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Uruguay: Second Review Under the Stand-By Arrangement, Requests for Modification and Extension of the Arrangement, and Waiver of Nonobservance and Applicability of Performance Criteria, and Exchange System—Staff Report; Staff Supplements; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Uruguay

In the context of the Second Review Under the Stand-By Arrangement, Requests for Modification and Extension of the Arrangement, and Waiver of Nonobservance and Applicability of Performance Criteria, and Exchange System, the following documents have been released and are included in this package:

- the staff report for the Second Review Under the Stand-By Arrangement, Requests for Modification and Extension of the Arrangement, and Waiver of Nonobservance and Applicability of Performance Criteria, and Exchange System, prepared by a staff team of the IMF, following discussions that ended on March 7, 2003, 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 March 10, 2003.** 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 Letter of Intent dated February 24, 2003.

- a Press Release summarizing the **views of the Executive Board as expressed during its March 17, 2003 discussion** of the staff report that completed the request and/or review.

- a statement by the Executive Director for Uruguay.

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

URUGUAY

Second Review Under the Stand-By Arrangement, Requests for Modification and Extension of the Arrangement, and Waiver of Nonobservance and Applicability of Performance Criteria, and Exchange System

Prepared by the Western Hemisphere Department
(In consultation with other departments)

Approved by Markus Rodlauer and Liam P. Ebrill

March 10, 2003

- **Program discussions and Article IV consultation:** Since the completion of the last review, in August 2002, staff teams have visited Uruguay on four occasions, including two visits in January-February. The Article IV consultation discussions were also initiated, to be concluded at the time of the next (third) review under the program (the last Article IV discussion was concluded in February 2001).

- **Staff team**: The January-February staff teams were comprised of Mr. Terrier (Head), Mr. Braumann, and Ms. Honjo (all WHD), Messrs. Lee and Seelig (both MAE), Ms. De Bolle (PDR), Ms. Gonzalez (FAD), and Mr. Thorne (ICM). The mission was assisted by Mr. Bauer, the Resident Representative in Montevideo. Messrs. Oks (World Bank) and Fernandez Arias (IDB) overlapped with the January mission.

- **Program**: In the Letter of Intent (EBS/03/27), the authorities describe their economic program for 2003 and request a one-year extension of the current Stand-By Arrangement, through end-March 2005, as well as a rephasing of purchases over the extended period. They have also requested that the repurchase expectations under the SRF (SDR 128.7 million) arising in 2003 be moved to an obligations basis.

- **Financing assurances:** A supplementary Letter of Intent and a supplement to the Staff Report will be issued shortly before the Board discussion, to inform Executive Directors on progress in securing financing assurances for the program.

- **Article VIII status**: Uruguay has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains an exchange system mostly free of restrictions on current international transactions.

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I. BACKGROUND AND RECENT DEVELOPMENTS

1. **Since 1998, Uruguay has experienced a severe downturn in economic activity—the sharpest in Latin America, after Argentina.** Following average annual rates of growth of 3½ percent during 1990-98, real GDP contracted by 7½ percent during 1999-2001 and by a further 11 percent in 2002 (Table 1 and Figures 1 and 2). This decline reflected primarily the weakening in the regional economy, the Argentine crisis, and the lack of access to credit. While inflation reached 26 percent in 2002, private sector wages remained virtually flat in nominal terms, in a context of high unemployment rates (18.6 percent by year-end).[1] Imports contracted sharply in U.S. dollar terms (36 percent), and the external current account balance shifted from a deficit of 2.9 percent of GDP in 2001 to a surplus of 1.2 percent (Table 2).

2. **In 2002, the economic recession was compounded by a financial crisis.** Initially confined to non-residents, deposit outflows accelerated in March, spreading to resident depositors as a result of problems at two local banks and events in Argentina. Growing concerns about financial sustainability led to a sharp downgrade in Uruguay's sovereign credit rating. To help stabilize the banking system, in June and August the Fund approved two substantial augmentations of access (totaling SDR 1.5 billion) under the stand-by arrangement. In early August, the central bank suspended the operations of four private domestic banks; reprogrammed foreign currency time deposits in public banks by up to three years; and established a Fund for the Stabilization of the Banking System (FSBS) designed to fully back existing foreign currency sight deposits at domestic banks. This strategy, supported by additional financial assistance from the Fund, the IDB, and the World Bank, helped stop the deposit outflows during the remainder of the year. Private sector deposits with the banking system bottomed out in early October 2002 and rose by US$235 million (3 percent) in the last quarter. The end-December NIR and NDA performance criteria were observed (Table 3).

Uruguay: U.S. dollar deposits (changes)
(In millions of U.S. dollars)

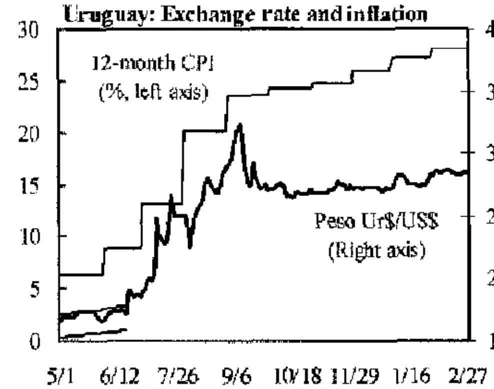
	2002				2003	
	Q1	Q2	Q3	Q4	Jan.	Feb.
TOTAL	**-1,645**	**-2,984**	**-1,756**	**235**	**-49**	**-111**
Public banks	-6	-927	-539	54	13	-61
Pri. Local banks	-682	-616	-605	-51	1	-8
Foreign banks	-957	-1,441	-611	232	-62	-41
Subsidiaries	-558	-721	-300	18	-2	-9
Branches	-399	-720	-311	215	-60	-32

Sources: Central Bank of Uruguay.

3. **A new round of deposit outflows took place in late January, but it has now stopped.** Concerns about the status of the government's economic program as well as rumors of pesification of bank deposits and loans prompted renewed deposit outflows, partly reversing the reflows registered in the last quarter of 2002. Reflecting these outflows as well as public sector market debt payments, gross official reserves fell to about US$540 million by end-February 2003, equivalent to only half the domestic reserve liabilities of the central bank. Despite the recent volatility in deposits, the exchange rate has remained relatively stable.

[1] From end-1998 through end-2001, private sector wages remained broadly flat in real terms.

4. **In recent months, exchange rate stability has led to a steady decline in short-term peso interest rates.** Peso bill rates have fallen from over 150 percent last September to 55 percent at end-February 2003. The government has also resumed U.S. dollar bill auctions, albeit of very limited sizes and maturities. Since the beginning of this year, it has built up a stock of US$35 million of the U.S. dollar bills, auctioned at average interest rates of between 6 and 9 percent.



5. **In 2002, the improvement in the primary balance of the combined public sector was less than expected.** The primary balance is estimated to have shifted from a deficit of 1.1 percent on GDP in the first half of 2002 to a surplus of 1.6 percent in the second half (Table 4). However, for the year as a whole, the improvement was lower than envisaged under the program, with an estimated surplus of 0.3 percent of GDP compared with 1.4 percent. Tax collections fell short of program projections despite the adoption of two tax packages in February and May 2002, which included an increase in the tax on wages and pensions, new excise taxes on the tariffs charged by public utilities, and a broadening of the VAT base. The operating surplus of public enterprises was also lower than programmed, mainly because tariff adjustments lagged behind the increases in costs (a large share of which is linked to exchange rate variations). As noted in paragraph 13 and Box 1, significant adjustments in public tariffs are to take place in 2003.

6. **Expenditure restraint, together with lower interest payments, helped limit the fiscal shortfall.** In 2002, public sector wages and salaries were raised by only 1½ percent, compared with an end-of-period inflation rate of 25.9 percent. Total non-wage expenditure declined by an average of 12 percent in real terms, but central government social expenditure (including education, health, and housing) was largely protected, falling only by 7 percent in real terms while real unemployment benefits rose by about 10 percent. Interest payments were significantly lower than expected, in part due to a less depreciated exchange rate than envisaged under the program. Below-the-line data are not yet available to assess the end-2002 performance criteria on the combined public sector deficit and the nonfinancial public sector debt stock. Preliminary data indicate that, during 2002, the public sector debt ratio (including the debt to the Fund) rose sharply, to close to 90 percent of GDP, reflecting in part the additional debt incurred to support the banking system and the depreciation of the peso against the U.S. dollar.

7. **Progress on the structural front has been mixed.** The government only took gradual and partial steps to increase private sector participation in areas previously reserved for public enterprises (including port management, construction and operation of toll roads, cellular phone services, and insurance). Progress was made toward reforming the public bank BROU, with the launching of a long-term restructuring program, alignment of its capital requirements with those of private banks, and a strengthening in its management. Structural benchmarks on the presentation to congress of a reform of the pension system for the military

and a reform to rationalize and simplify the tax system were observed, the former with a delay. However, other benchmarks (weekly publication of bank data, reform of the pension fund for bank employees, and measures to foster competition in the telecommunications and oil sectors) were not met, and have been included in conditionality for 2003.

8. **The political and social situation has remained calm, despite the hardship caused by the economic recession.** In this context, the existence of a relatively broad social safety net, and the government's efforts to shield priority social expenditure from adjustment have helped mitigate the adverse impact of the recession (Box 1). Although in November 2002 the National Party withdrew its ministers from the cabinet, the government has been able to garner congress' support for its main policy initiatives. While no longer in the cabinet, the National Party has reaffirmed on a number of occasions its willingness to continue supporting the government in Congress. However, as the date for the presidential elections (scheduled for late 2004) approaches, the political environment is expected to become more challenging for the government.

Box 1. Uruguay: Poverty and Social Safety Nets

Uruguay, with a population of 3.3 million, has traditionally enjoyed strong social indicators: 90 percent of the population has access to primary education; infant mortality (14.1 per 1,000 live births) is among the lowest in Latin America; and poverty levels declined during the 1990s while income distribution improved. Estimates for 2001 show that only 12 percent of the Uruguayans were living below the poverty line[1] and less than 2 percent in conditions of extreme poverty. However, poverty increased in 2002, due to the sharp decline in output and income.

Uruguay has a wide range of social protection schemes. Social spending is explicitly protected by law from budgetary cuts, and the authorities have aimed at prioritizing spending towards the programs that are best targeted. Protection of social spending is also a key element of ongoing World Bank and IDB loans.

- In **education**, emphasis is being placed on: (i) enhancing the school food program (PAE) which currently provides coverage to 45 percent of children in public schools; (ii) ensuring the provision of adequate preschool and primary education to children living in poor environments (via longer school days, improved school infrastructure and equipment, teacher training and the purchase and distribution of educational material); and (iii) a program to improve secondary education, favoring youth employment.

- The **public health system** targets the poor, by classifying users by income levels. Unlike the private system (financed through social security contributions and direct fees), the public system is financed with government revenue. Priorities include: (i) health facilities, specifically those for primary and secondary care; (ii) spending under the Family Medicine Program that targets the poorest mothers and children; and (iii) public health programs such as the Expanded Immunization Program (PAI), the Program for Epidemiological Control, and the AEDES Campaign to prevent dengue fever.

- **Social security** is administered by the BPS, with a range of programs targeted at both contributors and noncontributors. The BPS spends over 5 percent of GDP a year on social benefits (excluding normal pensions) to protect the most vulnerable groups: low-income households, single-parent households headed by women, low-income adults without access to the contributory pensions system, and the unemployed. Coverage includes: (i) unemployment insurance; (ii) family allowances and healthcare services, which originally covered only affiliated workers and their families but have recently been expanded to the unemployed, low-income households, and single-parent households; (iii) old age and disability pensions, available to low income adults over the age of 70 or with handicaps; and (iv) social development programs for retirees and pensioners. There is also a minimum pension of Ur$1,344 a month, equivalent to 112 percent of the minimum wage.

[1] Data obtained from the Economic Commission for Latin America and the Caribbean (ECLAC).

II. Policies for the Program

A. Macroeconomic Framework

9. **The macroeconomic framework is based on a return to economic growth.** Although most economic indicators remain depressed and real GDP is projected to decline by 2 percent in 2003, the most recent export data (for December) are encouraging and there are early signs that the economy will bottom out this year. The recovery is expected to gather strength during 2003, leading to projected real GDP growth rates of 4-4½ percent in 2004-05. The monetary program aims at limiting inflation to about 26 percent in 2003, taking into account projected increases in utility prices, and targets a decline to single-digit level beginning in 2004. A key objective of the program is to reinforce the basis for medium term debt sustainability.

Text Table A. Macroeconomic Framework, 2002-05

	Est.	Projections		
	2002	2003	2004	2005
Real GDP growth (in percent)	-11.0	-2.0	4.5	4.0
Inflation (end-of-period, in percent)	25.9	26.3	9.6	9.2
Combined public sector primary balance				
(in percent of GDP)	0.3	3.2	3.2	3.3
External current account surplus				
(in percent of GDP)	1.2	2.3	1.6	1.2

Sources: Uruguayan authorities; and Fund staff estimates.

B. Monetary and Fiscal Policies

10. **Following the move to a floating exchange rate regime in mid-2002, the central bank has adopted base money growth as its intermediate monetary target.** Consistent with the inflation objective, base money is projected to rise by 25 percent during 2003 (Table 5). Building on progress made so far, the central bank plans to strengthen its open market operations, with a view to creating a deeper and more liquid market for short-term peso debt instruments. Over time, the authorities intend to move to an inflation-targeting framework for the conduct of monetary policy.

Text Table B. Monetary Program, 2003
(In billions of Uruguayan pesos)

	2002	2003			
	Dec.	Mar.	Jun.	Sep.	Dec.
Net international reserves 1/	-33.0	-47.3	-41.4	-40.0	-36.7
Net domestic assets	44.2	58.3	53.2	51.7	50.7
Monetary base	11.2	11.0	11.8	11.6	14.0
Memorandum item:					
Gross reserves (in billions of U.S. dollars)	0.8	0.6	1.0	1.2	1.4

1/ As defined in the Technical Memorandum of Understanding, and evaluated at program accounting rates.

11. **The authorities' economic program seeks to credibly improve public finances in 2003, and to provide the basis for a sound medium-term fiscal position.** The authorities are committed to raising the primary surplus of the combined public sector to 3.2 percent of GDP in 2003, consistent with a reduction in the overall deficit from 4.3 percent of GDP to 3.1 percent. They agreed with the staff that achieving these objectives will require both an enhanced revenue effort and expenditure restraint. Over the medium-term, the primary surplus is projected to grow to about 4 percent of GDP.

12. **In 2003, the authorities intend to firmly control the growth of primary spending, especially wages and pensions.** Overall, primary spending is projected to rise by only 14 percent in nominal terms, or about half the rate of inflation. Goods and services outlays will be streamlined under recently-established centralized procurement mechanisms for the purchase of medical supplies and food. Savings under these schemes (0.2 percent of GDP) will be used to make room for an increase in public investment, which has been sharply retrenched since 1999. As in 2002, the authorities plan to protect non-wage expenditure in priority social programs.

13. **In 2003, public sector revenue is conservatively assumed to decline by ½ percent of GDP.** Part of this decline would reflect lower tax collections on income and profits associated with weak economic conditions. The projections also take into account weaker-than-expected tax collections in the second half of 2002 and the full-year impact of the fiscal packages approved last year. The decline in tax revenue will be partially compensated by adjustments in public tariffs which, together with cost savings, would lead to an improvement of 0.7 percentage point of GDP in the operating surplus of public enterprises (Box 2). The authorities also plan to enhance revenue collection by reforming the tax refund scheme to exporters, and by taking steps to strengthen revenue administration and control.

14. **The authorities are committed to strengthen the tax reform package submitted to Congress in December 2002.** The current draft law aims at increasing efficiency and facilitating tax administration, through a broadening of the VAT base and a gradual reduction in rates; eliminating several low-yielding taxes to incorporate them into the main excise tax; and generalizing the corporate income tax to all productive sectors. Assuming that the envisaged reduction in rates were to be handled with caution, the reform would be broadly revenue neutral. In an effort to improve the revenue outcome, staff suggested that the authorities strengthen the proposal through: (a) expanding the VAT base to agricultural inputs and real estate rentals, and unifying the two main VAT rates; (b) incorporating the taxes on bank assets and net worth into the generalized enterprise income tax; and (c) eliminating revenue earmarking. The authorities have requested technical assistance from FAD in the design of a revised tax reform proposal, and will not push for passage until there is a revised proposal. Presentation to congress of revised tax reform legislation by end-June is a structural performance criterion under the program.

Box 2. Public Enterprises

The fiscal program includes an increase in the operating surplus of public enterprises from 2.3 percent of GDP in 2002 to 3 percent in 2003. This improvement would return the operating surplus to the level registered in 2001, correcting for the weak performance observed in 2002 (mostly due to tariff adjustments that lagged behind the rise in operating costs). Two main factors will support the projected recovery:

Tariff adjustments. The four main public enterprises increased their tariffs by 10-26 percent in January and February 2003, and are scheduled to implement two further adjustments in May and August, to reach cumulative increases of 23-49 percent by year-end. These adjustments will help improve revenue by the equivalent of 1.5 percent of GDP.

Tight controls on operating expenditure. Total current outlays of public enterprises are expected to increase only by about 0.6 percent of GDP from 2002 to 2003, supported by wage restraint and implementation of early retirement programs.

15. **Over the medium term, the consolidated public sector primary surplus is targeted to gradually rise to about 4 percent of GDP.** The authorities explained that they plan to rely on the revenue improvement associated with the gradual recovery in economic activity, expenditure restraint, and the dampening effect on outlays deriving from the 1997 social security reform to achieve this objective. The staff noted that achieving and sustaining such primary surplus would also require additional efforts on the revenue side. As noted in paragraph 7 of the MEFP, the authorities are committed to broaden the forthcoming tax reform to yield additional revenue over the medium term, and to complement it through a significant strengthening in tax administration.[2]

[2] Several tax collection agencies have recently begun to exchange taxpayer information, and an integrated database for routine cross-checks of information is being set up. The authorities have also designated withholding agents for VAT in activities prone to evasion, and initiated a drive to combat informal trade.

C. The Banking System

16. **The authorities are proceeding with the resolution of the four banks suspended in August 2002.** In the discussions, staff emphasized the risks associated with reopening weak banks in the current difficult economic and financial environment, and the importance of ensuring that any reopened bank was viable. The authorities generally agreed, but also noted that they attached a high importance to minimizing the disruption in credit flows to the economy and to the need to protect depositor confidence. The main steps of the action plan of the government are as follows:

- **In December 2002, congress approved several amendments to the banking law,** aimed at strengthening the powers of the central bank in the area of bank resolution and establishing that the government would attempt to protect deposits in the liquidated banks up to US$100,000.

- **In the coming weeks, the authorities plan to create a new bank (Nuevo Banco Comercial-NBC) with the good quality assets of three suspended banks.** These banks were placed in liquidation in January 2003, and trust funds have been created to manage their assets. In late February, the NBC purchased the good quality assets of the liquidated banks from the trust funds, in a competitive bidding process. It will pay for the assets with its own CDs, carrying a 2 percent interest rate and repayable over six years and, in turn, the trust funds will distribute these CDs to all the general creditors, including the government.

- **The authorities are firmly committed to ensure that any new or reopened bank will have to be viable and meet all prudential norms, so that it does not pose risks to the rest of the banking system or to public finances.** To that effect, over the next two-to-three weeks, the government is committed to evaluating—jointly with Fund staff—the business plan and viability of NBC before it is allowed to operate.

- **To partially cover the losses of depositors, the government plans to give up part of its claims.** It will transfer part of the CDs that it will receive to private depositors (some US$215 million), to help meet the US$100,000 protection, and use the remaining proceeds (US$125 million) to capitalize the new bank. As a result, the recovery of assets by the government will be significantly lower than envisaged earlier (the government had lent US$1 billion to the three banks).

- **The new bank will be government-owned, although it will operate under the legal framework of private banks.** The government plans to sell its equity shares in the bank as soon as conditions permit. However, with the new bank initially fully government-owned, over 55 percent of total banking system assets would be in the hands of the government.

- **Discussions with the minority shareholder on the resolution of the fourth suspended bank have stalled,** and on February 28 the government announced the liquidation of the bank and the creation of a trust to facilitate the disposal of its assets.

The staff remains in close touch with the authorities for appropriate and timely disposal of the bank's assets and other aspects of liquidation.

17. **In the rest of the banking system, progress has been mixed.** The restructuring process for the mortgage bank BHU has been slow. In December, congress approved a new charter transforming the BHU into a nonbank housing institution. As part of the reforms undertaken under the World Bank SAL I operation, BHU is developing and implementing a plan to reduce its operational costs, improve asset recovery, and complete a comprehensive audit of its portfolio.

18. **Beginning in August 2003, repayment of the first tranche of reprogrammed deposits will become due.** The government has reaffirmed its intention to repay deposits on schedule (US$510 million fall due during August-December), which will require the public bank BROU to have sufficient liquidity to cover potential deposit withdrawals. In recent months, BROU has been accumulating liquid assets for that purpose. The deposit reprogramming gives rise to an exchange restriction under Article VIII, as it captures nonresident deposits that could have been derived from current international transactions.

D. Financing Assurances

19. **A large part of the 2003 financing requirements is to be covered by program loan disbursements from the World Bank, the IDB, and bilateral creditors.** Total financing requirements for 2003 are estimated at US$1.4 billion, of which US$660 million are to be covered by the World Bank and the IDB. Program loan disbursements from the World Bank are projected to amount to US$250 million, under both the ongoing SAL I operation and a new operation in support of reforms to foster competition and improve efficiency in the provision of public services. This new operation (SAL II) is expected to be presented to the Executive Board of the Bank in April 2003. IDB program disbursements are projected to amount to US$325 million, in support of reforms in the social, financial, and health sectors. Disbursements from bilateral creditors are projected to amount to US$50 million.

20. **The remaining financing needs for 2003 (US$700-720 million) are expected to be met through a debt operation and modest bond placements in the domestic markets.** The authorities are presently working to fill this gap. As part of these efforts they are preparing a debt proposal with their financial and legal advisors—the details of this proposal will be provided after the authorities have made a shelf filing with the U.S. Securities and Exchange Commission and consulted with bondholders. The authorities have agreed that, before Board consideration of this review, they will issue a supplementary LOI elaborating on the debt proposal. Based on this LOI, a supplement to the staff report will provide an assessment of the medium-term outlook and debt sustainability. In addition to the debt operation, gross debt placements in the domestic market, including to the private pension funds, are expected to amount US$250 million in 2003 (just over 2 percent of GDP).

III. Program Modalities and Risks

A. Access to Fund Resources and Program Monitoring

21. **Access.** The current 24-month stand-by arrangement, in an initial amount equivalent to SDR 594.1 million (193.8 percent of quota), was approved in March 2002 and augmented on two occasions (June 25, 2002 and August 8, 2002), to SDR 2,128 million (694.4 percent of quota). Undisbursed access under the stand-by arrangement, which total SDR 1,016.6 million, would, under the proposed rephasing, be disbursed over the extended period through March 2005 (Table 6). Upon completion of the current (second) review, a purchase of SDR 218.5 million (71 percent of quota) would become available. In addition, it is proposed that repurchase expectations under the SRF arising in 2003 (SDR 128.7 million) be converted to an obligations basis.[3] Repayment of the SRF could cause undue hardship at a time when the authorities are taking firm action to strengthen the balance of payments.

22. **Reviews and performance criteria.** The program envisages quarterly reviews during the remainder of the program (see Table 6). As specified in the Memorandum of Economic and Financial Policies (EBS/03/27), performance criteria have been established for March 31, 2003 and June 30, 2003 for central bank net international reserves and net domestic assets, the primary balance of the combined public sector, and the debt stock of the nonfinancial public sector. Indicative targets in these areas have been set for end-September and end-December, which will be converted into performance criteria at the time of the third review. In addition, there are indicative targets throughout 2003 for the overall balance of the combined public sector and the monetary base.

23. **Structural performance criteria.** Presentation to congress of revised tax reform legislation is a performance criterion for end-June—as noted, this is a crucial reform to support medium term fiscal sustainability. A continuous structural performance criterion has also been specified in the banking area, under which no banks are to be opened or reopened unless they are viable and meet all prudential norms. Strict adherence to this requirement will serve to underpin the authorities' restructuring efforts while ensuring the stability of the banking system.

B. Capacity to Repay the Fund

24. **The full use of remaining access under the arrangement would raise the debt service profile substantially, particularly in 2006-07.** In 2006, debt service obligations would peak at 7.2 percent of GDP (6.3 percent in 2007), or about 28 percent of exports of goods and services (Tables 7 and 8). At its peak, debt service to the Fund would account for close to half of all external debt service due. These high numbers indicate considerable risk

[3] The proposed extensions would cover the repurchase expectations under the SRF arising on June 27 and December 27, 2003, of SDR 64.35 million each. Extension of the SRF repurchase expectations is consistent with the applicable criteria under the SRF.

to the Fund and imply that continued active Fund involvement beyond the current arrangement may be necessary. To balance these risks and safeguard Fund resources, the program includes comprehensive measures to restore the economy's growth potential and ensure debt sustainability over the medium term. The staff will continue to closely monitor Uruguay's capacity to repay the Fund and any need for corrective measures if medium-term projections turn less favorable than currently expected.

C. Program Risks

25. **Notwithstanding the progress made so far, Uruguay continues to face major vulnerabilities, and there are significant risks to the program.** The combination of the vulnerabilities described below creates a highly fragile outlook that could be derailed by any significant shock or slippage in program implementation.

- As noted, the **situation in the banking system** is fragile, and there is a danger that external or domestic developments could prompt another run on deposits. Given the low level of reserves, the central bank has only limited scope to provide liquidity assistance to banks. Additionally, renewed deposit outflows would bring gross international reserves to a dangerously low level (Table 9).

- In the **fiscal area**, achieving and sustaining the targeted large increase in the primary surplus is a major challenge. In particular, lower-than-expected revenue collections, or pressure to grant higher wage and pension increases, could reopen significant financing gaps and risk a downward spiral of confidence and renewed loss of reserves.

- There are risks associated with the **financing assurances**, which will be described in the forthcoming supplement to the staff report.

D. Safeguards Assessment

26. **During 2002, the Treasurer's Department of the Fund completed an on-site safeguards assessment of the central bank of Uruguay.** The assessment identified risks with the external and internal audit mechanisms, and a need for improving transparency in the annual financial statements of the central bank. To address vulnerabilities, staff recommended that the central bank significantly step up the audit mechanisms, including with respect to the FSBS. The authorities are in the process of implementing these recommendations and are committed to completing an external audit of the FSBS by September 30, 2003.[4]

[4] The government is committed to using the resources of the FSBS as initially intended. The undisbursed assets of the FSBS have been progressively reduced, to US$380 million at end-February.

IV. Staff Appraisal

27. **The staff commends the Uruguayan authorities for their sustained efforts to implement sound economic policies and ensure a return to sustained growth, amidst very difficult circumstances.** In particular, notwithstanding the sharp decline in activity registered during 2002, the authorities were able to maintain prudent fiscal and monetary policies, and displayed a strong commitment to preserve the integrity of legal contracts in the financial system and the elsewhere in the economy.

28. **Despite these achievements, Uruguay continues to face major vulnerabilities—there is no room for slippage, and further measures may well be needed if any of the downside risks materialize.** The situation in the banking system remains fragile, and new shocks to depositor confidence could prompt renewed deposit outflows which, in turn, would lead to a further drop in the gross reserves of the central bank. Also, any deviation from the program could have adverse consequences on market sentiment. Finally, the authorities will need to ensure that all the financing assurances are in place for the program and press ahead with their structural reform program to unlock the envisaged disbursements from the World Bank and the IDB. Further progress in the area of structural reforms is key to a return to economic growth.

29. **For 2003, achieving the targeted primary surplus will hinge mainly on continued success in containing public sector wages and pensions increases.** The staff welcomes the authorities' commitment to limit those increases, given the tight budget constraint and the minimal wage increases granted in the private sector. The shortfall from last year's primary surplus target underscores the importance of strictly implementing the fiscal program for 2003.

30. **Over the medium term, a sustained improvement in the fiscal accounts will require both expenditure restraint and an improved tax effort.** There is a risk that the sharp compression of real wages and pensions in 2002-03 will at least partly unwind over the medium term, which would need to be compensated by savings elsewhere. A sustained strengthening of the public finances therefore calls for structural expenditure reforms and improvements in tax collections. The staff encourages the authorities to reform the revenue administration and take advantage of the debate in congress on the tax reform to broaden the taxpayer base, so that revenue responds buoyantly once the economic recovery takes hold. The authorities will also need to build a consensus and move ahead decisively with their program of concessions and to advance in the area of privatization.

31. **After the severe shocks experienced in 2002, restoring a viable banking system is key to Uruguay's growth prospects.** In staff's views, the government's decision to protect deposits up to US$100,000 in the suspended banks, designed to help reduce the risks of a run on deposits, has high fiscal costs and may, in addition, create an expectation that deposits in other banks will also be insured. In resolving the suspended banks, the authorities will need to adhere strictly to their commitment that any new or reopened banks must be viable and comply with all prudential requirements. Failure to do so would lead to renewed uncertainty in the banking system and entail future fiscal or quasi-fiscal losses. The staff urges the

authorities to press ahead with the ongoing reform of the mortgage bank (BHU), in close collaboration with the World Bank.

32. **Because of the extraordinary risks associated with the program, close monitoring is essential.** The program features quarterly reviews, including of financing assurances, as well as a range of quantitative and structural performance criteria. The staff encourages the authorities to monitor developments closely and to react proactively, in close consultation with the staff, to any emerging deviations or difficulties. The staff recommends extension of SRF repurchase expectations arising during 2003. The staff also recommends approval of the exchange restriction under Article VIII arising from the reprogramming of bank deposits, given that this measure is temporary and does not discriminate among depositors.

33. **Notwithstanding the risks to the program, the staff recommends completion of the second review and approval of the authorities' requests for waivers, extension of the arrangement, and rephasing of purchases.** The authorities' strengthened program for 2003 represents a balanced effort to create the conditions for a resumption of economic growth that merits the support of the international community. The sizable upfront purchases from the Fund are designed to help rebuild the gross reserves position of the central bank, a critical buffer against possible shocks and key to nurturing confidence in the banking system. The prior action on, and subsequent reviews of, financing assurances provide safeguards and incentives as regards the full participation by all parties involved in the financing of the program.

Figure 1. Uruguay: Selected Economic Indicators

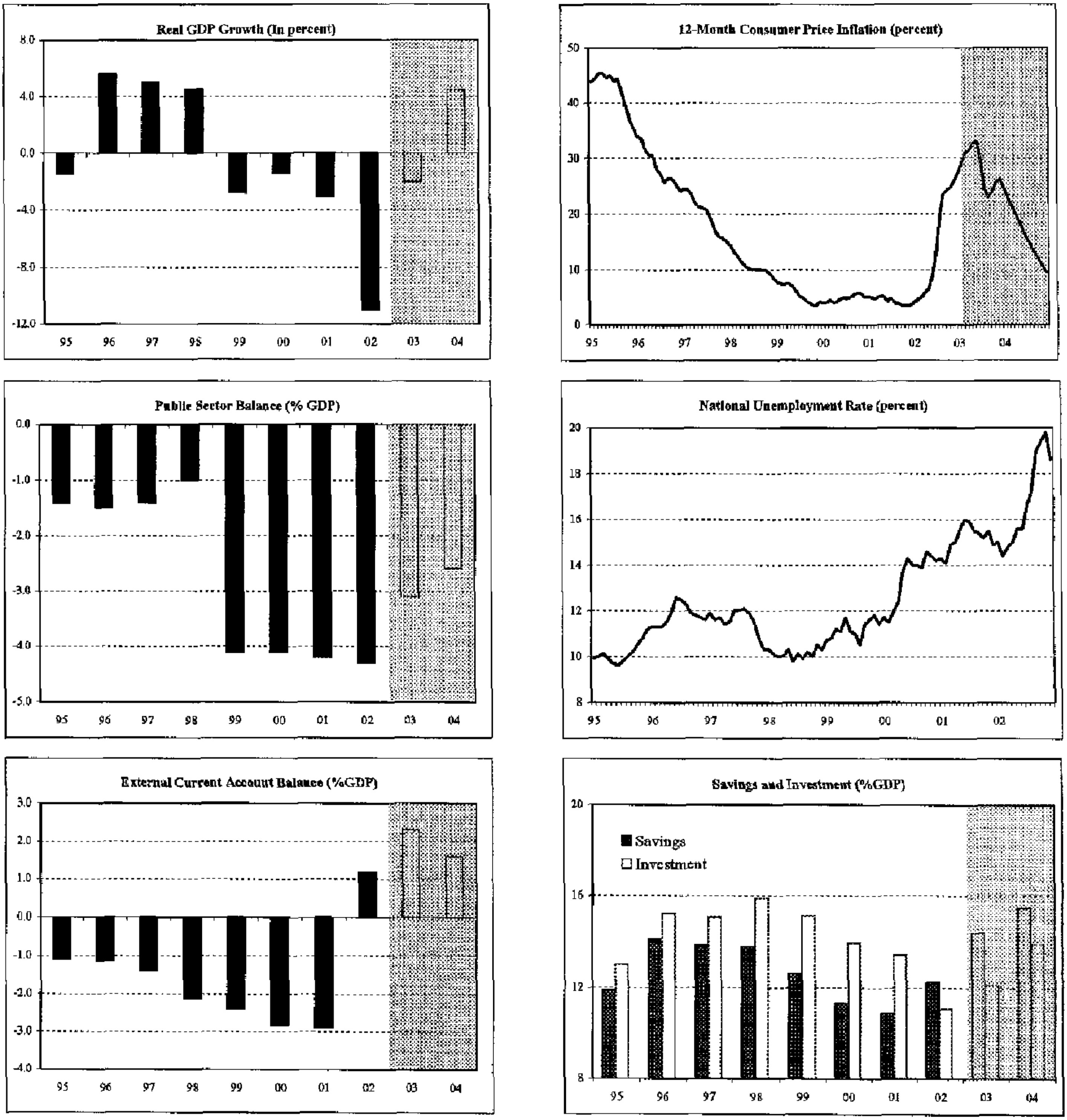


Figure 2. Real Exchange Rate Indicators

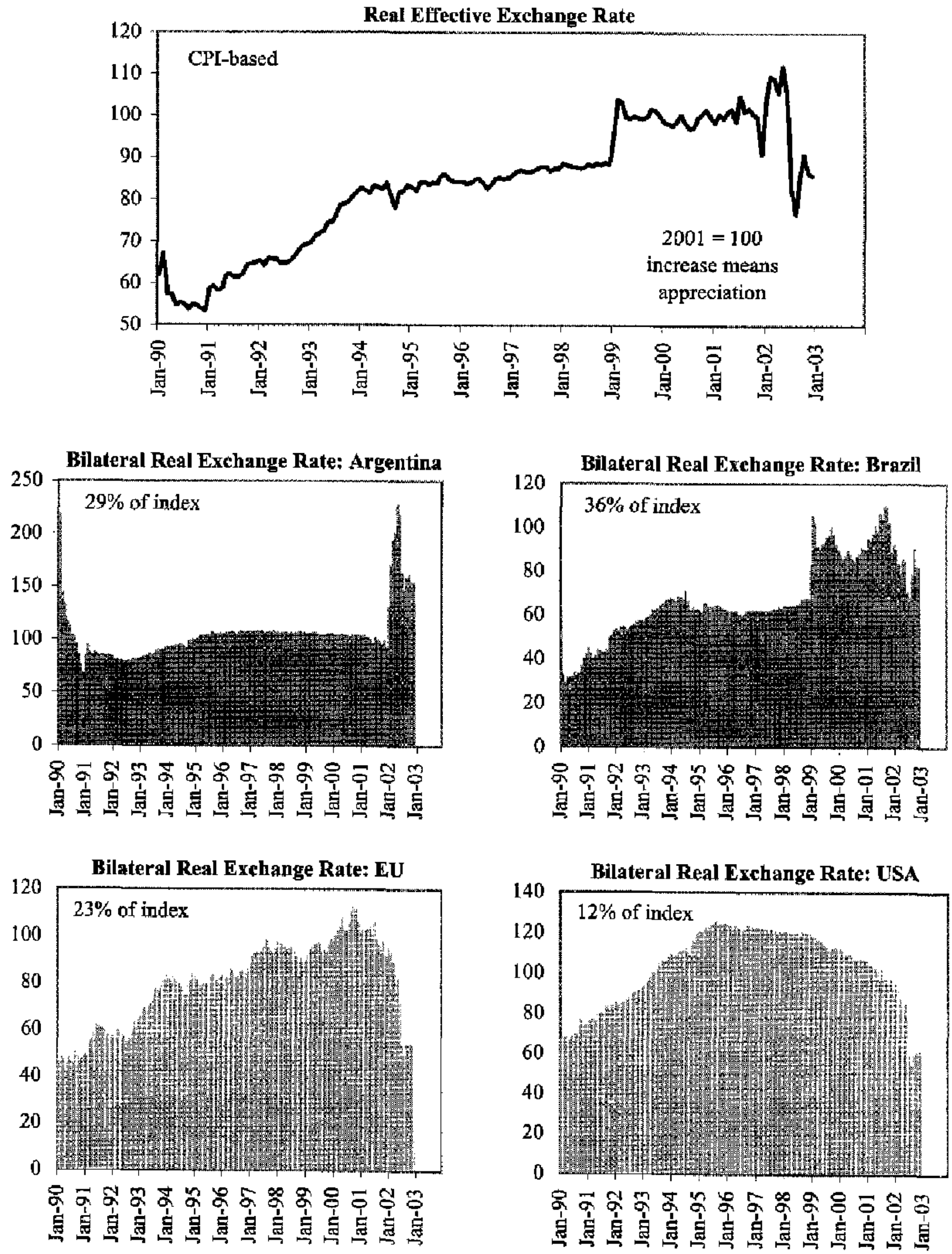


Table 1. Uruguay: Selected Economic and Financial Indicators

	1999	2000	2001	Rev. Prog. 2002	Est.	Proj. 2003	Proj. 2004
	(Percentage change)						
Output, prices, and wages							
Real GDP	-2.8	-1.4	-3.1	-11.1	-11.0	-2.0	4.5
GDP deflator	4.2	4.0	5.6	35.2	18.5	31.2	16.6
CPI inflation							
Average	5.7	4.8	4.4	24.2	14.0	27.9	21.2
End of period	4.2	5.1	3.6	39.2	25.9	26.3	9.6
Exchange rate change (Ur$/US$)							
Average	8.3	6.7	10.1	99.1	59.6	...	...
End of period	7.4	7.7	18.0	170.9	84.5	...	...
Public sector wages (end of period)	6.9	2.9	5.2	1.5	1.5	7.2	...
GDP							
In Ur$ billions	237.1	243.0	248.6	298.6	262.2	337.0	410.7
In US$ billions	20.9	20.1	18.7	11.3	13.0	11.0	12.0
Monetary indicators 1/							
Currency issued	6.9	-3.9	-0.2	12.9	5.8	19.8	...
M-2	4.7	3.5	0.7	-1.5	11.0	14.9	...
M-3	13.2	10.2	19.6	-19.2	20.8	35.8	...
Credit to the private sector (constant exch. rate)	5.3	0.3	-3.8	-16.8	-16.6	-2.4	...
Prime interest rates (percent, average)							
Foreign currency loans	8.3	8.3	8.2	...	...	...	...
Domestic currency loans	24.4	20.7	24.7	...	83.0	...	...
	(In percent of GDP, unless otherwise indicated)						
Public sector operations							
Revenue	32.3	31.4	32.1	29.9	31.0	30.4	31.5
Noninterest expenditure (incl. discrepancy)	34.4	32.9	33.3	28.6	30.7	27.2	28.3
Primary balance	-2.0	-1.5	-1.2	1.4	0.3	3.2	3.2
Interest	2.1	2.6	2.9	5.0	4.6	6.3	5.8
Overall balance	-4.1	-4.1	-4.2	-3.6	-4.3	-3.1	-2.5
Savings and investment							
Gross domestic investment	15.1	14.0	13.4	12.3	11.1	12.1	13.9
Public	3.4	3.5	3.7	3.2	2.4	3.0	3.1
Private	11.8	10.5	9.8	9.1	8.6	9.1	10.8
Gross national savings	12.6	11.3	10.6	13.9	12.2	14.4	15.5
Public	0.3	-0.6	-0.5	-0.8	-1.9	-0.1	0.5
Private	12.3	11.9	11.1	14.7	14.1		15.0
Foreign savings	2.4	2.8	2.9	-1.6	-1.2	-2.3	-1.6
External indicators							
Merchandise exports, fob (US$ millions)	2,291	2,384	2,144	2,073	1,900	2,082	2,270
Merchandise imports, fob (US$ millions)	3,186	3,311	2,914	2,078	1,867	1,873	2,061
Merchandise terms of trade (percentage change)	-4.7	-6.6	-0.7	9.8	3.8	-1.3	0
Current account balance (US$ millions)	-502	-566	-533	178	150	251	188
Overall balance of payments (US$ millions) 2/	13	167	302	-2,362	-2,322	646	430
Public debt (in percent of GDP) 3/	40.8	45.3	54.1	95.0	88.6	106.2	98.9
External debt (in percent of GDP) 4/	39.5	44.3	47.8	92.9	79.1	97.9	96.5
Of which: External public debt	26.9	30.4	31.4	77.1	63.9	84.2	80.2
Gross official reserves (US$ millions)	2,602	2,779	3,099	737	776	1,422	1,852
In months of imports of goods and services	7.8	8.0	10.0	3.3	3.7	6.8	8.1
Ratio to short-term debt 5/	1.1	1.1	1.1	0.5	0.3	0.6	0.8
REER (percentage depreciation -, e.o.p.)	10.2	-0.7	-5.3	...	-13.2	...	...

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

1/ Evaluated at the accounting exchange rate of Ur$29/US$ for 2003.

2/ Defined as changes in reserve assets.

3/ Defined for combined public sector.

4/ Excludes nonresident deposits.

5/ Residual maturity. Does not include nonresident deposits.

Table 2. Uruguay: Summary Balance of Payments, 2000-04

(In millions of U.S. dollars)

	2000	2001	2002 Q1	2002 Q2	2002 Q3	2002 Q4	Est. 2002	2003 Q1	2003 Q2	2003 Q3	2003 Q4	Proj. 2003	Proj. 2004
Current Account	-566.3	-533.2	144.6	-51.0	-1.4	57.8	149.9	208.5	-8.4	14.8	35.7	250.6	188.0
Goods and Services	-533.1	-447.1	119.9	-51.3	53.7	135.7	258.0	242.8	25.9	49.5	70.3	388.6	373.0
Goods	-927.3	-770.9	-29.0	-37.1	49.4	50.2	33.4	100.8	33.9	59.2	15.2	209.1	209.1
Exports	2383.8	2143.6	469.4	527.2	450.7	452.9	1900.2	538.3	535.1	503.2	505.7	2082.3	2269.7
Imports	3311.1	2914.5	498.4	564.4	401.3	402.7	1866.8	437.6	501.2	444.0	490.5	1873.3	2060.6
Services	394.2	323.8	148.9	-14.2	4.3	85.5	224.6	142.1	-8.0	-9.7	55.2	179.5	163.9
Exports	1275.8	1132.3	313.1	156.2	152.8	225.1	847.2	290.6	151.2	148.0	216.5	806.3	846.6
Imports	881.6	808.4	164.2	170.4	148.5	139.6	622.6	148.5	159.3	157.7	161.3	626.8	682.7
Income	-60.7	-113.8	15.9	-8.4	-63.9	-94.8	-151.1	-45.3	-45.3	-45.3	-45.3	-181.2	-230.0
Current transfers	27.5	27.7	8.7	8.7	8.7	16.9	43.0	11.0	11.0	10.6	10.6	43.2	45.0
Financial Account	771.7	794.3	-649.2	-657.8	-263.1	-147.8	-1718.0	-377.8	411.3	157.9	204.5	395.8	242.1
Direct investment, net	274.1	319.3	29.4	16.3	-0.8	25.0	69.8	25.0	25.0	50.0	50.0	150.0	200.0
Portfolio investment, net	295.5	553.0	-107.0	458.8	76.7	-133.3	295.2	-167.1	-29.1	-29.6	-42.4	-268.2	-76.4
Government Securities	294.0	323.7	33.5	202.7	-66.7	-74.9	94.5	-167.1	-29.1	-29.6	-42.4	-268.2	-76.4
Issues	537.8	715.9	85.4	232.6	133.7	0.0	451.7	0.0	0.0	0.0	0.0	0.0	36.0
Amortization	243.8	392.2	51.9	29.9	200.4	74.9	357.1	167.1	29.1	29.6	42.4	268.2	112.4
Banks	1.5	229.4	-140.4	256.1	143.3	-58.3	200.6	0.0	0.0	0.0	0.0	0.0	0.0
Public banks	-4.5	-42.4	-8.3	125.1	0.8	0.0	117.6	0.0	0.0	0.0	0.0	0.0	0.0
Private banks	6.0	271.7	-132.1	131.0	142.5	-58.3	83.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Investment, net	202.1	-78.1	-571.6	-1132.8	-339.0	-39.6	-2083.0	-235.7	415.4	137.5	196.9	514.0	118.4
Loans	437.1	-1040.9	186.1	339.0	823.7	-39.6	1309.3	-79.3	423.7	214.3	205.6	764.3	243.7
Nonfinancial public sector	157.7	182.4	-17.7	-107.8	665.0	15.8	555.4	-38.1	239.3	134.0	117.4	452.6	68.7
Disbursements	286.7	351.3	17.1	24.1	701.5	48.8	791.6	21.0	306.0	196.0	183.6	706.6	316.0
Amortization	129.0	168.9	34.8	131.9	36.5	33.0	236.2	59.1	66.7	62.0	66.2	254.0	247.3
Other, net (fin. Derivative)	0.0	0.0	51.0	0.0	0.0	-36.6	14.4	0.0	0.0	0.0	0.0	0.0	0.0
BCU / use of IMF resources	-45.7	-57.7	154.1	673.9	40.6	-18.8	849.8	280.4	180.4	108.4	108.4	677.6	325.1
Of which: FSBS resources	0.0	0.0	0.0	0.0	-716.5	0.0	-716.5	0.0	0.0	0.0	0.0	0.0	0.0
Banks	325.1	-1165.6	-1.2	-227.1	118.0	0.0	-110.3	-321.6	4.0	-28.1	-20.3	-365.9	-150.0
Public banks	3.8	-3.7	3.4	6.1	0.5	0.0	10.0	0.0	0.0	0.0	0.0	0.0	0.0
Private banks	321.4	-1161.9	-4.6	-233.2	117.5	0.0	-120.3	-321.6	4.0	-28.1	-20.3	-365.9	-150.0
Deposits	-33.7	1003.5	-227.8	-353.4	-393.7	0.0	-974.9	-50.0	1.7	-76.8	-8.7	-133.8	-112.6
Public banks	47.3	302.3	177.6	156.7	-33.9	0.0	300.4	0.0	0.0	-64.8	0.0	-64.8	0.0
Of which: nonresident deposit flows	76.6	335.4	-27.2	-245.4	-88.9	0.0	-361.5	0.0	0.0	-64.8	0.0	-64.8	0.0
Private banks	-81.0	701.3	-405.4	-510.1	-359.8	0.0	-1275.3	-50.0	1.7	-12.0	-8.7	-69.0	-112.6
Of which: nonresident deposit flows	716.3	941.4	-1110.0	-1580.2	-1149.9	0.0	-3840.2	0.0	0.0	0.0	-8.7	-8.7	100.0
Other flows, net	-201.3	-40.7	-530.0	-1118.5	-768.9	0.0	-2417.4	-106.4	-10.0	0.0	0.0	-116.4	-12.6
Banks	33.7	-9.5	-49.2	-109.6	46.6	0.0	-112.2	0.0	0.0	0.0	0.0	0.0	0.0
Public banks	36.6	-9.7	13.3	-114.2	41.2	0.0	-59.7	0.0	0.0	0.0	0.0	0.0	0.0
Private banks	-2.9	0.2	-62.5	4.6	5.4	0.0	-52.5	0.0	0.0	0.0	0.0	0.0	0.0
Nonfinancial private sector	-235.0	-31.2	-162.0	-862.0	0.0	0.0	-1024.0	0.0	-10.0	0.0	0.0	-10.0	-212.6
Foreign currency held outside banks	0.0	0.0	-318.8	-146.9	-815.5	0.0	-1281.2	-106.4	0.0	0.0	0.0	-106.4	200.0
Errors and Omissions	-38.5	41.1	-402.1	-23.2	-462.1	133.1	-754.2	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	166.8	302.2	-906.8	-732.0	-726.7	43.1	-2322.4	-169.3	402.8	172.7	240.1	646.4	430.1
Reserve Assets (- increase)	-166.8	-302.2	906.8	732.0	726.7	-43.1	2322.4	169.3	-402.8	-172.7	-240.1	-646.4	-430.1
Memorandum Items:													
Current account in percent of GDP	-2.8	-2.9	...	...	...	...	1.2	...	...	...	...	2.3	1.6
Financial account in percent of GDP	3.8	4.3	...	...	...	...	-13.2	...	...	...	...	3.6	2.0
Gross International Reserves	2779.0	3099.0	2192.9	1470.6	734.3	775.7	775.7	606.4	1009.2	1181.9	1422.1	1422.1	1852.1
in months of imports of GNFS	8.0	10.0	9.9	6.0	4.0	4.3	3.7	3.1	4.6	5.9	6.5	6.8	8.1

Sources: Central Bank of Uruguay and Fund staff estimates.

Table 3. Uruguay: Performance Under the 2002 Economic Program 1/

	Sep-02			Nov-02				Dec-02			
	Prog.	Actual	Margin (+)	Prog.	Adj. Prog	Actual	Margin (+)	Prog.	Adj. Prog	Actual	Margin (+)
A. Quantitative Performance Criteria											
(In millions of Uruguayan pesos)											
1. Combined public sector balance (cumulative floor) 6/	-9,600	-9,041	**559**	...	...	...	...	-10,950	...	...	...
2. General government expenditure (cumulative ceiling) 6/	23,700	21,878	**1,822**	29,600	29,600	27,136	**2,464**	32,900	32,900	29,878	**3,022**
3. Change in the net domestic assets of the BCU (ceiling) 3/ 4/	26,100	24,082	**2,018**	24,235	26,815	24,813	**2,002**	28,400	31,625	24,616	**7,009**
4. Change in currency issue (ceiling) 2/ 3/	755	765	**-10**	985	985	661	**324**	2,650	2,650	1,976	**674**
5. Net international reserves of the BCU (-decrease) 3/ 4/	-1,010	-933	**77**	-930	-1,033	-966	**67**	-1,030	-1,159	-906	**253**
(Stock of debt at the end of the period; in millions of U.S. dollars)											
6. Nonfinancial public sector gross debt (ceiling) 4/ 5/	8,025	7,918	**107**	8,025	8,025	...	...	8,025	8,025	...	...

	Date	Status
B. Structural Performance Criteria		
1. Congressional approval for the extension of the May tax measures.	31-Oct	Observed
C. Structural benchmarks		
1. Weekly publication of banking data with a one-week lag.	31-Aug	Not observed
2. Evaluation of the adequacy of BROU's current regularization plan and development of a plan of compliance with all prudential regulations.	31-Aug	Observed
3. Presentation to Congress of pension reforms:		
Military	31-Oct	Observed with delay
Bank employees	31-Dec	Not observed
4. Presentation to Congress of a comprehensive reform to rationalize and simplify the tax system.	31-Dec	Observed
5. Presentation to Congress legislation to foster competition in the telecommunications sector.	31-Dec	Not observed
6. Presentation to Congress of legislation to foster competition in the oil sector.	31-Dec	Not observed

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

1/ As defined in the Technical Memorandum of Understanding.
2/ Indicative target.
3/ Cumulative from end-June 2002.
4/ Adjusted for upwards/downwards for any increase/decrease in disbursements from the World Bank and IDB.
5/ All maturities. Adjusted for debt issued for recapitalization of banks.
6/ Cumulative from end-December 2001.

Table 4. Uruguay: Public Sector Operations, 2000-04 1/

	2000	2001	2002 Q1	2002 Q2	2002 Q3	2002 Q4/Prel.	2002 Prel.4/	2002 Prog.	2003/Prog. Q1	2003/Prog. Q2	2003/Prog. Q3	2003/Prog. Q4	Prog. 2003	Proj. 2004
(In millions of pesos)														
Revenue	**76,348**	**79,731**	**19,267**	**19,401**	**20,743**	**21,949**	**81,361**	**89,425**	**23,606**	**23,356**	**26,249**	**29,177**	**102,389**	**129,407**
Taxes	50,774	53,759	13,471	13,906	14,704	15,751	57,832	64,090	16,582	16,519	17,911	20,934	71,946	91,052
VAT and excise taxes	27,409	29,437	7,546	7,044	7,245	7,842	29,677	32,390	9,011	8,852	9,304	10,975	38,141	47,158
On income and profits	12,640	12,719	2,987	3,539	3,876	3,930	14,333	15,672	3,951	3,921	4,368	4,939	17,180	23,762
On foreign trade	1,968	2,428	567	670	688	805	2,730	4,556	1,063	910	1,021	1,228	4,221	5,143
On property and other	8,757	9,176	2,371	2,652	2,895	3,174	11,092	11,472	2,557	2,836	3,218	3,792	12,404	14,989
Social security contributions 2/	14,879	13,623	3,329	3,289	2,977	2,647	12,242	12,726	3,195	3,160	3,661	3,493	13,509	18,614
Nontax revenue	5,849	5,122	1,053	1,148	1,209	1,864	5,274	5,243	1,387	1,638	2,124	1,821	6,970	8,471
Current surplus of public enterprises	4,845	7,227	1,413	1,059	1,853	1,688	6,012	7,366	2,443	2,038	2,553	2,929	9,964	11,270
Noninterest expenditure	**79,964**	**82,781**	**20,298**	**19,702**	**19,405**	**21,072**	**80,477**	**85,308**	**21,435**	**21,727**	**22,949**	**25,537**	**91,648**	**116,084**
Current 3/	71,534	73,698	18,009	18,183	18,442	19,430	74,064	76,824	18,788	19,611	20,341	22,634	81,374	103,309
Wages	17,221	18,074	4,431	4,250	4,670	4,807	18,158	18,439	4,662	5,245	4,699	5,507	20,114	26,155
Goods and services	11,260	12,833	3,051	2,680	2,977	3,349	12,057	13,001	2,565	2,782	3,632	4,052	13,031	17,716
Social security benefits	40,992	41,148	10,492	10,415	10,562	10,622	42,091	41,561	10,887	10,936	11,430	12,183	45,436	53,625
Other	2,061	1,642	36	838	232	651	1,757	3,823	674	647	581	892	2,794	5,812
Capital (Government and enterprises)	8,430	9,083	2,289	1,519	963	1,642	6,413	8,484	2,647	2,117	2,608	2,902	10,274	12,775
Primary balance	**-3,616**	**-3,050**	**-1,031**	**-301**	**1,338**	**877**	**884**	**4,117**	**2,171**	**1,629**	**3,300**	**3,640**	**10,740**	**13,323**
Interest	6,308	7,276	1,937	1,712	5,398	3,116	12,163	15,016	5,552	4,486	6,116	5,066	21,220	23,707
Overall balance	**-9,924**	**-10,326**	**-2,969**	**-2,013**	**-4,060**	**-2,238**	**-11,280**	**-10,900**	**-3,381**	**-2,857**	**-2,816**	**-1,426**	**-10,480**	**-10,384**
(In percent of GDP)														
Revenue	**31.4**	**32.1**	**32.1**	**31.2**	**31.8**	**29.3**	**31.0**	**29.9**	**31.6**	**29.5**	**31.4**	**29.3**	**30.4**	**31.5**
Taxes	20.9	21.6	22.5	22.3	22.6	21.0	22.1	21.5	22.2	20.9	21.5	21.0	21.3	22.2
VAT and excise taxes	11.3	11.8	12.6	11.3	11.1	10.5	11.3	10.8	12.1	11.2	11.1	11.0	11.3	11.5
On income and profits	5.2	5.1	5.0	5.7	6.0	5.2	5.5	5.2	5.3	5.0	5.2	5.0	5.1	5.8
On foreign trade	0.8	1.0	0.9	1.1	1.1	1.1	1.0	1.5	1.4	1.2	1.2	1.2	1.3	1.3
On property and other	3.6	3.7	4.0	4.3	4.4	4.2	4.2	3.8	3.4	3.6	3.9	3.8	3.7	3.6
Social security contributions 2/	6.1	5.5	5.6	5.3	4.6	3.5	4.7	4.3	4.3	4.0	4.4	3.5	4.0	4.5
Nontax revenue	2.4	2.1	1.8	1.8	1.9	2.5	2.0	1.8	1.9	2.1	2.5	1.8	2.1	2.1
Current surplus of public enterprises	2.0	2.9	2.4	1.7	2.8	2.3	2.3	2.5	3.3	2.6	3.1	2.9	3.0	2.7
Noninterest expenditure	**32.9**	**33.3**	**33.9**	**31.7**	**29.8**	**28.1**	**30.7**	**28.6**	**28.7**	**27.5**	**27.5**	**25.6**	**27.2**	**28.3**
Current	29.4	29.6	30.0	29.2	28.3	25.9	28.2	25.7	25.2	24.8	24.4	22.7	24.1	25.2
Wages	7.1	7.3	7.4	6.8	7.2	6.4	6.9	6.2	6.2	6.6	5.6	5.5	6.0	6.4
Goods and services	4.6	5.2	5.1	4.3	4.6	4.5	4.6	4.4	3.4	3.5	4.3	4.1	3.9	4.3
Social security benefits 3/	16.9	16.6	17.5	16.7	16.2	14.2	16.1	13.9	14.6	13.8	13.7	12.2	13.5	13.1
Other	0.8	0.7	0.1	1.3	0.4	0.9	0.7	1.3	0.9	0.8	0.7	0.9	0.8	1.4
Capital (Government and enterprises)	3.5	3.7	3.8	2.4	1.5	2.2	2.4	2.8	3.5	2.7	3.1	2.9	3.0	3.1
Primary balance	**-1.5**	**-1.2**	**-1.7**	**-0.5**	**2.1**	**1.2**	**0.3**	**1.4**	**2.9**	**2.1**	**4.0**	**3.6**	**3.2**	**3.2**
Interest	2.6	2.9	3.2	2.8	8.3	4.2	4.6	5.0	7.4	5.7	7.3	5.1	6.3	5.8
Overall balance	**-4.1**	**-4.2**	**-5.0**	**-3.2**	**-6.2**	**-3.0**	**-4.3**	**-3.6**	**-4.5**	**-3.6**	**-3.4**	**-1.4**	**-3.1**	**-2.5**
Memorandum item:														
GDP (millions of pesos)	243,027	248,619	59,942	62,231	65,131	74,888	262,192	298,637	74,703	79,087	83,497	99,750	337,036	410,724

Sources: Ministry of Finance; and Fund staff estimates.

1/ Program figures including extra budgetary operations.
2/ Excludes contributions that are transferred to the private pension funds.
3/ Includes central government transfers to BPS, Caja Militar and Caja Policial.
4/ Preliminary figures suggest that the PC on the cumulative overall balance was missed. This result might be reverted pending submission of the official below-the-line fiscal data.

Table 5. Uruguay: Summary Accounts of the Banking System, 2000-03 1/

			2002				2003			
	Dec-00	Dec-01	Mar.	Jun.	Sept.	Dec.	Mar.	Jun.	Sept.	Dec.
(In millions of pesos)										
I. Central Bank										
Net foreign Assets	27,773	40,358	26,448	4,850	-13,407	-18,702	-36,074	-29,624	-27,295	-23,476
(in millions of U.S. dollars)	2,219	2,733	1,692	262	-497	-686	-1,244	-1,022	-941	-810
Net international reserves	32,897	43,652	29,458	8,567	-6,262	-5,236	-19,117	-12,667	-10,802	-6,982
(in millions of U.S. dollars)	2,629	2,956	1,885	463	-232	-192	-659	-437	-372	-241
Other net foreign assets	-5,124	-3,294	-3,010	-3,717	-7,146	-13,466	-16,957	-16,957	-16,493	-16,493
(in millions of U.S. dollars)	-409	-223	-193	-201	-265	-494	-585	-585	-569	-569
Net domestic assets	-15,624	-27,707	-15,136	6,234	25,193	30,392	46,863	40,866	38,448	36,820
Credit to public sector	-1,013	-3,454	-3,830	2,846	6,219	2,201	7,320	7,320	7,320	7,320
Credit to financial system	-18,177	-27,179	-15,453	-690	2,878	-4,106	-6,952	-7,614	-8,204	-9,159
Credit to the private sector	484	284	295	330	437	439	462	462	462	462
Other	3,082	2,642	3,852	3,749	15,659	31,858	46,032	40,698	38,870	38,197
Monetary liabilities	12,149	12,651	11,312	11,084	11,785	11,690	10,788	11,243	11,153	13,345
Currency issued	9,470	9,449	8,294	8,025	8,790	10,001	9,283	9,882	9,793	11,985
Currency in circulation	7,284	7,095	6,003	5,920	6,285	7,680	6,943	7,530	7,379	9,571
Vault cash	2,186	2,354	2,291	2,106	2,505	2,321	2,340	2,352	2,414	2,414
Private sector deposits	2,678	3,203	3,018	3,059	2,996	1,689	1,505	1,360	1,360	1,360
II. Public and Private Banks 1/										
Net foreign assets	-7,050	-10,313	-5,236	-5,023	1,236	13,741	17,095	19,806	22,238	25,311
(in US$ million)	-563	-698	-335	-271	46	504	589	683	767	873
Net domestic assets	117,853	144,429	135,695	130,972	150,170	151,358	157,261	157,105	156,900	158,375
Credit to the public sector	5,933	10,082	9,789	10,592	8,675	8,323	8,806	8,906	9,006	9,106
Credit to financial system	13,752	25,880	18,096	-298	-6,179	1,186	4,028	4,883	5,660	6,675
Credit to the private sector	124,044	133,636	137,712	148,126	185,855	175,873	182,299	181,187	180,105	180,466
Other	-25,877	-25,169	-29,902	-27,448	-38,182	-34,023	-37,872	-37,872	-37,872	-37,872
Liabilities to private sector	110,803	134,116	130,459	125,949	151,405	165,099	174,356	176,910	179,138	183,687
III. Banking System										
Net foreign assets	20,723	30,045	21,212	-173	-12,172	-4,961	-18,980	-9,818	-5,058	1,836
(in US$ million)	1,656	2,034	1,357	-9	-451	-182	-654	-339	-174	63
Net domestic assets	100,043	114,369	118,268	135,101	172,858	179,429	201,784	195,619	192,934	192,782
Credit to the public sector	4,920	6,628	5,959	13,437	14,893	10,524	16,126	16,226	16,326	16,426
Credit to rest of financial system	-6,611	-3,653	351	-3,094	-5,806	-5,241	-5,264	-5,083	-4,957	-4,898
Credit to the private sector	124,529	133,920	138,007	148,456	186,293	176,312	182,761	181,649	180,567	180,928
Of which: Local currency	42,830	42,037	41,191	39,080	37,396	35,634	35,556	36,490	36,594	37,290
Of which: Foreign currency	81,699	91,883	96,815	109,376	148,897	140,678	147,205	145,159	143,973	143,638
Other	-22,795	-22,526	-26,050	-23,699	-22,523	-2,165	8,160	2,826	998	325
Broad money (M3)	120,766	144,414	139,480	134,928	160,686	174,468	182,804	185,801	187,877	194,618
(Annual percentage change)										
Currency issued	-3.9	-0.2	-0.8	-6.1	7.7	5.8	11.9	23.1	11.4	19.8
Broad money (M2=currency+ peso deposits)	3.5	0.7	-8.8	-17.0	-14.6	11.0	20.5	32.7	34.1	14.9
Broad money (M3=M2 + res. US$ deposits)	10.2	19.6	10.8	0.6	19.3	20.8	31.0	34.7	34.7	35.8
Credit to private sector (const. exch. rate)	0.3	-3.8	-4.5	-9.2	-13.8	-16.6	-17.2	-13.7	-8.5	-2.4
Total deposits held by residents	11.4	21.0	11.5	1.0	20.0	21.5	31.8	38.2	16.9	10.9
Local currency	6.7	1.8	-10.7	-20.9	-20.1	12.1	22.7	36.1	40.3	11.7
Foreign currency and indexed deposits	12.5	25.3	16.3	5.4	27.9	23.1	33.2	38.5	14.0	10.8
Consumer price inflation (e.o.p.)	5.1	3.6	5.1	8.9	23.5	25.9	31.0	32.9	22.9	26.3
Memorandum Items:										
Nonresidents' f/c deposits (US$ million)	5,284	6,608	5,118	3,367	2,453	2,409	2,359	2,359	2,359	2,359
Currency/Deposit ratio	0.35	0.34	0.32	0.34	0.37	0.33	0.30	0.32	0.31	0.36
Exchange rate of presentation	12.5	14.8	15.6	18.5	27.0	27.3	29.0	29.0	29.0	29.0

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

1/ Includes the Bank of the Republic (BROU), the National Mortgage Bank (BHU), private banks and cooperatives. Does not include off-shore banks.

Table 6. Uruguay: Proposed Availability of Purchases 1/

Augmented, extended, and rephased SBA			
SBA (April 2002 to March 2004)	**SDR**	**% quota**	
April 4, 2002	122.6	40.0	Program approval
June 25, 2002	386.1	126.0	First Augmentation approval 1/
August 8, 2002	603.0	196.7	Second Augmentation approval, completion of the first review and observance of end-June 2002 performance criteria. 2/
Mid-March, 2003	218.5	71.3	Completion of the second review and observance of end-December 2002 performance criteria.
May 19, 2003	145.7	47.5	Completion of the third review and observance of end-March 2003 performance criteria.
Aug. 18, 2003	93.2	30.4	Completion of the 4th review and observance of end-June 2003 performance criteria.
Nov. 18, 2003	93.2	30.4	Completion of the 5th review and observance of end-September 2003 performance criteria.
Feb. 20, 2004	93.2	30.4	Completion of the 6th review and observance of end-December 2003 performance criteria.
Mid-May, 2004	93.2	30.4	Completion of the 7th review and observance of end-March 2004 performance criteria.
Mid-Aug., 2004	93.2	30.4	Completion of the 8th review and observance of end-June 2004 performance criteria.
Mid-Nov, 2004	93.2	30.4	Completion of the 9th review and observance of end-September 2004 performance criteria.
Mid-Feb, 2005	93.2	30.4	Completion of the 10th review and observance of end-December 2004 performance criteria.
Total access	2128.4		
Percent of quota	694.4		
Annual access (in percent of quota)	434.0		
Average annual access (in percent)	231.5		

Source: Fund staff estimates.

1/ Of which, SDR128.7 million under the SRF.

2/ Augmentation equals SDR376 million (123 percent of quota) and SDR 257.4 million cancellation (84 percent of quota) of remaining SRF resources (EBS/02/141, Table 11).

Table 7. Uruguay: Projected Payments to the Fund as of February 25, 2003 1/

(In millions of SDRs)

	Overdue	2003	2004	2005	2006	2007	2008
Obligations from existing drawings							
Principal (repurchases)	0.0	57.1	128.7	226.6	566.5	339.9	0.0
Charges and interest 2/	0.0	34.8	46.8	37.0	20.7	5.4	0.9
On Fund credit	0.0	33.9	45.9	36.1	19.8	4.5	0.0
On use of SDRs	0.0	0.9	0.9	0.9	0.9	0.9	0.9
Total obligations	0.0	91.9	175.5	263.6	587.2	345.3	0.9
(percent of quota)	0.0	30.0	57.3	86.0	191.6	112.7	0.3
Obligations from prospective drawings							
Principal (repurchases)	0.0	0.0	0.0	0.0	130.0	345.2	366.6
Charges and interest 2/	0.0	11.8	30.9	44.3	43.1	25.6	11.1
On Fund credit	0.0	11.8	30.9	44.3	43.1	25.6	11.1
On use of SDRs	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total obligations	0.0	11.8	30.9	44.3	173.1	370.8	377.7
(percent of quota)	0.0	3.8	10.1	14.5	56.5	121.0	123.2
Cumulative (existing and prospective)							
Principal (repurchases)	0.0	57.1	128.7	226.6	696.5	685.1	366.6
Charges and interest 2/	0.0	46.6	77.7	81.3	63.8	31.0	12.0
On Fund credit	0.0	45.7	76.8	80.4	62.9	30.1	11.1
On use of SDRs	0.0	0.9	0.9	0.9	0.9	0.9	0.9
Total obligations	0.0	103.7	206.4	307.9	760.3	716.1	378.6
(percent of quota)	0.0	33.8	67.3	100.5	248.1	233.6	123.5
Memorandum Items:							
Purchases		550.6	372.8	93.2	0.0	0.0	0.0
Debt service to the Fund		103.7	206.4	307.9	760.3	716.1	378.6
(percent of exports of goods and services)		4.8	8.8	12.2	27.9	24.4	12.1
XGNFS in millions of US$		2,888.6	3,116.3	3,371.4	3,635.5	3,907.4	4,185.3
Fund credit outstanding							
(end period)		1,683.6	2,056.4	1,923.0	1,226.5	541.4	174.8
(percent of quota)		549.3	670.9	627.4	400.2	176.6	57.0
(percent of GDP)		20.4	22.9	19.4	11.6	4.7	1.4

Sources: Treasurer's Department; and Fund staff estimates and projections.

1/ Assuming all scheduled purchases are made and that repurchases under the SBA and SRF are made on an obligations basis.

2/ Projections are based on current rates of charge, including burden-sharing where applicable, for purchases in the GRA. The current SDR interest rate is assumed for net use of SDRs.

Table 8. Uruguay: Indicators of Capacity to Repay the Fund, 2002-08

Uruguay	2002	2003	2004	2005	2006	2007	2008
Argentina and Turkey	2001	2002	2003	2004	2005	2006	
Uruguay							
Fund repurchases and charges							
In millions of SDRs	50.9	103.7	206.4	307.9	760.3	716.1	378.6
In millions of U.S. dollars	69.9	138.1	275.2	410.9	1,014.4	954.3	504.5
In percent of exports of goods and NFS	2.5	4.8	8.8	12.2	27.9	24.4	12.1
In percent of GDP	0.5	1.3	2.3	3.1	7.2	6.3	3.1
In percent of quota	16.6	33.8	67.3	100.5	248.1	233.6	123.5
In percent of overall external debt service	4.7	9.5	18.2	24.1	44.0	42.0	27.7
In percent of foreign reserves 1/	9.0	9.7	14.9	23.1	71.1	88.4	50.4
Fund credit outstanding (End-period)							
In millions of SDRs	1,318.8	1,683.6	2,056.4	1,923.0	1,226.5	541.4	174.8
In millions of U.S. dollars	1,810.7	2,242.1	2,742.3	2,566.0	1,636.4	721.5	232.9
In percent of exports of goods and NFS	65.9	77.6	88.0	76.1	45.0	18.5	5.6
In percent of GDP	14.0	20.4	22.9	19.4	11.6	4.7	1.4
In percent of quota	430.3	549.3	670.9	627.4	400.2	176.6	57.0
In percent of public sector external debt	21.9	24.1	28.7	28.0	19.1	9.0	3.2
In percent of overall external debt	17.7	20.8	23.9	23.0	15.5	7.3	2.5
In percent of foreign reserves 1/	233.4	157.7	148.1	144.0	114.7	66.8	23.3
Memorandum items (In millions of U.S. dollars unless otherwise noted):							
Exports of goods and NFS	2,747.4	2,888.6	3,116.3	3,371.4	3,635.5	3,907.4	4,185.3
Quota (Millions of SDRs)	306.5	306.5	306.5	306.5	306.5	306.5	306.5
GDP	12,969.2	10,994.2	11,960.3	13,246.9	14,118.9	15,209.4	16,157.8
U.S. dollar per SDR (WEO projection)	1.3730	1.3317	1.3335	1.3344	1.3342	1.3326	1.3326
Public sector external debt	8,285.0	9,287.0	9,604.2	9,359.6	8,888.6	8,377.4	7,790.8
Overall external debt service	1,481.2	1,446.1	1,410.5	1,609.9	2,230.2	2,216.2	1,780.4
Overall external debt	10,256.2	10,758.2	11,546.8	11,322.3	10,866.3	10,340.1	9,738.5
Foreign reserves 1/	775.7	1,422.1	1,852.1	1,781.7	1,427.0	1,080.0	1,001.5
Argentina (As of September 2001)							
Fund repurchases and charges							
In millions of SDRs	1,377.0	4,989.0	3,078.0	2,130.0	4,033.0	4,118.0	...
In millions of U.S. dollars	1,700.0	6,700.0	4,100.0	2,900.0	5,200.0	5,300.0	...
In percent of exports of goods and NFS	5.4	19.4	10.9	7.0	11.7	10.7	...
In percent of GDP	0.6	2.2	1.3	0.9	1.5	1.6	...
In percent of quota	65.0	235.7	145.4	100.6	190.5	194.5	...
In percent of overall external debt service	4.4	19.1	11.6	8.2	14.9	14.5	...
In percent of foreign reserves 1/	6.2	21.1	12.0	7.9	13.1	12.4	...
Fund credit outstanding (End-period)							
In millions of SDRs	12,434.0	13,096.0	11,568.0	9,692.0	6,154.0	2,099.0	...
In millions of U.S. dollars	15,400.0	16,600.0	14,400.0	12,300.0	7,700.0	2,700.0	...
In percent of exports of goods and NFS	48.8	50.9	41.0	31.9	17.9	5.5	...
In percent of GDP	5.5	5.7	4.8	3.9	2.3	0.8	...
In percent of quota	587.3	618.6	546.4	457.8	290.7	99.1	...
In percent of public sector external debt	17.1	17.8	15.6	13.4	8.5	3.1	...
In percent of overall external debt	10.2	10.7	9.1	7.6	4.7	1.6	...
In percent of foreign reserves 1/	56.2	52.4	42.2	33.5	19.4	6.3	...
Turkey (As of May 2001)							
Fund repurchases and charges							
In millions of SDRs	1,263.0	5,166.0	1,539.0	2,205.0	4,522.0	3,256.0	...
In millions of U.S. dollars	1,669.7	6,870.8	2,059.2	2,965.7	6,118.3	4,405.4	...
In percent of exports of goods and NFS	3.0	11.6	3.2	4.3	8.3	5.8	...
In percent of GDP	0.9	3.5	1.0	1.4	2.6	1.8	...
In percent of quota	131.0	536.0	160.0	229.0	469.0	338.0	...
In percent of overall external debt service	2.9	13.1	4.0	...	...	...	...
In percent of foreign reserves 1/	7.7	30.7	8.3	10.6	20.3	13.0	...
Fund credit outstanding (End-period)							
In millions of SDRs	13,636.0	10,194.0	9,241.0	7,573.0	3,421.0	282.0	...
In millions of U.S. dollars	18,026.8	13,558.0	12,364.5	10,185.7	4,628.6	381.5	...
In percent of exports of goods and NFS	32.4	22.8	19.3	14.8	6.3	0.5	...
In percent of GDP	10.2	6.9	6.0	4.7	2.0	0.2	...
In percent of quota	1,415.0	1,058.0	959.0	786.0	355.0	29.0	...
In percent of public sector external debt	23.5	17.8	16.3	13.4	6.3	0.5	...
In percent of overall external debt	15.4	11.6	10.5	...	...	...	...
In percent of foreign reserves 1/	82.9	60.6	49.6	36.3	15.4	1.1	...

Source: Fund staff estimates.

1/ Gross International Reserves.

Table 9. Uruguay: Vulnerability Indicators

	2000	2001	Est. 2002	Proj. 2003	Proj. 2004
(Annual percentage change, unless otherwise indicated)					
Financial sector indicators					
Broad money	10.2	19.6	20.8	35.8	...
Credit to the private sector (const. exch. Rate)	0.3	-3.8	-16.6	-2.4	...
Share of nonperforming loans in total loans (in percent)	16.4	16.9	31.4	...	...
Prime interest rates (percent, average) - domestic loans	20.7	24.7	...	...	...
Prime interest rates, real (percent, average) - domestic loans	14.9	20.4	...	...	...
External Indicators					
Merchandise exports (in U.S. dollars)	4.1	-10.1	-11.4	9.6	9.0
Merchandise imports (in U.S. dollars)	3.9	-12.0	-35.9	0.3	10.0
Merchandise terms of trade	-6.6	-0.7	3.8	-1.3	0.0
REER appreciation (+)	-0.7	-5.4	-4.0	...	...
(In percent of GDP, unless otherwise indicated)					
Current account balance	-2.8	-2.9	1.2	2.3	1.6
Capital and financial account balance	3.8	4.3	-13.2	3.6	2.0
Of which: Net foreign direct investment	1.4	1.7	0.5	1.4	1.7
Portfolio investment (securities etc.)	1.5	3.0	2.3	-2.4	-0.7
Other net inflows (deposits, loans, trade credits, etc.)	1.0	-0.4	-16.1	4.7	1.1
Total external debt including nonresident deposits	72.7	85.5	91.5	112.1	110.4
Of which: Public sector excl. nonresident deposits	30.3	31.2	63.9	84.5	80.3
Foreign currency deposits (nonresidents)	28.4	37.6	12.4	14.2	13.9
In percent of exports GNFS	399.1	487.4	432.0	426.5	423.9
Total external debt excluding nonresident deposits	44.3	47.8	79.1	97.9	96.5
In percent of exports GNFS	243.0	272.8	373.3	372.4	370.5
External interest payments to exports GNFS (in percent)	21.7	24.6	23.9	19.8	19.0
External amortization payments to exports GNFS (in percent)	14.4	18.8	30.0	30.3	26.3
(In millions of U.S. dollars, unless otherwise indicated)					
Central Bank reserve liabilities	150	144	968	1,663	...
Short term foreign assets of the financial sector	7,367	7,695	4,026	4,692	...
Short term foreign liabilities of the financial sector	6,365	7,423	4,297	4,207	...
Gross official reserves	2,779	3,099	776	1,422	1,852
In months of imports GNFS	8.0	10.0	3.7	6.8	8.1
In percent of total debt service	210.2	217.8	52.4	98.3	131.3
In percent of broad money	28.8	31.8	12.1	21.2	...
In percent of base money	365.9	483.0	203.8	343.1	...
In percent of short-term external debt incl. deposits 1/	33.6	31.8	19.7	37.0	46.6
In percent of short-term external debt excl. deposits 1/	108.9	114.7	33.4	62.3	80.1
Financial Market Indicators					
Foreign currency debt rating (Moody's) 2/	Baa3	Baa3	B3	B3	...
Foreign currency debt rating (S&P) 2/	BBB-	BBB-	B-	CCC-	...
Spread of benchmark bonds (basis points, end of period) 3/	326.0	251.0	1,609.0	1,831.0	...
Exchange rate (per U.S. dollar, period average)	12.15	13.3	21.3	...	...

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

1/ By remaining maturity.

2/ For 2003, as of February 25.

3/ For 2000, the data reported are the spread of the 2009 bond and, from 2001 onward, the spread of the 2012 bond. Data for 2003 are at end-February.

URUGUAY-FUND RELATIONS
(As of January 31, 2003)

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

A. Financial Relations

II. **General Resources Account:**

	In millions of SDRs	In percent of Quota
Quota	306.50	100.0
Fund holdings of currency	1,625.31	530.28

III. **SDR Department:**

	In millions of SDRs	Percent of Allocation
Net cumulative allocation	49.98	100.0
Holdings	18.16	36.34

IV. **Outstanding Purchases and Loans:**

	In millions of SDRs	In percent of quota
Stand-by arrangements	1,318.80	430.28

V. **Financial Arrangements:**

Type	Approval Date	Expiration Date	SDR Millions Amount Approved	SDR Millions Amount Drawn
Stand-by	4/01/02	3/31/04	2,128.30	1,111.70
Of which SRF	6/25/02	8/08/02	128.70	128.70
Stand-by	5/31/00	5/31/02	150.00	150.00
Stand-by	3/29/99	3/28/00	70.00	0.00

VI. **Projected Obligations to Fund:** (Obligation Basis) (SDR millions; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	185.80		226.63	566.50	339.88
Charges/interest	43.59	36.91	35.45	20.19	5.02
Total	229.39	36.91	262.08	586.69	344.90

B. Nonfinancial Relations

VII. **Safeguards Assessment:** Under the Fund's safeguards assessment policy, the Central Bank of Uruguay (CBU) is subject to a Safeguards Assessment with respect to the Stand-By Arrangement that was approved on April 1, 2002 and considered for augmentation on June 24, 2002. An assessment of the CBU's external audit mechanism to determine whether the CBU publishes annual financial statements that are independently audited in accordance with internationally accepted standards was completed on October 19, 2000. In June 2002, an on-site safeguards assessment was completed. The assessment identified a further need to improve the external audit mechanism, including providing for an independent audit committee to oversee this process, and to conduct an external audit of the FSBS.

VIII. **Exchange Rate Arrangement**: The currency is the Uruguayan peso (Ur$). The peso was floated on June 20, 2002. On January 31, 2002, buying and selling interbank rates for the U.S. dollar, the intervention currency, were Ur$28.35 and Ur$28.40 respectively. Uruguay's exchange system is mostly free of restrictions on payments and transfers for current international transactions. The reprogramming of time deposits at BROU and BHU gives rise to an exchange restriction under Article VIII, as it prevents nonresidents affected by the reprogramming from transferring abroad proceeds of recent current international transactions.

IX. **Article IV Consultation:** The 2001 Article IV Consultation was concluded by the Executive Board on February 14 (EBS/01/17). Uruguay is on the standard 12-month cycle.

X. **FSAP participation, ROSCs, and OFC Assessments:** The ROSC-module on fiscal transparency was published on March 5, 2000. A ROSC-module on data dissemination practices was published on October 18, 2001. The authorities have requested participation in an OFC assessment for early 2002. The FSAP exercise started in November 2001; its completion has been delayed until the situation stabilizes.

XI. **Technical Assistance:** A STA mission on money and banking statistics took place in March 1999. A multisector STA mission took place in November 1999 which developed an overall action plan for statistics management in Uruguay, including detailed recommendations for bringing Uruguay's data dissemination policies and practices into line with the Fund's SDDS. Technical assistance in the areas of tax and customs administration had been provided by the FAD in 1996. In June 2000 and May 2001, FAD provided technical assistance in the area of quasi-fiscal activities in the public sector. In December 2001, STA provided technical assistance to help Uruguay subscribe to the SDDS. In September 2002, FAD provided technical assistance in the areas of tax policy and revenue administration to prepare a comprehensive tax reform.

XII. **Resident Representative**: Mr. Andreas Bauer

Relations with the World Bank Group

In the past, Bank project lending has been focused on infrastructure and agriculture developments. In addition, in the late 1980s, the Bank began providing support through structural adjustment lending. The first SALs of 1987 and 1989 supported export growth through incentives and tariff reform; strengthening public finances and the social security system; improving public investment programming; and strengthening the banking sector. A stand-alone debt and debt service reduction operation (DDSR) was also approved in 1991.

In the 1990s, the Bank continued to support infrastructure development oriented towards exports of natural resource-based goods (e.g., forestry). In addition, the Bank supported programs in basic education and institutional development of the health sector. An adjustment loan supported reforms that established the multi-pillar social security system.

The Bank's recent lending has continued to support the social sectors and selected infrastructure investment, with a focus on reforming public enterprises and the regulatory system. During 2000, two loans were approved: a Financial Sector Adjustment Loan (FSAL) - that supported actions to strengthen the framework for the functioning of the financial system – and a Water Sector Adaptable Program Loan. In early 2001, a technical assistance loan was approved to help establish a public utility regulatory department. In end-July 2001, the Board approved the Foot and Mouth Disease Emergency Recovery Project, financing livestock vaccinations. In October 2002, the Bank approved a SAL and a SSAL operation. A second SAL and accompanying SSAL focusing on improving public services have been already negotiated and are likely to be presented to the Board for approval in early April 2003.

The last Portfolio Performance Review took place in December 2002. At this time, the portfolio comprised eight investment projects for a total of US$382 million in commitments (of which US$182.9 million are undisbursed) in addition to one SAL and SSAL. The investment projects concentrate primarily in the infrastructure sector, with five out of eight projects totaling an amount of US$293.5 million in commitments (or 76.7 percent of the portfolio). In addition, the portfolio of investment projects comprises two operations in the education sector, and one emergency project in the agriculture sector. The portfolio exhibited a marked fall in disbursements in 2002, indicating growing difficulties in project implementation.

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

	Commitments (Net of Undisbursed Cancellations)	Disbursements	Amount
I. IBRD Operations (as of February 20, 2003)			
Sector			
Agriculture	18.5	12.1	6.4
Central Government and Administration	318.6	212.4	101.3
Telecommunication	6.0	0.4	5.6
Education	70.0	26.4	43.6
Power	147.5	88.5	58.9
Transportation	140.5	95.0	40.5
Water Supply	27.0	2.3	24.7
Total	**728.1**	**437.1**	**281.0**
Total outstanding (due IBRD)			**697.1**

II. IFC Operations (as of January 31, 2003)

	Loans	**Equity**	**Quasi**	**Participation**
Held	32.0	15.0	24.9	1.8
Disbursed	15.3	15.0	24.9	1.8

III. IBRD Loan Transactions (calendar year)

	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Disbursements	40.5	37.0	31.7	38.7	50.4	143.9	66.3	134.2	64.7	233.5
Repayments	49.2	56.2	77.8	69.7	67.9	64.1	63.2	57.9	72.5	75.3
Net Lending	-8.7	-19.2	-46.1	-31.0	-17.5	79.8	3.1	76.3	-7.8	158.2

Sources: World Bank (IBRD data); and IFC (IFC data).

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

The most recent IDB's Country Strategy for Uruguay focuses on the following priority areas for the Bank's action, by providing support to: (i) initiatives that enhance the regional and international competitiveness of domestic output and encourage private investment, where production is based on the country's comparative advantages and the use of modern technology, in order to foster healthy competition and allow for integration with both the regional and international markets; (ii) the further reform of the State, its modernization and improvements in governance, with a view to diminishing the role of the State in the economy; increase its efficiency; rationalize expenditure and target its interventions; and reduce its role in the production of domestic goods and services; and (iii) improving social welfare and increasing equity, particularly to those families and children living in poverty, allowing them to participate in the development process; reforming education and the health sectors, as well as developing social safety nets for families at risk, particularly in the poorest sectors. Support will also continue to be given to ongoing actions in the fields of citizen safety, housing, sanitation and potable water supply.

In 2002, the IDB approved four loans: (i) in the competitiveness strategic area, a Multisector Global Credit Program for US$180 million, providing medium and long term financing for investment by private enterprises; (ii) in the public sector reform area, a loan for Improvement in Municipal Management (IMM), for US$3 million; and (iii) in the welfare and equity, a loan for Infancy, Adolescents and Families at Risk, for US$40 million. In addition, the special operation for Social Protection and Sustainability was approved in August 2002, for US$500 million, thus supporting the financial package provided by the multilateral organizations. The Lending Program for 2003 anticipates a Financial Sector Loan for US$200 million, in support of reforms in the sector, as well as a Development and Management Program for the Municipalities for US$60 million.

Financial Relations with the Inter-American Development Bank
(US$ millions)

I. IDB Active Portfolio[1]
(US$ millions)

Strategic Lending Areas	Approved	Disbursed	Undisbursed
Competitiveness and Regional Integration	665	478	186
Reform of the State and Governance	163	112	50
Social Welfare and Equity[2]	518	240	278
Total	**1,345**	**830**	**515**
Total outstanding debt (due IDB)			**1988**

II. IDB Net Flows of Convertible Currency
(US$ millions)

	1995	1996	1997	1998	1999	2000	2001	2002[3]
Disbursements	67,5	92,2	178,7	150,8	358,5	162,9	214,2	558,6
Repayments	37,4	35,4	45,7	48,3	57,0	59,4	60,7	73,1
Net Loan Flows	**30,1**	**56,8**	**133,0**	**102,5**	**301,5**	**103,5**	**153,5**	**485,5**

Source: Inter-American Development Bank.

1/ As of December 31, 2002
2/ Excludes Program for Social Protection and Sustainability
3/ As of December 31, 2002

Statistical Issues

The statistical database in Uruguay is generally adequate for the assessment and monitoring of macroeconomic policies. The multisector mission of November 10–24,1999 developed an action plan that includes recommendations for bringing Uruguay's data dissemination policies and practices into line with the Fund's Special Data Dissemination Standard (SDDS). The authorities have made significant progress in implementing the mission's recommendations, both with respect to timeliness of dissemination of the SDDS data categories, and in terms of methodological changes to improve data quality. During a recent staff visit to Montevideo (April 5–6, 2001) to present the findings of the data module of the Report on Observance of Standards and Codes (ROSC), the Uruguayan authorities reiterated their commitment to subscribe to the SDDS in the near future. An SDDS mission visited Montevideo (December 5–14, 2001) to assist the authorities in finalizing their work toward subscription to the SDDS. However, Uruguay has not yet subscribed to the SDDS.

1. Real sector

National account statistics have a number of shortcomings, including the use of an outdated benchmark year 1983, limited coverage of the enterprise survey, long publication lags, inadequate information on the informal economy, and incomplete quarterly accounts. The BCU compiles and disseminates annual GDP estimates in current and constant prices by production and expenditure approach, as well as quarterly constant price GDP estimates by production approach. Gross national income, gross disposable income and gross savings are also available annually. The November 1999 multisector mission recommended a range of improvements including the completion of the revision of data and methods that had already been partially carried out, introduction of annually chained volume measures, incorporation of new benchmark survey data, and compilation of quarterly estimates of GDP at current prices.

The authorities do not provide trade price and volume indices for publication in the *IFS*.

Both the consumer and wholesale price indices are reported on a regular and timely basis for publication in the *IFS*. The consumer price index has a base period of March 1997 =100, and the wholesale price index has a base of January 1988=100. The coverage of the CPI is limited to the capital city. No producer price index has been reported for publication in the *IFS*.

2. Government finances

Official data on the central administration, the state enterprises and the social security system are complete and current, but there are problems with the currentness of the data on the local governments; there are also problems with the currentness of the financing and debt data reported for inclusion in the Fund's statistical publications. The multisector mission that visited Uruguay in November 1999 reviewed the sources used for the compilation of central government financing and identified sources of information for local governments. The

mission made recommendations for the compilation of these data and their reporting to STA. The information reported for publication in the Government Finance Statistics Yearbook 2000 (*GFSY 2000)* included, some data on central government financing and on selected aggregates for local governments; however these data were not updated in the *GFSY 2001* publication.

3. Monetary accounts

Two STA money and banking statistics missions visited Montevideo in July 1998 and March 1999. The missions reviewed with the authorities the currentness, coverage, and classification of the monetary accounts for the banking system and developed a unified system for reporting data to the Fund. The multisector mission that visited Uruguay in November 1999 continued previous missions' work on improving the basic source data and the methodology for compiling monetary statistics. The mission developed a database that contains the data needs for publication in *IFS* and for operational uses by WHD.

The Central Bank of Uruguay (CBU) has adopted the new presentation of the monetary accounts for the central bank and a new call report form for the other depository corporations. The multisector mission recommended adopting the new reporting system which is based on these tables. STA has already received a submission of data based on the new reporting system for the central bank.

4. Balance of payments

Balance of payments statements are compiled and published on a quarterly basis. Data are compiled following the recommendations of the Balance of Payments Manual (5th edition). The authorities have made significant progress in implementing the mission recommendations in order to improve the coverage and quality of the balance of payments estimates. The directory of direct investment enterprises have been updated and measures have been introduced to improve the survey on inward investment; quarterly surveys have been introduced in the case of services, and other activities not currently covered; the coverage of reserve assets has been revised to exclude certain assets that are not available to finance balance of payments needs. Uruguay compiles and reports to STA annual data on the international investment position (IIP). The new surveys would also allow for improved coverage of the private sector in the international investment position.

URUGUAY: Core Statistical Indicators

as of February 21, 2003

	Exchange Rates	International Reserves	Reserve/base money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	External Public Debt
Date of latest observation	2/21/03	2/20/03	2/20/03	1/03	6/01	2/21/03	1/03	11/02(X) 12/02 (M)	9/02	12/02	9/02	9/02
Date received	2/21/03	2/21/03	2/21/03	2/21/03	7/25/02	2/21/03	4/02/03	1/03	12/02	1/03	12/02	12/02
Frequency of data	Daily	Daily	Daily	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Frequency of reporting	Daily	Daily	Daily	Monthly	Monthly	Daily	Monthly	Monthly	Quarterly	Monthly	Quarterly	Quarterly
Source of data	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Central Bank	Institute of Statistics	Central Bank	Central Bank	Ministry of Finance	Central Bank	Central Bank
Mode of reporting	E-mail	E-mail	E-mail	E-mail	E-mail	E-mail	Web	Web	E-mail/ Web	E-mail/ Web	E-mail/ Web	Web
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Daily	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly

Montevideo, Uruguay
February 24, 2003

Dear Mr. Köhler

Since the augmentation of the Stand-By Arrangement last August, financial indicators have stabilized. The Government of Uruguay has formulated an economic program to create the conditions for a resumption of economic growth, as described in the attached Memorandum of Economic and Financial Policies for 2003.

In support of these efforts, the Government of Uruguay requests: (i) completion of the delayed second review under the Stand-By Arrangement, and availability of a purchase equivalent to SDR 218.5 million upon completion of the review; (ii) a one-year extension of the current arrangement, through March 31, 2005; and (iii) the rephasing of all remaining purchases under the arrangement, in an amount equivalent to SDR 798.1 million (Table A). We also request that the repurchase expectations arising during the arrangement period be moved to an obligations basis.

Data are not yet available to assess observance of the end-December 2002 performance criteria on the cumulative balance of the combined public sector and the nonfinancial public sector debt. The government accordingly requests waivers of applicability with respect to these two performance criteria. We also request a waiver for the nonobservance of the standard performance criterion on exchange restrictions in connection with the reprogramming of time deposits at BROU and BHU. All other continuous and end-December 2002 performance criteria under the Stand-By Arrangement were observed, as well as all structural performance criteria.

We are confident that the policies set out in the attached Memorandum of Economic and Financial Policies and the continued support of the international financial organizations will provide the needed stability for the sustained resumption of economic growth. Nonetheless, the government stands ready, in consultation with the Fund, to take any additional measures necessary to ensure the success of the program. Reviews under the arrangement in 2003 will be completed by May 31, 2003, August 31, 2003, and November 30, 2003. These reviews will be held in conjunction with financing assurances

reviews, and will assess overall performance under the program and observance of the performance criteria for end-March 2003, end-June 2003 and end-September 2003, respectively.

Sincerely yours,

/s/
Julio de Brun
President
Central Bank of Uruguay

/s/
Alejandro Atchugarry
Minister of Economy and Finance
Republic of Uruguay

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

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

Table A. Phasing under Uruguay Arrangement

(In millions of SDRs)

	Existing Phasing			Proposed Phasing	
	SDR	In percent of Quota		SDR	In percent of Quota
Oct. 20, 2002	145.2	47.4			
Dec. 19, 2002	145.2	47.4			
Feb. 20, 2003	145.2	47.4	Mid-March, 2003	218.5	71.3
May 19, 2003	145.2	47.4	May 19, 2003	145.7	47.5
Aug. 18, 2003	145.2	47.4	Aug. 18, 2003	93.2	30.4
Nov. 18, 2003	145.2	47.4	Nov. 18, 2003	93.2	30.4
Feb. 20, 2004	145.2	47.4	Feb. 20, 2004	93.2	30.4
			Mid-May, 2004	93.2	30.4
			Mid-Aug., 2004	93.2	30.4
			Mid-Nov, 2004	93.2	30.4
			Mid-Feb, 2005	93.2	30.4
Total	1016.6	331.7		1016.6	331.7

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2003

I. MAIN PROGRAM OBJECTIVES

1. Building on the 2002 program, the government has elaborated policies for 2003 aimed at creating the conditions for a resumption of economic growth while keeping inflation under control. The economy is projected to gradually recover during this year, although real GDP is nevertheless projected to fall by 2 percent on a full year basis. The recovery will be led by exports, and the external current account surplus is projected to widen from 1.2 percent of GDP in 2002 to 2.4 percent.

2. The key objectives of the program are to ensure fiscal, monetary, and banking soundness. Its main components are: (a) the 2003 budget, which seeks to achieve a primary surplus of the combined public sector of 3.2 percent of GDP; (b) a monetary program aimed at limiting inflation to about 27 percent by year-end; (c) the deepening of structural measures needed to strengthen the fiscal position over the medium term; (d) to ensure sufficient financing assurances to meet the financing need for 2003; and (e) a comprehensive resolution of the suspended domestic banks.

3. The performance criteria under the program are set out in Table 1 and defined in the attached Technical Memorandum of Understanding. Table 2 presents the prior actions and structural benchmarks under the program. The government will also observe the standard performance criteria against imposing exchange restrictions, multiple currency practices, and import restrictions for balance of payments reasons. There will be three program reviews in 2003, including for financing assurances.

II. FISCAL POLICIES

4. In 2003, the primary surplus of the combined public sector will rise significantly, setting the basis for a sustainable fiscal position over the medium term. Under the current set of policies, the primary surplus will be 3.2 percent of GDP in 2003, to be achieved mainly through expenditure restraint. The primary surplus of the combined public sector is projected to average 3.3 percent of GDP in 2004-05, and to progressively rise to about 4 percent of GDP over the medium term. Over time, improvements in the revenue base will help underpin the primary surplus target.

5. Regarding expenditure policy, the nominal growth of non-interest expenditure will be limited to 14 percent in 2003. The nominal increase in discretionary spending, including wages and pensions, will be restrained to ensure achievement of the program's objectives. If, however, tax revenue were to be higher than envisaged under the program, consideration will be given to higher increases in discretionary spending, provided there is compliance with the program objectives. In addition, any cash or in-kind salary advances will be avoided. The main elements of the fiscal framework for 2003 are as follows:

Consolidated Public Sector Summary Accounts 1/
(in Ur$ billion)

	2002	Q1	Q2	Q3	Q4	2003
Revenue	72.8	21.7	21.3	24.1	26.6	93.8
Non-Interest Expenditure	72.3	19.6	19.8	20.9	23.1	83.3
Of which: Wages	14.7	3.8	4.2	3.7	4.4	16.1
Social security benefits 2/	42.1	10.9	10.9	11.4	12.2	45.4
Primary Balance	0.5	2.1	1.6	3.2	3.6	10.5

1/ As defined in the Technical Memorandum of Understanding, excluding local governments.
2/ Includes pensions and other social security benefits from the BPS and the police and military pension funds.

Expenditure savings equivalent to 0.2 percent of GDP will be achieved under the newly established program for centralization of public sector procurement of medical supplies and food. Social expenditure will be protected and, following significant reductions in recent years, capital expenditure is programmed to recover somewhat in 2003.

6. Revenue of the consolidated public sector is projected to remain at about 30 percent of GDP in 2003. This performance will be supported by: (i) the full-year effect of the tax measures adopted in May 2002; (ii) an increase of the current surplus of public enterprises by 0.7 percent of GDP led by expenditure restraint and adjustments in public tariffs to reflect operating costs; and (iii) a reform of the tax refund scheme for exporters. The government also intends to significantly strengthen tax administration and combat evasion through improved data exchange between collection agencies, the designation of agents of retention for the VAT in activities prone to evasion, and renewed efforts to combat informal commerce and smuggling. The government will not grant new ad hoc tax exemptions to specific sectors of the economy and will develop a framework for reviewing and streamlining existing ones.

7. The government will advance tax reform, designed to increase efficiency, facilitate tax administration, and enhance revenue collections over the medium term. The main objectives of the reform are to: (i) broaden the VAT base; (ii) eliminate several low-yielding taxes by incorporating them under the umbrella of the main excise-type tax; (iii) unify and consolidate existing income tax schedules, which will ensure comparable treatment for all sectors, and expand the taxpayer base; and (iv) rationalize and simplify the tax system. During the first half of the year, the government will seek to build the political consensus needed for reforms that will support the improvement in the primary surplus projected over the medium term. To that effect, the government will, with the support of technical assistance from the Fund's Fiscal Affairs Department, work on a revised draft law that will be submitted to congress by end-June for approval by end-December 2003. The government will also seek congressional approval of the reforms of the pension funds for the police and the military by end-July and end-September 2003, respectively.

III. The Banking System

8. The government is committed to taking all steps needed to enhance confidence in the domestic banking system. In December 2002, congress approved a banking law aimed at facilitating the restructuring of the four banks suspended last August, broadening the powers of the central bank in the area of bank resolution, and extending the coverage of prudential regulations to include state-owned banks. The government will work in close consultation with the Fund's staff to ensure that any new steps taken toward the resolution of suspended banks are consistent with a further strengthening of the banking system (Table 3).

9. In the coming months, emphasis will be placed on the resolution of the four banks suspended in August 2002 and the reform of the mortgage bank BHU.

- A working plan for the resolution of the four banks is being prepared in close collaboration with Fund staff, to be finalized by end-February 2003. Under this plan, any restructured bank will have to be viable, possess a sound business plan, meet all prudential norms, and demonstrate that it does not pose potential risks to the rest of the banking system or to public finances. This is a structural performance criterion under the program.

- The reform of the BHU, which is part of the World Bank SAL I operation, will be accelerated. Following congressional approval of its new charter in December 2002, BHU has been transformed into a non-bank institution. Foreign currency deposits have been transferred to the public bank BROU and the government will ensure that sufficient resources are made available to cover the liabilities transferred. The government is working on the business plan of the BHU with a view to reducing its operating costs, improving asset recovery, and completing a comprehensive audit of the bank's portfolio.

10. The government will continue to use the resources of the Fund for the Stabilization of the Banking System (FSBS) for the purpose of providing backing for the sight and savings deposits of domestic banks, as originally envisaged. The government will continue to invest the funds not yet disbursed in highly liquid and secure international assets. The recommendations of the on-site Safeguards Assessment completed by the Fund in 2002 are being implemented. In particular, the government is committed to conducting an external audit of the FSBS before September 30, 2003.

IV. Exchange Rate and Monetary Policies

11. The government is committed to a floating exchange rate policy with only minimum intervention in the foreign exchange market. Consistent with this approach, in late 2002, the central bank introduced a new framework for the conduct of monetary policy, under which monetary base developments are used to anchor inflation expectations. The monetary program for 2003 seeks to limit inflation to about 27 percent, consistent with a 19 percent

expansion in base money during the year. Pre-announced monthly targets are being set to keep base money growth in line with the desired medium-term path, while short-term monetary instruments are being used to minimize intra-month volatility. The NDA and NIR performance criteria of the program are presented in Table 1.

12. The central bank will introduce new instruments of monetary management. It recently initiated weekly auctions of inflation-indexed six-month Treasury bills, in addition to the daily auctions of short-term peso bills with maturities ranging from one week to two months. The Central Bank is committed to broadening further the range of instruments of liquidity management, including the possible issuance of its own certificates of deposit.

13. The government is committed to avoid introducing schemes aimed at providing debt relief to specific sectors of the economy. In January, a facility was launched to ease debt repayments for small debtors in the agricultural sector, through partial debt relief by the public bank BROU. The scope of this facility is limited and it will be implemented with strict control to avoid quasi-fiscal implications and moral hazard problems.

V. Policies for Fostering Growth and Protecting Vulnerable Groups

14. In recent months, the government took further steps to establish an improved regulatory framework and to open competition in activities previously reserved exclusively to the state. In this context, a multisectoral regulatory unit for energy and water services was created; regulations for the transmission, distribution, and wholesale of electricity issued; and the maintenance of the public railroad separated from the public rail transport company. In addition, authorization was obtained from Congress to divest the remaining stake in the national airline PLUNA; sell the public holding company of a large road infrastructure concession; issue concessions in the mining sector; and auction the concession for the operations at the international airport of Montevideo in the first half of 2003. These reforms are being supported under a new World Bank adjustment loan of US$250 million that was negotiated in December 2002 and is scheduled to be presented to the Board shortly. The government will continue to promote the IDB-supported credit facility that has been helping to restore bank credit to the export sector.

15. The government has taken concrete steps to mitigate the adverse impact of the recession on vulnerable groups. Priority social programs in education, health and social protection have been shielded from expenditure cuts in 2002 and in the 2003 budget under both World Bank and IDB Adjustment Programs. Protected programs include: (i) family support; (ii) the school feeding program; (iii) the national supplementary food program; and (iv) the primary education quality improvement program. Targeting of social programs is being improved, by integrating databases of beneficiaries of different agencies, cross-checking benefit duplications, and reducing cross-subsidies through the public health system.

VI. Financing Assurances

16. The government is working on the financing assurances for the 2003 program. It is confident that steadfast implementation of its structural reform program will enable disbursements from the World Bank and the Inter-American Development Bank in a total amount of US$655 million in 2003, including US$575 million under program loans (US$250 million from the World Bank and US$325 million from the IDB). Disbursements from bilateral creditors are projected to amount to US$50 million. The government will finalize and provide adequate financing assurances prior to Board discussion of the program.

Table 1. Uruguay: Performance Criteria and Indicative Targets Under the 2003 Economic Program 1/

	2002 Base	Mar-03	Jun-03	Sep-03 2/	Dec-03 2/
A. Quantitative Performance Criteria					
(In millions of Uruguayan pesos)					
1. Combined public sector primary balance (cumulative floor) 3/ 4/		2,170	3,800	7,100	10,740
2. Combined public sector overall balance (cumulative floor) 2/ 3/ 4/ 5/		-3,385	-6,240	-9,055	-10,480
3. Change in the net domestic assets of the BCU (ceiling) 3/ 6/		14,000	9,000	7,600	6,600
4. Change in monetary base (ceiling) 2/ 7/		165	790	1,175	2,325
(In millions of U.S. dollars)					
5. Net international reserves of the BCU (-decrease) 3/ 6/		-490	-290	-245	-130
(Stock of debt at the end of the period; in millions of U.S. dollars)					
6. Nonfinancial public sector gross debt (ceiling) 4/ 8/	8,820	8,915	9,010	9,055	9,055
B. Structural Performance Criteria					
1. Presentation to Congress of revised tax reform legislation that meets the objectives specified in paragraph 7.					30-Jun
2. No banks will be opened or reopened unless they are viable and meet all prudential norms.					Continuous

1/ As defined in the Technical Memorandum of Understanding.

2/ Indicative target.

3/ Cumulative change from end-December 2002.

4/ Adjusted upwards/downwards for changes in social security contributions, as defined in the TMU.

5/ Adjusted upwards/downwards for changes in interest payments, as defined in the TMU.

6/ Adjusted upwards/downwards for changes in program disbursements from the World Bank and IDB, as defined in the TMU.

7/ Cumulative change from December 2002 average.

8/ All maturities. The 2002 base includes US$294 million of unsecuritized debt arising from an agreement between the Ministry of Finance and BROU.

Table 2. Uruguay: Prior Actions and Structural Benchmarks under the 2003 Economic Program

A. Prior Actions	
1. Obtain and present to staff evidence of adequate financing assurances to meet financing needs for the 2003 program	
B. Structural benchmarks	
1. Issuance of decree or regulations to foster competition in the telecommunications sector	March 31
2. Publication of monthly bank balance sheet data with a two-month lag	Continuous 1/
3. Prepare a strategy document for disposal of remaining assets of suspended banks	March 31
4. Approval by Congress of the reform of the pension funds for the police	July 31
5. Approval by Congress of the reform of the pension funds for the military	September 30
6. Completion of the external audit of the FSBS	September 30
7. Presentation to Congress of the reform of the pension system for bank employees	December 31
8. Issuance of decree or regulations to foster competition in the oil sector	December 31

1/ Beginning with data for March 31.

Table 3. Principles of Effective Bank Restructuring

1. To engender confidence, a newly created or recapitalized bank will present a clean balance sheet and adequate provisions. Specifically, any new bank should not be exposed to nonperforming loans, unless such loans are backed by a put option. The government will take appropriate and timely measures to facilitate the distribution of the certificates of deposit related to the put option.

2. As a normal supervisory practice, the capital of any new or recapitalized bank would be above the minimum prudential requirement.

3. The business plan for the banks should satisfactorily demonstrate viability. In addition, viability under conservative assumptions needs to be assured, as reflected in the levels of its cash flows and the adequacy of earnings.

4. The bank should have sufficient liquidity to assure that, under conservative assumptions, it can meet its obligations to depositors and other creditors. This may involve a reprogramming of deposits and/or conversion of deposits into equity.

5. Given the current fragile environment, application of a 100-percent reserve requirement during the first year on new U.S. dollar sight deposits of the bank will foster confidence.

6. To promote good governance, the Board of Directors, except for the CEO, should not have any line responsibilities and should be of sufficient size to provide independent monitoring. In addition, the external audit of the bank should be undertaken by an internationally recognized firm.

7. Consistent with BCU prudential regulations, management and shareholders of any restructured bank will be subject to a "fit and proper" evaluation consistent with international practice. Similarly, prudential measures related to connected lending will be applied where appropriate.

8. A concrete plan is needed to deal with nonperforming loans and other assets not purchased or retained by the bank. This is critical for maintaining creditor discipline and repayment culture.

URUGUAY – TECHNICAL MEMORANDUM OF UNDERSTANDING

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

17. **Cumulative Primary Balance of the Combined Public Sector.** The Combined Public Sector comprises the Central Administration (including as defined in "Article 220" of the Constitution, *Salto Grande*, and the funds managed directly in the ministries (*Fondos de Libre Disponibilidad*), the social security system (*Banco de Prevision Social*), the local governments (*Intendencias*), the public enterprises (ANCAP, ANTEL, UTE, OSE, AFE, ANP, INC, and ANCO), and the quasi-fiscal balance of the Central Bank (BCU).

- The public sector primary balance, excluding valuation adjustments, will be calculated as the overall balance measured from below the line *minus* interest payments measured from above the line.

- The below the line overall balance will be measured on the basis of information provided by the BCU on: (a) the change in the nonfinancial public sector debt (defined below), including all short term debt, in foreign currency and pesos; (b) change in net bank credit to the nonfinancial public sector in foreign currency and pesos; (c) other nonbank financing including privatization; and (d) the quasi-fiscal balance of the BCU (defined below).

- The limit on the primary balance of the combined public sector will be adjusted *downward* (*upward*), i.e., the limit on the surplus would narrow (widen), by the amount that the actual social security contributions to the private pension system exceeds (falls short of) the projected amounts in the program, specified in Schedule A.

Schedule A
(in millions of Uruguayan pesos)

	Mar-03	Jun-03	Sep-03	Dec-03
Projected Social security contributions 1/	704	1,386	2,160	2,868

1/ Cumulative basis

18. **Cumulative Balance of the Combined Public Sector (indicative target).** The combined public sector balance is calculated as the sum of the primary balance of the combined public sector described in 1 and interest payments. The limit on the balance of the combined public sector will be adjusted *downward* (*upward*), i.e., the limit on the deficit would widen (narrow), by the amount that the interest payments exceed (fall short of) the projected amounts in the program, specified in Schedule B for end-March, end-June, and end-September. The limit on the balance of the combined public sector will be adjusted

upward, i.e., the limit on the deficit would be narrowed, by the amount that the interest payments fall short of the projected amounts in the program at end-December.

Schedule B
(in millions of Uruguayan pesos)

	Mar-03	Jun-03	Sep-03	Dec-03
Projected interest payments 1/	5,552	10,038	16,154	21,220

1/ Cumulative basis

19. **The quasi-fiscal 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.

20. **Cumulative changes in net domestic assets (NDA) of the BCU** is defined as the difference between end-of-period monetary base and net international reserves (NIR) of the BCU as defined in 5 and 6 below. The flow of NIR will be valued at the accounting exchange rate of Ur$ 29 pesos per US$. The limit on the change in the NDA will be adjusted by the difference between actual program loan disbursements by the World Bank and IDB and scheduled loan disbursements as reflected in Schedule C:

- The NDA ceiling at end-June will be adjusted *upward* in the event of shortfalls compared with projected program loan disbursements, up to a limit of US$75 million.

- The NDA ceiling will be adjusted *downward* in the event of excesses over projected program loan disbursements by their full amount.

Schedule C
(in millions of U.S. dollars)

	Mar-03	Jun-03	Sep-03	Dec-03
Total Program disbursements 1/	**0**	**285**	**460**	**575**
World Bank	0	125	200	250
IDB	0	160	260	325

1/ Cumulative basis

21. **Monetary base** is defined as the sum of (1) currency issue; (2) nonremunerated and remunerated peso sight deposits of BROU, BHU, private banks, and other institutions defined below at the BCU; and (3) call 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, off-shore institutions (IFEs), insurance companies, exchange houses, stock brokers, and the nonfinancial private sector. The monetary base excludes central government 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.

22. **Cumulative changes in 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 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.

- Excluded from gross international reserves are all foreign currency claims arising from off-balance sheet transactions (such as derivatives instruments), claims on residents, 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.

- Also excluded from gross international reserves are foreign exchange assets in the escrow account at the BCU created to provide backing to sight and savings deposits at the public banks and the closed domestic banks (the escrow account at the BCU). Funds not used to support banks will be invested in highly liquid and secure international assets to be reported daily to the International Monetary Fund and will be subject to periodic special audits.

- BCU reserve liabilities include all foreign currency-denominated liabilities of the BCU with original maturity of one year or less to residents and nonresidents, the use of Fund resources, any net position on foreign exchange derivatives with either residents or nonresidents undertaken directly by the BCU or by other financial institutions on behalf of the BCU.

- For the purpose of the NIR calculation, (a) the gold holdings of the BCU will be valued at the accounting rate of US$42 per troy ounce; (b) liabilities to the IMF will be valued at US$/SDR rate of December 31, 2002; (c) gains or losses from gold swaps and other operations will be excluded; and (d) 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 31, 2002.

23. **The NIR floor will be adjusted** by the difference between actual program loan disbursements by the World Bank and IDB, and scheduled loan disbursements by the World Bank and IDB as reflected in Schedule C, in the following manner:

- The NIR floor at end-June will be adjusted *downward* in the event of shortfalls compared with projected program loan disbursements, up to a limit of US$75 million.

- The NIR floor will be adjusted *upward* in the event of excesses over projected program loan disbursements by their full amount.

24. **The nonfinancial public sector gross debt** refers to (a) the outstanding stock of gross debt in domestic and foreign currency owed or guaranteed by the public sector as defined in (1) above excluding the BCU[1]. Debt in the form of leases will be calculated as the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.[2]

25. **The overall nonfinancial public sector debt ceiling will be adjusted *upward* (*downward*) by** (1) the upward (downward) revisions made to the actual nonfinancial public sector gross debt stock at end-2002;[3] (2) the difference between the actual and projected amount of social security contributions that are transferred to private pension funds according to schedule A; (3) the difference between the actual and projected interest payments, specified in Schedule B for end-March, end-June, and end-September; the ceiling will be adjusted *downwards* by the amount that the interest payments fall short of the projected amounts at end-December; (4) the difference between actual and scheduled program disbursements by the World Bank and IDB as reflected in schedule C below; and (5) the overperformance with respect to the targets on the BCU's net international reserves up to a limit of US$250 million.

26. **The data for assessing compliance with the quantitative performance criterion** on net international reserves will be provided by the BCU no later than one week after each

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[1] 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).

[2] The suppliers' contracts of ANTEL with equipment providers Ericsson and NEC, which predate the Fund's consideration of lease contracts for programming purposes, are expensed under goods and services as rental outlays and, therefore, excluded from the definition of nonfinancial public sector gross debt for program purposes.

[3] The debt stock at end-2002 includes US$294 million of unsecuritized debt from an agreement between the Ministry of Finance and BROU.

test date. The data for the assessment of all other quantitative performance criteria and indicative targets will be provided by the BCU no later than two months after each test date.

Montevideo, Uruguay
March 12, 2003

Dear Mr. Köhler

This supplement to our Letter of Intent dated February 24, 2003 is to inform you that the Government of Uruguay is preparing a comprehensive debt exchange program. This operation is an important element of our economic program which is designed to restore sustained economic growth, stable public finances, and a strong external position.

To this end, the Government of Uruguay has filed the relevant securities documentation with the U.S. Securities and Exchange Commission in order to initiate consultations with the private sector creditor community. We intend to launch exchange offers in early April 2003 and expect to complete the debt exchange by early May 2003. The key objectives of the operation are to: (i) provide sufficient cash flow relief in order to fully eliminate any residual financing needs during 2003-05; and (ii) achieve a sustainable debt and debt service profile over the medium term, under the economic assumptions contemplated in the Letter of Intent. We understand that achieving the above-defined key objectives is a condition for the completion of the third review under the stand-by arrangement.

Together with the targeted improvement in the primary surplus close to 4 percent of GDP over the medium term, the debt-to-GDP ratio is projected to decline to a manageable level of less than 55 percent by 2012 under the assumptions contemplated in the program. In turn, the improvement in the profile of the debt service and clear prospects for medium-term debt sustainability should enable a gradual return to market access, strengthen investor confidence, and support a durable recovery of growth.

As noted, we are consulting our private creditor community in designing the details of the exchange. On a preliminary basis, we expect the operation to have the following broad features: (1) the exchange offer will include almost all outstanding government securities denominated in foreign currencies having an original term of more than 12 months; (2) assure, as far as possible, the equal treatment among creditors; (3) the exchange will maintain the original currency of the old bonds and will extend maturities compared with the old bonds; and (4) participation in the exchange will be voluntary. Nevertheless, to ensure the financing of our program and medium-term cash-flow relief, we are aiming for a high level of participation by creditors in the exchange.

While we believe that we will be able to implement this debt exchange, the government stands ready to take, in consultation with the Fund, any additional measures that may be necessary to ensure successful implementation of the program.

Sincerely yours,

/s/
Julio de Brun
President
Central Bank of Uruguay

/s/
Alejandro Atchugarry
Minister of Economy and Finance
Republic of Uruguay

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

INTERNATIONAL MONETARY FUND

URUGUAY

Second Review Under the Stand-By Arrangement, Requests for Modification and Extension of the Arrangement, and Waiver of Nonobservance and Applicability of Performance Criteria, and Exchange System—Supplementary Information

Prepared by the Western Hemisphere Department
(In consultation with other departments)

Approved by Markus Rodlauer and Liam P. Ebrill

March 12, 2003

Contents Page

I. Introduction and Background

1. **Context.** As anticipated in the Staff Report (EBS/03/27, Supplement 1), this supplement provides additional information on the authorities' debt proposal and financing assurances for the 2003 program, and discusses the implications of this proposal for Uruguay's medium-term outlook. A supplementary Letter of Intent covering the debt proposal is attached.

2. **Stand-By Arrangement.** As explained in the main staff report, the current Stand-By Arrangement was approved in March 2002 and augmented on two occasions in June and August 2002. Completion of the second program review, initially contemplated for October 2002, has been delayed, primarily because of insufficient progress in the resolution of suspended banks and in addressing large residual financing needs for 2003 and the medium term. Recent progress on the suspended banks is reported in the Staff Report. The authorities have been working on a debt proposal aimed at eliminating the residual financing needs over the next few years and achieving a sustainable debt profile over the medium term. A consensus seems to be emerging in Uruguay on the need for a debt restructuring and, so far, the political reception to the government's initiative has been supportive.

3. **Performance Criteria.** Staff is still assessing whether the end-December performance criteria on the nonfinancial public sector debt stock and the cumulative public sector overall balance were met. Partial data for the cumulative public sector balance would indicate that the performance criterion may have been exceeded by a small margin and, for this reason, a waiver of nonobservance is needed (for the performance criterion on the public sector debt stock, the authorities have asked for a waiver of applicability).

II. The Debt Proposal

4. **On March 11, 2003 the authorities filed the necessary preliminary securities documentation for a voluntary debt exchange with the U.S. Securities and Exchange Commission.** They plan to start to consult with bondholders shortly, to seek their views on a comprehensive public debt exchange operation. They see this process of consultation as an important element of their cooperative and market-friendly approach. They intend to conduct it over the next three weeks, and to launch the exchange in the first half of April 2003, for completion in the first half of May.[1] A supplement to the registration will be filed at the time the exchange offer is launched, specifying the detailed terms of the new securities which will be offered.

5. **While specific details of the exchange offer will be developed in the consultation process, the basic strategy aims at significantly extending maturities while broadly**

[1] The operation will be conducted by Salomon Smith Barney, after another advisory bank removed itself citing a conflict of interest.

preserving the existing coupon rates on outstanding securities. The focus of the operation is on clarity and simplicity, with a view to maximizing the participation of both institutional and retail investors. Most of Uruguay's market debt was contracted in recent years at relatively low market spreads, when Uruguay enjoyed an investment grade rating.[2] Extending maturities at roughly the existing coupon rates, therefore, offers both cash flow relief and medium-term debt reduction in net present value terms (compared with a scenario in which securities would be refinanced on maturity at the market yields for Uruguayan securities). The main features of the planned exchange are described in Box 1. Within this framework, the features may be amended as part of the consultation process, but the authorities intend to preserve the targeted overall financing benefits and reduction in the debt burden.

Box 1: Preliminary Outline of the Government's Planned Debt Exchange

- **The debt exchange would cover most foreign-currency government securities** (both international-law and domestic-law governed bonds). The total amount of debt that could be exchanged is around US$4 to US$5 billion. Detailed information on Uruguay's market debt is presented in Table 1.

- **The operation would offer to exchange the old securities for a mix of new securities with longer maturities.** The maturity extension would be consistent with an elimination of the financing gaps in 2003-07 and achieving a sustainable debt service profile thereafter.

- **There could also be a small upfront cash payment to investors in bonds with the shortest maturities** (2003 and 2004). Given their cash constraint, the authorities estimate that the total amount of the cash payments would be small in comparison with the amount of outstanding bonds with these maturities.

- **Participation in the exchange would be voluntary,** for both international-law and domestic-law governed bonds. Completion of the international and domestic parts of the exchange would be made contingent on each other to preserve inter-creditor equity.

- **The authorities are developing a variety of features and mechanisms designed to deliver a high investor participation rate.**

6. **The authorities agreed with the staff that achieving a high investor participation rate in the exchange is critical for the viability of the operation.** They expressed confidence that the design of the operation will help them reach a minimum level of 85 percent participation, and are projecting that they will actually achieve 90 percent. The specific terms are still being defined and will be designed, in consultation with bondholders, to enhance investor participation in the new bonds. For example, with respect to the domestic bonds, of which there are at present a large number of small issues, the new domestic bonds would have greater liquidity, as the small old issues would be aggregated into larger new ones.

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[2] Uruguay was investment grade until February 2002.

Figure 1. Uruguay: Debt Service

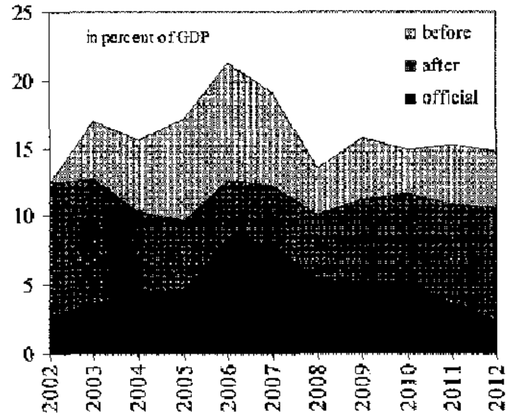
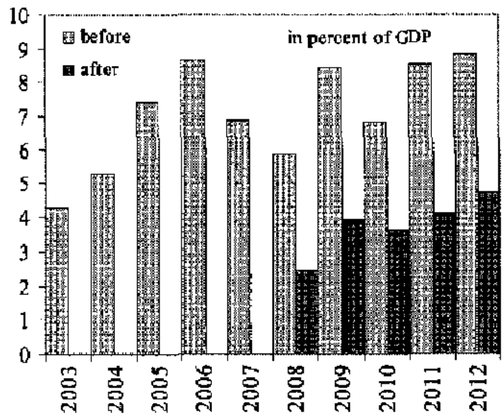


Figure 2. Uruguay: Residual Financing Needs



III. Financing Assurances and Medium-Term Outlook

7. **Assuming a 90 percent participation rate, the debt exchange would eliminate residual financing needs in 2003-07** (Tables 2-4). Before the exchange, the gross market financing needs of the government, after World Bank and IDB disbursements, are estimated at US$720 million in 2003 and at an average of US$1 billion a year in 2004-05. The debt operation would help reduce these financing needs by US$470 million in 2003 and about US$800 million a year on average in 2004-05. The authorities are confident that the remaining needs (US$250 million[3] and US$130 million, respectively) can be financed through the placement of securities in the domestic market.

8. **The medium-term scenario aims at a return to moderate growth.** With a reduced debt burden and sustained improvement in the macroeconomic framework, the economy is projected to recover from the current large output gap during 2004-06 and, subsequently, to grow at a rate of 2½–3 percent, closer to Uruguay's estimated long-run potential. The peso is also projected to recover partially from the recent large real depreciation against the U.S. dollar, but its real value is assumed to settle some 25 percent below its end-2001 level. The external current account should be in surplus over the next five years, although this surplus would gradually narrow as the economy recovers and the real exchange rate strengthens. Gross reserves are targeted to rise significantly over the next few years, from the critically low present levels, to provide some cushion against shocks and for improved coverage of future debt service payments (including to the Fund).

9. **The projections assume continued large primary surpluses as well as multilateral support over the medium term.** As noted in the staff report, the authorities aim to raise the primary surplus of the combined public sector to close to 4 percent of GDP

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[3] Total net placements of short-term securities in the domestic market amounted to US$93 million from January 1, 2003 through March 6, 2003.

over the medium term, which will require sustained expenditure restraint and a further strengthening of the revenue effort. The World Bank and IDB would make gross disbursements totaling around US$500 million a year in 2003-04; after that, disbursements are assumed to gradually fall back to maintain net exposure levels over the next ten years. Given the large repayments to the Fund from 2006 onward, the scenario assumes that, contingent on the normal applicable requirements for Fund support including a satisfactory policy stance, Fund financial support to Uruguay would continue for some time after the end of the current arrangement, albeit on a gradually declining scale.

10. **Under this scenario, and with the debt operation as outlined above, Uruguay's medium-term market financing needs and debt profile appear manageable.** The extension of maturities on Uruguay's market debt at interest rates well below current or projected future market yields strongly improves the debt dynamics, resulting in a significantly lower debt and debt service profile than if the government were financing itself in the market without conducting an exchange (Figures 1 and 2). The debt-to-GDP ratio would fall from 100 percent in 2003 to 58 percent by 2010.

IV. Risks and Program Monitoring

11. **The medium-term projections are subject to significant risks.** In particular, achievement of the targeted fiscal primary surplus will be crucial, as will be the implementation of structural reforms to create the conditions for renewed growth in Uruguay. If the primary surplus were to be at 3 percent of GDP over the medium term instead of the average of close to 4 percent assumed in the baseline scenario, the debt-to-GDP ratio would be close to 70 percent by 2010 (compared with 58 percent in the baseline scenario). If the real exchange rate (measured against the U.S. dollar) were to be some 10 percentage points more depreciated than envisaged in the baseline scenario, the debt-to-GDP ratio would also be about 70 percent by the end of the period.

12. **There are also risks associated with the debt operation.** These risks reflect, in particular, potential problems in implementation, the difficult economic environment which leaves little or no room for maneuver in case of unforeseen developments, and the impact of the operation on the banking system. Taken together, they make for a fragile outlook that can be derailed by any unforeseen shock.

- **Implementation.** The financing of the program and medium-term sustainability hinge critically on the debt exchange achieving the targeted high participation from bondholders. At this stage, there is inevitable uncertainty about the likely participation rate, as the bondholder consultation process is only just beginning. Staff agrees with the authorities that, to achieve a high participation rate, creditors will have to be assured about a viable medium-term outlook and the authorities' commitment to the program. In addition, after consulting with their creditors, the authorities might have to consider including specific terms to increase the attractiveness of the new bonds versus the old bonds, while remaining within the broad framework of the operation.

- **Market financing**. Even with a successful exchange, some (albeit modest) market financing needs would still exist for 2003-05, and these would gradually rise over time (see Figure 1). While staff agrees with the authorities that these needs are manageable, gaps would re-emerge if access to markets is less than expected.

- **Banking system.** As noted in the staff report, the situation in the banking system remains highly fragile, and any shock or slippage in program implementation risks triggering renewed deposit outflows. Although bank holdings of government bonds are relatively low, at less than 5 percent of total assets of banks, the debt operation needs to be managed very carefully. In particular, the authorities should be prepared to implement contingency measures to stem further outflows and loss of reserves, if necessary.

- **Capacity to repay the Fund.** Even if the debt exchange is implemented as anticipated, there will likely be a need for continued Fund support after the end of the current Stand-By Arrangement. If such support does not materialize, presumably because government policies are not adequate, repayments to the Fund would be at significant risk.

13. **Because of the substantial risks, close monitoring of the debt operation and financing assurances is essential.** Attaining the objectives of eliminating residual gaps for 2003-05 and ensuring a sustainable debt and debt service profile over the medium term, as envisaged under the debt operation, will be a condition for completion of the next (third) review under the arrangement. A sensitivity analysis shows that, if participation in the exchange were to be of only 50 percent, financing gaps equivalent to 2½ percent of GDP would remain during the 2003-05 period (Table A). Financing assurances will be reviewed at each of the program reviews.

Table A. Uruguay: Sensitivity of Debt Analysis

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
	(In percent of GDP)											
Total public debt												
No participation	45	83	100	92	83	78	71	67	64	62	60	59
50 percent participation	45	83	100	92	82	77	70	66	62	60	58	56
90 percent participation	45	83	100	92	82	76	69	64	61	58	55	53
***Of which*: market debt**												
No participation	28	45	51	47	43	41	38	39	40	41	42	43
50 percent participation	28	45	51	47	42	40	37	37	38	39	39	40
90 percent participation	28	45	51	47	42	39	36	36	37	37	37	38
Residual financing needs												
No participation	...	...	4.3	5.3	7.4	8.7	6.9	5.9	8.4	6.8	8.5	8.8
50 percent participation	...	...	1.9	2.4	3.3	3.9	3.1	4.0	5.9	5.0	6.1	6.5
90 percent participation	...	...	0.0	0.0	0.0	0.0	0.0	2.4	3.9	3.6	4.1	4.7

Source: Fund staff estimates.

V. Staff Appraisal

14. **In the staff's view, the proposed exchange is a bold and innovative attempt to address Uruguay's financing gaps and debt sustainability through a cooperative approach with existing creditors.** The proposed exchange is designed to be comprehensive, simple, voluntary, and NPV-reducing at market yields and, if successfully implemented, it provides reasonable assurances that the program is fully financed and medium-term debt sustainability can be achieved.

15. **Nevertheless, the debt operation and the associated financing assurances are subject to substantial risks.** There is uncertainty as to how many investors will actually participate in the exchange, partly because there are few previous examples (and none on this scale) of a preemptive debt restructuring that avoids an interruption of payments while asking investors to accept a reduction in net present value terms. This uncertainty is compounded by the wide range of instruments involved in the exchange and the diverse creditor base. The staff therefore urges the authorities to work vigorously toward timely completion of the exchange with a near-universal participation rate, along with steadfast implementation of all other key program elements. Failure to achieve the targeted participation rate would reopen financing gaps and concerns over debt sustainability, and thereby question the viability of the authorities' proposed approach.

16. **Despite those risks, the staff believes that the proposed debt exchange, if fully implemented and in combination with the other program policies, provides reasonable assurances that Uruguay's financing needs under the program can be met in a sustainable manner.** The entire program, including the proposed debt exchange, represents a balanced effort of adjustment and financing, including from official and private creditors. The staff therefore reaffirms its recommendation in the staff report for completion of the second review and approval of the authorities' requests for waivers, extension of the arrangement, and rephasing of purchases. The staff also supports the request for a waiver of nonobservance for the cumulative balance of the combined public sector for end-December 2002.

Table 1: Uruguay. Structure of Public Sector Debt as of end-2002 1/

	U.S. dollar millions		Share of total debt	
Total	10,797			
Market debt	5,804		53.7%	
International bonds		3,255		30.2%
Domestic bonds		1,524		14.1%
Domestic US dollar bills		317		2.9%
Domestic peso bills		109		1.0%
UI-indexed bonds		178		1.7%
Brady bonds		420		3.9%
Multilateral loans	4,493		41.6%	
IMF		1,786		16.5%
World Bank		718		6.7%
IDB		1,948		18.0%
Others		41		0.4%
Bilateral loans	257		2.4%	
Others	244		2.3%	

	U.S. dollar millions	Share of total debt
Currency composition		
U.S. dollars 2/	7,691	71.2%
Euros	443	4.1%
Yen	253	2.3%
Pounds sterling	43	0.4%
Chilean pesos	292	2.7%
Uruguayan pesos	288	2.7%
SDRs	1,786	16.5%
Residence of holder 3/		
Total debt		
Nonresident	6,959	64.5%
Resident	3,838	35.5%
Of which: market debt		
Nonresident	2,022	34.8%
Resident	3,781	65.2%
Interest rate composition		
Fixed	3,703	34.3%
Floating 4/	6,688	61.9%
Inflation-indexed	471	4.4%

Sources: Central Bank of Uruguay and Fund staff estimates.

1/ Includes the central bank but excludes state banks from the definition of "public sector". Excludes deposit liabilities of the public sector.

2/ Assumes that all multilateral loans (apart from IMF), bilateral loans and "other" debt are in US dollars.

3/ Assumes that all domestic securities are held by residents, unless reported as held in custody by domestic custodians for non-residents. Also assumes that one-third of the international securities for which the residence of the owner is not reported are held by residents, and two-thirds by nonresidents. (This differs from the balance of payments classification which makes the stylized assumption that all securities for which the residence of the holder is not reported are held by non-residents. Under the balance of payments classification, residents' share of market debt is 41.4 percent.)

4/ Assumes that all multilateral, bilateral and "other" debt is floating.

Table 2. Uruguay: Nonfinancial Public Sector Cash Flow 1/

(In millions of U.S. dollars)

	2000	2001	2002	2003					2004
			Prel.	Q1	Q2	Q3	Q4	Prog.	Proj.
A. Needs	**1,305**	**2,157**	**1,826**	**617**	**274**	**243**	**233**	**1,367**	**1,091**
Interest payments, nonfinancial public sector	179	531	533	191	135	168	137	632	608
Amortization requirements	1126	1626	1293	426	139	75	96	735	483
Market debt, including commercial loans	831	1376	1057	367	72	13	29	480	236
Official (World Bank, IDB and bilateral creditors)	295	250	236	59	67	62	67	255	247
B. Available financing	**1,871**	**2,336**	**1,825**	**535**	**211**	**133**	**117**	**996**	**684**
Placement of bonds and bills	1,460	1,915	1,088	140	50	18	42	249	184
Official (World Bank, IDB and bilateral creditors) 2/	320	349	103	21	306	196	184	707	316
World Bank	...	...	...	0	125	75	50	251	148
IDB	...	...	...	0	160	100	63	323	168
Other 3/	...	...	...	21	21	21	71	134	0
Other international loans	0	0	190	0	0	0	0	0	0
Other, including net credit from the banking system	91	72	444	361	-154	-90	-117	0	0
Privatization	0	0	0	0	0	0	0	0	30
Asset recovery	0	0	0	13	9	9	9	40	154
C. Primary surplus, NFPS (+)	**-565**	**-179**	**1**	**82**	**63**	**111**	**116**	**371**	**407**
D. Gap (A-B-C)	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Memorandum Items:									
Overall balance, combined public sector	-820	-771	-572	-120	-96	-89	-43	-348	-299
Overall balance of the NFPS	-745	-710	-531	-109	-72	-58	-22	-260	-201
Overall balance of the central bank	-76	-61	-41	-11	-23	-32	-21	-87	-98
Primary surplus, NFPS (in percent of GDP)	-1.3	-0.9	0.5	3.1	2.4	4.2	3.8	3.4	3.4

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

1/ After debt operation.

2/ In 2002, excludes disbursements from World Bank and IDB to the FSBS.

3/ Includes bilateral creditors and project loans by the World Bank and IDB.

Table 3. 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)	-3.1	-11.0	-2.0	4.5	4.0	4.0	3.0	3.0	3.0	2.5	2.5	2.5
Real U.S. dollar exchange rate (change in percent)	-13.8	-26.8	-12.4	4.5	4.5	2.9	2.8	1.3	0.1	0.0	0.0	0.0
Primary balance: Consolidated public sector	**-1.2**	**0.3**	**3.2**	**3.2**	**3.3**	**3.3**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**
Non-financial public sector	-0.9	0.5	3.4	3.4	3.5	3.5	4.0	4.0	4.0	4.0	4.0	4.0
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	**-4.2**	**-4.3**	**-3.1**	**-2.5**	**-1.8**	**-1.7**	**-0.8**	**-0.4**	**-0.3**	**-0.7**	**-0.9**	**-1.1**
Non-financial public sector	-3.9	-4.0	-2.4	-1.7	-1.0	-0.9	0.0	0.4	0.5	0.1	-0.1	-0.3
BCU	-0.3	-0.3	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
						B. Debt Dynamics (In percent of GDP)						
Gross non-financial public sector debt	**45**	**83**	**100**	**92**	**82**	**76**	**69**	**64**	**61**	**58**	**55**	**53**
						C. Cash Flow (in millions of U.S. dollars)						
Gross borrowing needs	**2,092**	**3,443**	**996**	**684**	**523**	**519**	**490**	**670**	**763**	**873**	**1,025**	**1,270**
Public sector deficit	715	532	261	201	136	121	-4	-70	-82	-20	26	67
Amortization	1,377	2,911	736	483	387	399	494	740	845	893	1,000	1,203
Market debt 2/	1,208	2,675	481	236	184	240	308	507	590	638	724	915
IDB/WB and other official debt	169	236	255	247	203	158	186	234	255	255	275	288
Gross Financing	**2,092**	**3,443**	**996**	**684**	**523**	**519**	**490**	**274**	**101**	**231**	**267**	**361**
Market debt	1,035	1,088	249	184	76	120	93	277	296	316	338	363
IDB/WB and other official debt	349	800	707	316	203	158	186	234	255	255	275	288
Other 3/	708	1,555	40	184	244	241	211	-237	-450	-340	-346	-290
Residual financing needs	...	...	**0**	**0**	**0**	**0**	**0**	**396**	**662**	**642**	**759**	**910**
						D. Other Indicators						
Total debt service (in percent of GDP)												
Before debt exchange		12.4	16.9	15.6	17.1	21.3	19.1	13.5	15.7	14.8	15.2	14.7
After debt exchange		14.9	12.7	10.3	9.6	12.6	12.2	10.1	11.1	11.6	10.8	10.6
o.w. official		2.8	3.6	4.4	4.6	8.5	8.0	5.3	5.1	5.1	3.7	2.4
Residual financing needs (in percent of GDP)												
Before debt exchange		...	4.3	5.3	7.4	8.7	6.9	5.9	8.4	6.8	8.5	8.8
After debt exchange		...	0.0	0.0	0.0	0.0	0.0	2.4	3.9	3.6	4.1	4.7
Average interest rate (in percent)		7.2	5.9	5.6	5.5	5.7	5.6	5.5	5.7	6.7	7.5	8.2

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

1/ After debt operation.

2/ Includes commercial bank loans, cash payments to investors and assistance to banks (US$1.6 billion in 2002)

3/ Includes privatization proceeds, asset recovery, and use of reserves minus IMF amortizations.

Table 4. Uruguay: Medium-Term Outlook

	Prel.	Projections					
	2002	2003	2004	2005	2006	2007	2008
1. Ouput and Prices							
(Annual percentage change)							
Real GDP	-11.0	-2.0	4.5	4.0	4.0	3.0	3.0
Real domestic demand	-16.9	-4.0	5.5	4.9	4.7	3.9	3.7
Of which: Consumption	-14.9	-2.0	5.0	3.9	3.8	3.1	3.3
Consumer prices (end-of-period)	25.9	26.3	9.6	9.2	7.5	7.5	5.9
Merchandise export prices	-7.9	1.5	0.0	0.0	0.0	0.0	0.0
Export volume	-3.3	8.0	9.0	9.0	8.5	8.0	7.5
Merchandise import prices	-12.1	1.5	0.0	0.0	0.0	0.0	0.0
Import volume	-26.4	-1.1	10.0	10.0	9.0	9.0	8.0
Merchandise terms of trade	4.8	0.0	0.0	0.0	0.0	0.0	0.0
2. Savings and Investment							
(In percent of GDP)							
Gross domestic investment	**11.1**	**12.1**	**13.9**	**14.4**	**14.2**	**14.2**	**14.1**
Public sector, excluding public enterprises	2.4	3.0	3.1	3.1	3.1	3.1	3.1
Private sector	13.5	13.4	10.8	11.3	10.7	10.8	10.6
Gross national saving	**12.2**	**14.4**	**15.5**	**15.6**	**15.3**	**15.2**	**14.8**
Public sector	-1.9	-0.2	0.5	0.6	2.0	2.6	3.2
Private sector	14.1	14.5	15.0	15.0	13.3	12.6	11.7
Foreign saving	**-1.2**	**-2.3**	**-1.6**	**-1.2**	**-1.1**	**-1.0**	**-0.8**
3. Public Sector Operations							
(In percent of GDP)							
Overall balance	-4.3	-3.1	-2.5	-1.9	-1.8	-0.9	-0.4
Primary balance	0.3	3.2	3.2	3.3	3.3	3.8	3.8
4. Reserve Adequacy							
Gross official reserves							
In millions of US$	776	1422	1852	1782	1427	1080	1001
In months of imports of goods and services	3.7	6.8	8.1	7.1	5.2	3.6	3.1
In percent of short term debt							
excluding nonresident deposits	33.4	62.3	80.1	75.6	59.5	44.9	41.4
including nonresident deposits	19.7	37.0	46.6	42.7	32.4	23.4	20.7

Table 4. Uruguay: Medium-Term Outlook (Concluded)

	Prel.	Projections					
	2002	2003	2004	2005	2006	2007	2008
5. Balance of Payments and Other External Indicators							
(In millions of U.S. dollars)							
Current account balance	**150**	**251**	**188**	**159**	**157**	**148**	**129**
Trade Balance	33	209	209	207	214	206	208
Exports, f.o.b.	1,900	2,082	2,270	2,474	2,684	2,899	3,116
Imports, f.o.b.	1,867	1,873	2,061	2,267	2,471	2,693	2,908
Nonfactor services	225	179	164	146	129	107	86
Exports, f.o.b.	847	806	847	897	951	1,008	1,069
Imports, f.o.b.	623	627	683	751	823	901	983
Factor services (net)	-151	-181	-230	-240	-230	-210	-210
Transfers (net)	43	43	45	45	45	45	45
Financial account	**-1,718**	**396**	**242**	**-229**	**-512**	**-495**	**-208**
Foreign direct investment	70	150	200	200	250	250	250
Portfolio investment	295	-268	-76	-67	-6	-54	-98
Government securities	95	-268	-76	-67	-6	-54	-98
Issues	452	0	36	18	29	22	66
Amortization	357	268	112	85	35	76	165
Banks	201	0	0	0	0	0	0
Other investment	-2,083	514	118	-362	-756	-691	-359
Loans	1,309	764	244	-298	-930	-914	-488
Nonfinancial Public Sector	555	453	69	0	0	0	0
Disbursements	792	707	316	203	158	186	234
Amortization	236	254	247	203	158	186	234
Financial Public Sector	874	678	325	-178	-929	-914	-489
Private Banks	-120	-366	-150	-120	0	0	0
Deposits, net	-975	-134	-113	-75	-95	-61	100
Public Banks	300	-65	0	0	0	0	0
Private Banks	-1,275	-69	-113	-75	-95	-61	100
Other flows, net	-2,417	-116	-13	10	-196	-174	29
Unidentified Financing	0	0	0	0	465	457	0
Errors and omissions	**-754**	**0**	**0**	**0**	**0**	**0**	**0**
Overall balance	**-2,322**	**646**	**430**	**-70**	**-355**	**-347**	**-79**
Reserve Assets (- increase)	**2,322**	**-646**	**-430**	**70**	**355**	**347**	**79**
(In percent of GDP)							
Current account (deficit/surplus)	1.2	2.3	1.6	1.2	1.1	1.0	0.8
Financial account	-13.2	3.6	2.0	-1.7	-3.6	-3.3	-1.3
Total external debt	79.1	97.9	96.5	85.5	77.0	68.0	60.3
(In percent of exports of GNFS)							
Total external debt (excl. nonres. deposits)	373.3	372.4	370.5	335.8	298.9	264.6	232.7
Total external debt (incl. nonres. deposits)	432.0	426.5	423.9	389.6	354.2	321.2	290.3
Debt service	53.9	50.1	45.3	47.8	61.3	56.7	42.5
Of which: interest payments	23.9	19.8	19.0	18.7	17.7	15.9	14.3

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

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Second Review, Extends and Modifies Uruguay's Stand-By Credit Arrangement

The Executive Board of the International Monetary Fund (IMF) has completed the second review under the Stand-By Arrangement with Uruguay, approved a one-year extension through end-March 2005, and rephased projected disbursements over the extension period. Upon completion of the review, a disbursement of SDR 218.5 million (about US$303 million) became immediately available. The Executive Board also approved the authorities' request to shift repayments expectations under the Supplemental Reserve Facility arising in 2003 to an obligations basis, which shifts SDR 128.7 million (about US$178 million) in payments to 2004.

The current Stand-By Arrangement was initially approved on March 25, 2002 in an amount of SDR 594.1 million (about US$823 million) for a 24-month period (see Press Release No. 02/14). The arrangement was augmented by SDR 1.16 billion (about US$1.6 billion) on June 25, 2002 (see News brief No. 02 /54), and by SDR 376 million (about US$521 million) on August 8, 2002 (see News Brief. No. 02/87).

In commenting on the Executive Board decision on March 17, 2003, Eduardo Aninat, Deputy Managing Director and Acting Chairman, stated:

"Since Uruguay was hit by financial crisis and a deep recession last year, the authorities have implemented a series of measures designed to stabilize the economy and create the conditions for sustained recovery. In particular, fiscal and monetary policy have been adjusted and important steps have been taken to restructure the banking system. Although the economy remains in recession, there are signs that it will bottom out this year, and financial indicators have stabilized after the severe strains of last year.

"Nevertheless, the economic and financial situation is still challenging, reflecting, in particular, the high level of public debt, the remaining fragilities in depositor confidence, and the uncertain external environment. To address these vulnerabilities, the government has reinforced its economic program, with focus on the critical areas of fiscal policy, banking reforms, and financing and debt management.

"The fiscal program for 2003 aims at raising the primary surplus to 3.2 percent of GDP, a strong signal of the authorities' commitment to prudent macroeconomic policies. Achieving this target

will require strict control over public sector wages and pensions, while essential social outlays are appropriately being protected. The authorities are committed to raising the primary surplus further to around 4 percent of GDP over the medium term in order to ensure sustainable debt dynamics. Structural fiscal reforms will be critical to this goal, including comprehensive tax reform which is part of the agenda for this year.

"Restoring a viable banking system is key to Uruguay's growth prospects. The resolution of the four banks suspended in mid-2002 is moving into a decisive phase, and the authorities will make sure that any new or reopened bank is viable and complies with all prudential requirements. The authorities are proceeding with the reform of the mortgage bank (BHU), and steps have been taken to strengthen the regulatory powers of the central bank.

"The authorities are preparing a comprehensive and voluntary government debt exchange designed to eliminate residual financing needs during 2003-05 and to achieve a sustainable debt and debt service profile over the medium term. This proposal is welcomed as an appropriate step to address Uruguay's financing needs and debt sustainability in a cooperative approach with creditors. To meet its objectives and assure the financing of the program, the debt exchange will need to be completed on a timely basis and with sufficiently high participation of bondholders.

"The authorities' strengthened program for 2003 represents a strong and balanced effort to create the conditions for the resumption of economic growth that merits the support of the international community," Mr. Aninat said.

Statement by Guillermo Le Fort, Executive Director for Uruguay and David Vogel, Advisor to the Executive Director
March 17, 2003

1. At the outset, on behalf of the Uruguayan authorities we would like to thank staff and management for the continued and thorough support that Uruguay has received from the Fund during very challenging times. This support and our authorities' ownership of the program have allowed the country to overcome a severe banking crisis and undertake some important reforms and policy adjustments. As a result of these cooperative efforts, financial market conditions have stabilized since the last Board review, completed in August 2002, with the sole exception of an episode in early February, when doubts about the continuation of the program led to renewed pressures on the local banking system and, in general, towards the depreciation of Uruguayan assets. Those pressures have been overcome and the situation albeit fragile, is back to normal.

2. The exchange rate has remained stable and the effective depreciation has been much lower than initial projections under the program. Treasury bill yields in local currency have declined from around 150 percent in August 2002 to around 55 percent these days, mirroring a substantial reduction in expectations of inflation and peso depreciation. The country risk spreads have remained stubbornly high, but after having risen to a peak of around 3.000 basis points in July 2002 have declined to around 2000 basis points. Dollar-denominated deposits in local private as well as public banks were flowing back to the system until the end of January of this year when, for a few days, the financial system experienced a new episode of deposit outflows that could be attributed, in part, to anxiety caused by the long negotiations towards reaching an agreement with the Fund.

3. The effect of the crisis on domestic demand and economic activity has been strong, but has bottomed-up and it is beginning to be reversed. The economy has faced a strong adjustment in private consumption, which is estimated to have fallen by 15 percent in 2002 reflecting not only the very deep reduction in income, but also a sharp wealth effect associated to the banking crisis and the depreciation of the peso. It is possible, however, that the wealth effect would end-up being more limited than current perceptions to the extent that the authorities' efforts to address the crisis result in fewer losses to depositors than anticipated. Investment has been reduced sharply as a result of a massive credit crunch, large out-put gap and the prevailing uncertainties, and government expenditure has been sharply reduced as part of the adjustment program.

4. Despite the improved competitiveness resulting from the floating of the peso and the substantial fiscal adjustment, export growth and the recovery of economic activity have been limited by the credit crunch and by the even larger depreciation of currencies of main trading partners in the region. In that vein, the normalization of banking conditions and the gradual intensification of financial intermediation in pesos along with better access to credit by exporters should accelerate the recovery. In addition, the normalization of conditions in the region and the gradual correction of the over-shooting in other currencies should also help to consolidate export growth.

5. Exports are already showing signs of improvements, and in December 2002, for the first time in the year, the value of exports exceeded that of the same month in 2001. It is expected that this trend will be reinforced to the extent the program implementation progresses, helping to dissipate the uncertainties thus softening credit conditions. In addition, significant progress in the diversification of external markets is taking place. While at the end of 1999 –almost a year after the devaluation of the Real that substantially affected Uruguayan exports to Brazil-- the share of exports to the Mercosur was 45 percent of total, Mercosur share in total Uruguayan exports was only 32 percent in 2002. In the same period, the share of exports directed to the European market increased by 6 percentage points, that to the Asian markets by 4 percentage points and to the NAFTA by 2 percentage points. This diversification of exports reflects more than a reduced regional market but the result of efforts to explore and penetrate other market. So far, the increase of exports to Europe has been particularly important. Uruguay's share of exports to NAFTA countries is expected to increase substantially as a result of the recent reopening of the Canadian market for beef and the upcoming reopening of the Mexican and the U.S. markets. Moreover, the possibility of negotiating bilateral or multilateral trade agreements, with the U.S. and other partners, might strengthen the process of export growth and market diversification.

6. The policy response has primarily focused on the containment of the crisis and on the dissipation of the related uncertainties that are undermining the recovery. Thus, policies in the different areas are aiming to return Uruguay to a stable macroeconomic condition and to normalize the financial system while respecting to the extent possible existing contracts and property rights.

7. Although a very significant fiscal adjustment has taken place, including the adoption of two tax packages and containment of nominal expenditures in the face of a transitory pick-up in inflation, the primary fiscal surplus apparently will end-up being marginally lower than envisaged under the program for 2002. Even though noninterest expenditure has fallen significantly, both in nominal terms and as proportion of the GDP, the impact of the deep recession in public sector revenue severely limited the reflection of the adjustment in the fiscal balance.

8. As indicated in Table 4 of the main staff report, tax collections increased as a proportion of GDP in 2002, showing the partial effects of tax measures implemented in the second half of the year. The reduction of public sector revenue relative to GDP

responds to exogenous shocks and not policy slippages. The reduction of social security contributions as a percent of GDP resulted from the higher unemployment rate and lower real wages, while the lower operational surplus of public enterprises resulted from the cost hike related to the rise in international prices of inputs, mainly oil, and the depreciation of the peso.

9. The strength of the fiscal effort is better represented considering the significant shift of the primary fiscal balance during 2002, that jumped from a deficit of 1.1 percent of GDP in the first half of the year, to a surplus estimated at 1.6 percent of GDP in the second half. Encouraged by this progress, the authorities are committed to achieve the targeted primary surplus of 3.2 percent of GDP for this year and continue the adjustment until reaching the medium-term goal of 4 percent of GDP. The tight wage and pension policies that have been announced are strong signals in this regard. So, too, are the tariff adjustments in public enterprises, and the authorities' intention to strengthen the tax reform package with assistance from FAD.

10. Beyond expenditure containment, special provisions have been given to protecting certain socially oriented expenses. The effect of the crisis and the recession on the population at large has been severe, and the effects of the recovery in economic activity may take long to spill over from exports to the rest of the economy. As Box 1 of the main staff report underscores, Uruguay has traditionally enjoyed strong social indicators. In order to preserve these good fundamentals that would help the country to exit from the current circumstances, the government has given priority to a social program in education, health and social protection, focusing on mitigating the negative impact of the recession on the most vulnerable groups.

11. The Central Bank has continued with an active monetary policy through daily auctions of Treasury bills in pesos, whose yields, as we noted, have been declining significantly. Meanwhile, the authorities have initiated weekly auctions of inflation-indexed Treasury bills, introducing a debt denomination that should favor a gradual de-dollarization of the financial system. For now, the authorities are analyzing the introduction of inflation-indexed instruments with longer maturities, though they understand that the main steps in the development of the local capital markets cannot be effectively carried out before the public debt negotiations are not completed. Additionally, the authorities continue to study the appropriate conditions for moving to an inflation-targeting framework to guide monetary policy. The commitments implied by the inflation target regime would certainly contribute to dissipate uncertainties in the financial market, but it represents a major structural change that will require some time to implement.

12. Managing the banking crisis has been very challenging, and from the beginning the Uruguayan authorities have tried to base their working plan on sound pillars. As a recent issue of *The Economist* concludes, Uruguay's democracy is showing exemplary maturity, and the strategy to confront the crisis has counted with strong political support, which, for example, allowed the approval of a banking law in 2002, facilitating the restructuring of the four suspended banks. Moreover, the authorities'

steps were guided by the firm intention to liquidate non-viable institutions, allowing only those with strong capitalization and able to fulfill all the prudential regulations to be reopened. In this regard, the authorities decided definitively to close one of the suspended banks, Banco de Crédito, and to merge the other three suspended banks into a new banking institution that will be government-owned, but it will operate under the legal framework of private banks. After a very rigorous and independent analysis, this institution was found to have viability and sufficient capitalization and not to be a source of risk to the banking system or to the public finances. Furthermore, before re-opening it will have to meet all the prudential norms and regulations, and when market conditions permit will be offered to the private sector.

13. The mortgage public bank (BHU) has been closed and is in process of radical reforms to be transformed into a non-bank housing institution. BHU's deposits have already been transferred to the other public bank, the BROU, and its budget has been dramatically adjusted.

14. The authorities also have based their strategy on the principle of equity and fair treatment, resisting pressures to intervene in contracts among private agents or to establish schemes that provide debt relief to specific sectors which, in the end imply costs for creditors, other debtors and the society in general. The authorities are fully aware that maintaining that behavior is particularly important for the BROU that, in August, should repay the first tranche of reprogrammed deposits. The authorities understand that the fulfillment will provide a strong signal, helping to eliminate those uncertainties leading to perceptions of a larger wealth effect that has contributed to a depressed private consumption.

15. The same basis has been used to make the debt proposal. The Uruguayan authorities are fully aware of the need to address the financing gaps and ensure debt sustainability. At the same time, they believe that debt reprofiling should not be incompatible with the preservation of one of the most important assets that Uruguay has, its long history of protecting and respecting property rights. Therefore, the authorities have announced a voluntary debt exchange, maintaining the same principle of equity and fair treatment. In this regard, the proposal involves domestic and external bondholders and will not change the original currency of the bonds, extending the maturity of existing instruments with the roll-over interest rates of the order of the original coupons, much lower that current market rates.

16. The debt operation will further contribute to debt sustainability and will close the financing gaps for this and the next three years. According to the Staff Report Supplement 2, in the baseline scenario gross public debt as a percent of GDP falls from 100 in 2003 to 67 percent in the next five years and further to 59 percent of GDP in 2012. A good participation in the debt exchange will imply a further reduction of the debt level of around 6 percent of GDP towards the end of the period, but more importantly will provide the remaining financing to the program closing the existing gaps.

17. There are risks associated with the debt operation, mainly a low participation in the exchange. The authorities and their advisors are aware about the free rider behavior, and they have foreseen some contractual aspects to discourage it. It is important to note that some domestic institutional investors have already shown their inclination to participate in the program and the authorities are in a consultation process with external creditors. Even though some local banks hold government bonds, it does not seem a real risk, taking into account that the participation of public sector bonds in their asset portfolios is relatively small and, as some analysts have underscored, the main problem for holders is the uncertainty about future repayment. The implementation of the debt proposal and of the rest of the program should significantly reduce that uncertainty. Furthermore, as the staff report underscores the political reaction to the government's initiative has been supportive.

18. Structural reforms should contribute to sustain growth over the medium-term. Some reforms are already important elements in the program, including the opening-up to competition of activities previously reserved exclusively for the public sector. In addition, the law on economic recovery promulgated last September is allowing the government to issue concessions in the mining sector as well as auction the concession for operations of services including the international airport of Montevideo. Also, the authorities have been taking further steps to encourage investment in public infrastructure through a regime of private concessions. In every case, the law clearly underscores the need to follow a well defined process that demands great transparency.

19. A little more than a year ago, Uruguay lost the investment grade status as a result of a deep crisis ignited by severe exogenous shocks. The crisis was like an earthquake that devastated many areas of the country, but Uruguay counts on very sound pillars that will help the recovery back to sustained growth. Among them, a long lasting democratic tradition and solid institutions, and a well integrated society that facilitate reaching consensus. It is the authorities' commitment to continue implementing the program to address the current situation, based on these pillars and with the invaluable support of the Fund and the international community.