitment to implement them within 2007. Granting waivers on the basis of commitments for action at a future date within the timeframe of an arrangement is far from uncommon in Fund-supported programs.[36] Although less common, there are also precedents for completing programs

[36] The Fund grants waivers for missed performance criteria only if satisfied that the program will be successfully implemented, either because of the minor or temporary nonobservance or because of corrective actions taken by the authorities.

without some measures being implemented.[37] In this case, however, actions to be taken after an arrangement has expired are not subject to the monitoring framework of a Fund-supported program.

## IV. Concluding Thoughts

48. **Over the last few years, the Fund forged an important partnership with the Uruguayan authorities aiming to help the country overcome its worst financial and economic crisis**. Many factors contributed to program's overall success and Uruguay's strong economic recovery. First, the strong macro performance is testimony to the authorities' commitment to implement sound macro policies and advance reforms, notably in fiscal policy area. Second, good working relationship between Fund staff and the authorities led to the design of a coherent and credible policy framework that instilled market confidence. In this context, the January 2005 seminar was important to build a constructive relationship with the incoming authorities that was maintained throughout the program. Third, a broadly favorable external environment (market access, strong export growth and positive economic developments in partner countries) that outweighed the negative oil price shock.

49. **The early termination of the program should be seen as a sign of success, primarily for the authorities but also for the Fund**. Fund arrangements aim at helping members solve their balance of payments difficulties, by making resources temporarily available to them. This SBA achieved this. The cancellation reflects the improved macroeconomic and financial conditions, and the authorities' sense of readiness to graduate from Fund arrangements. For the Fund, it is important to have the right incentives in place for countries to separate from it, when other sources of financing are available. Uruguay's 2005 SBA is an example of a successor exceptional access arrangement in support of a strong adjustment program that proved to be an effective exit strategy for reducing Fund exposure, without putting at risk the revolving character of Fund resources.

50. **Would the program have been as successful had the external environment been less favorable?** External factors certainly contributed to Uruguay's overall economic performance, even though the terms of trade worsened considerably due to the higher oil prices. The external environment alone, however, cannot account for Uruguay's successful economic management over the last two years. The policy strategy under the program was appropriate to help Uruguay to emerge stronger, with less vulnerabilities and more robust institutions.

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[37] The 2005 Conditionality Review (available at http://www.imf.org/External/np/pp/eng/2005/030405.htm) notes that 17 percent of the GRA-supported programs were completed with "lapsed" measures during 1998–2003, i.e., structural performance criteria not implemented during the program period.

51. **The delays and the unfinished structural agenda were a disappointment**. To some extent, the authorities' eagerness to signal a relatively quick pace of reforms may have resulted in setting ambitious targets. Also, some measured flexibility and adjustment of the timing of the reform agenda was reasonable where reforms depend on congressional approval. However, the pending institutional reform measures seem to have lost their urgency in Congress outside a crisis context and strong macro performance might have weakened incentives for reform. The limited progress made since the program ended reinforces this view. Vulnerabilities however remain, and many challenges lie ahead if the current recovery is to be converted into a long-lasting one.

52. **Going forward, the authorities should continue to take advantage of the opportunity offered by the favorable environment to place the economy on a sound footing and protect it against abrupt market reversals**. In this context, the objectives of the 2005 SBA are germane: (i) a strong fiscal performance needs to be maintained as the cornerstone of the macroeconomic strategy in view of remaining vulnerabilities. This will require sustaining primary surpluses in the order of 4 percent of GDP until the debt has returned to more sustainable levels. In this context, addressing fiscal rigidities, including those posed by high and growing social transfers and wage outlays, will be key; (ii) further progress is needed to strengthen the resilience of the banking system and revive sound intermediation; (iii) the credibility of the monetary framework needs to be buttressed to consolidate low inflation and reduce dollarization; and (iv) a supportive environment for private sector activity needs to be maintained to encourage investment and sustain high economic growth.