INTERNATIONAL MONETARY FUND

Staff Country Reports

March 2006
IMF Country Report No. 06/123

Uruguay: Second Review under the Stand-By Arrangement, Requests for Modification, Waiver of Nonobservance and Applicability of Performance Criteria, and Extension of Repurchase Expectations in the Credit Tranches—Staff Report; Staff Statement; Press Release of 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, waiver of nonobservance and applicability of performance criteria, and extension of repurchase expectations in the credit tranches, 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, Waiver of Nonobservance and Applicability of Performance Criteria, and Extension of Repurchase Expectations in the Credit Tranches, prepared by a staff team of the IMF, following discussions that ended on December 9, 2005, with the officials of Uruguay on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 28, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of January 18, 2006 updating information on recent developments.

- a Press Release summarizing the views of the Executive Board as expressed during its January 18, 2006 discussion of the staff report that completed the review.

- a statement by the Executive Director for Uruguay.

The documents listed below have been or will be separately released.

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

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

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INTERNATIONAL MONETARY FUND

URUGUAY

Second Review under the Stand-By Arrangement, Requests for Modification, Waiver of Nonobservance and Applicability of Performance Criteria, and Extension of Repurchase Expectations in the Credit Tranches

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

Approved by Markus Rodlauer and Juha Kähkönen

December 28, 2005

Stand-By Arrangement. On June 8, 2005, the Board approved a three-year Stand-By Arrangement (SDR 766.3 million, 250 percent of quota) under the exceptional access policy. The first review was concluded on September 28, 2005. SDR 704.95 million remains to be disbursed and a purchase of SDR 30.7 million will become available upon completion of this (second) review. Outstanding Fund resources as of November 30, 2005 were SDR 1,612 million (526 percent of quota).

Recent economic developments. Leading indicators suggest continued solid growth, in line with the 6 percent target for 2005. Inflation has increased in recent months, although it is still below the central bank's target range. International reserves have strengthened further reflecting significant capital inflows.

The program is on track. All end-September quantitative performance criteria (PCs) were observed and structural reforms are progressing broadly as programmed notwithstanding some minor delays in the timetable (waiver for the PC on pension reform requested). Data to assess end-2005 quantitative PCs will not be available before the Executive Board meeting, but they are expected to be observed (waiver of applicability requested). Staff will update the Executive Board, prior to the discussion, on the submission to congress of financial sector legislation and the adoption of an action plan for BHU (end-2005 structural PCs), and any other relevant developments under the program.

Review issues. Policy discussions centered on the macroeconomic framework and structural reform agenda for 2006. The authorities have requested that repurchase expectations arising during 2006 be moved to an obligation basis.

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

Discussions. Staff teams visited Montevideo during October 25–November 8, November 30–December 1, and December 5–9. They met with Finance Minister Astori, Central Bank President Cancela, and other senior officials. The staff team comprised M. Piñón (Head), J. Canales-Kriljenko, S. Eble, (all WHD), A. Hajdenberg (FAD), H. Finger (PDR), and G. Gelos (Resident Representative). Missions from MFD (S. Seelig and A. Novoa) and FAD (headed by J. Seade and G. Schwartz) overlapped with the visits. M. Rodlauer (WHD), H. Torres and D. Vogel (both OED) participated in some of the policy discussions.

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EXECUTIVE SUMMARY

Background

The program is on track and economic developments have remained favorable. Growth remains robust (around 6 percent in 2005, as programmed), inflation is subdued, and the external position continues to strengthen, with buoyant exports and upward pressure on the peso. Fiscal performance has been better than expected, with public debt continuing to fall as a percentage of GDP. Structural reforms are also progressing well, with key new reform initiatives underway in several areas. While the police pension reform has been delayed somewhat (waiver of nonobservance requested), it is expected to be approved in early 2006. A waiver of applicability has been requested for the end-2005 quantitative PCs for which data will not be available by the time of the Board meeting.

Domestic support of the program remains solid, although it is entering a challenging phase with an ambitious structural reform agenda. While political and social pressures persist, the main thrust of the program remains well understood and supported by a broad domestic consensus. Nevertheless, important challenges still lie ahead, including key tax, financial sector, and pension reforms.

Near-term vulnerabilities have declined, but significant risks remain. Public debt is still high, the financial system remains highly dollarized, and the fiscal program is subject to risks from spending pressures and contingent liabilities in the banking system. The program is designed to contain these risks.

Policy discussions and staff appraisal

The authorities reiterated their commitment to the program's fiscal targets, pointing to the recent approval of the five-year budget. Their plans for tax reform, strengthening revenue administration, and further improvements in debt management are well placed. Staff emphasized the importance of adequate implementation of the planned tax reforms, to ensure achievement of the ambitious revenue targets in the budget. Implementing the long-planned pension reforms is also crucial for fiscal sustainability.

Financial sector reforms continue to progress well. The main elements of planned institutional reforms, including the central bank, supervisory authorities, and bank resolution, are well placed, and the draft action plan for housing bank BHU is appropriate. It will now be important to finalize these plans (staff will update the Board on further progress) and implement them.

Staff supports the authorities' request for extending repurchase expectations for February–December 2006 to an obligation basis. While the external position has improved, payment on an expectation basis would still create undue hardship and risks.

With the program on track, and the authorities' continued strong ownership, the staff recommends completion of the second review.

I. Developments under the Program

1. **The program is on track and economic developments have remained favorable.**

- With GDP growth above 6½ percent through September (y/y,), the programmed 6 percent GDP growth in 2005 is well within reach.

- Inflation has risen from its low earlier this year to 4.8 percent in November (y/y), although it is still below the December 2005 central bank target range of 5½–7½ percent.[1]

- The impact of higher oil prices has been absorbed quite well so far, in part reflecting the relatively low oil intensity of the economy (Box 1).

- The peso has continued to appreciate (by 12 percent vis-à-vis the US dollar this year); nonetheless it is still some 19 percent more depreciated in real effective terms than before the crisis. Exports have remained buoyant, up 17 percent y/y through September.

- External financing conditions have remained favorable, allowing Uruguay to place a new US$200 million global bond in November, which brought total international bond issues in 2005 to above US$1 billion.

- All end-September quantitative performance criteria (PC) were observed and the end-December PCs are likely to be observed.[2] The structural reform agenda has also progressed, with most structural PCs and benchmarks (BMs) observed. However, while the reform of the pension plan of the police was submitted to congress in November, its approval will take somewhat longer than envisaged (end-November PC); it is now envisaged for May 2006.

[1] With average inflation in 2005 substantially lower than programmed, nominal GDP has also been lower.

[2] The authorities are requesting a waiver of applicability for end-2005 quantitative PCs given that final data will not be available before March 2006.

Box 1: Effects of Oil Prices on the Uruguayan Economy

Uruguay is a non-oil-producing country with an oil import bill of some 5 percent of GDP (2004). This relatively low oil dependency is explained by its large hydropower resources.

To date, the sharp increase in international oil prices has been absorbed by the economy without significant disruptions.

- **Inflation has remained subdued, falling below the central bank's target range, despite full pass-through of oil prices.** This is attributable in part to the appreciation of the peso and the relatively small weight of oil products in the consumption basket (3.4 percent).

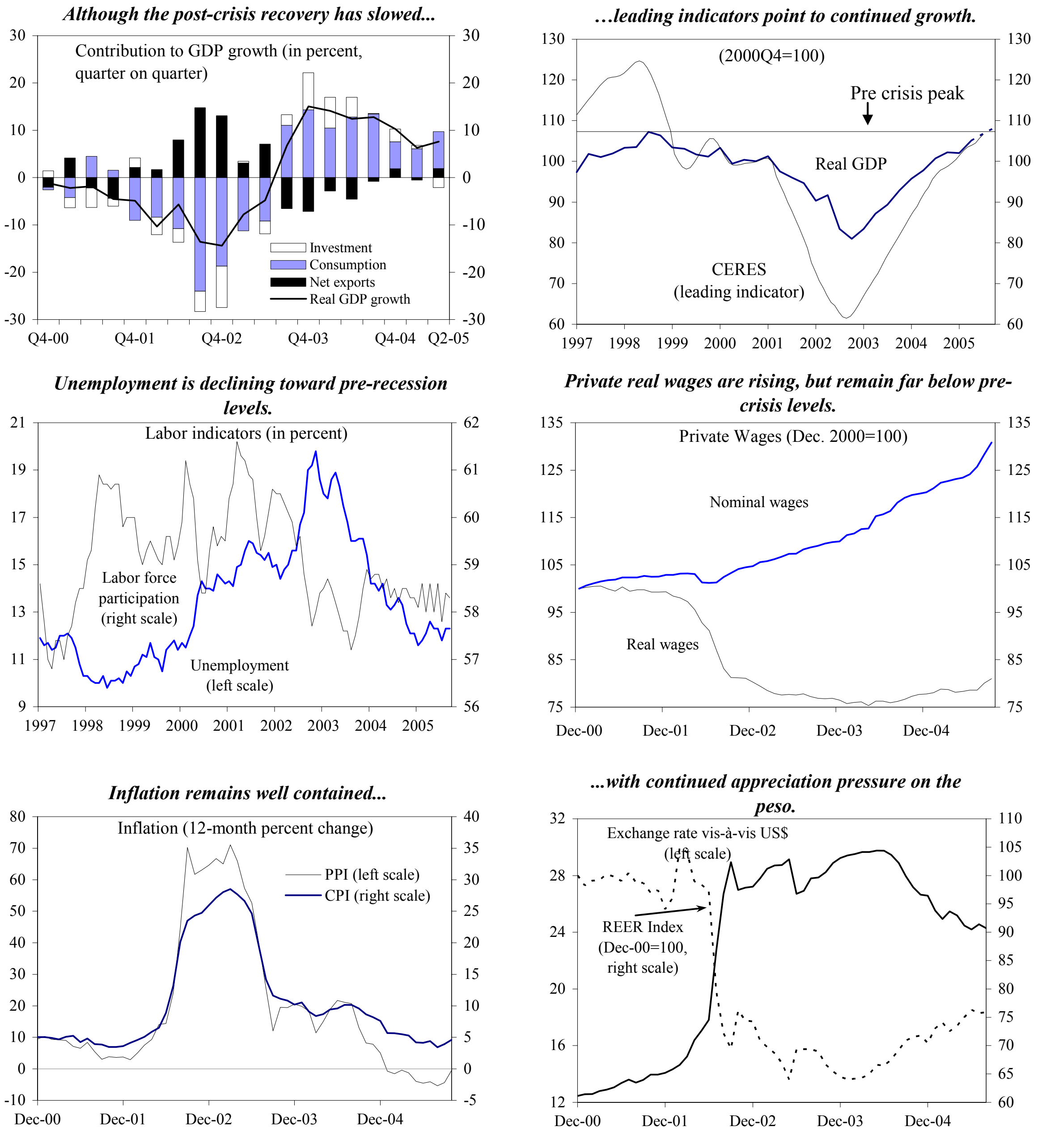
- **The impact on the balance of payments has been mitigated by strength in exports and the capital account.** Exports have been supported by an increase in commodity prices, including beef and rice. In addition, renewed access to international capital markets and continued private capital inflows have resulted in larger-than-programmed accumulation of international reserves.

- **The fiscal impact has been limited, as the bulk of oil taxes are specific and a full pass-through mechanism is in place.** In addition to the specific tax on all oil products, diesel and electricity are taxed at 14 and 23 percent VAT rates, respectively. Prices charged by the state-owned oil company ANCAP and electricity company UTE are periodically adjusted to fully pass on the increase in international oil prices.

Notwithstanding, continued oil price increases could have an impact. In this connection, the authorities:

- Have signed an oil import agreement with Venezuela to finance oil purchases at preferential terms.
- Are committed to continue with full pass-through of international price increases.
- Are planning to expand domestic refinery capacity, possibly through private investment.

Figure 1. Uruguay: Output and Prices



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

2. **Fiscal performance has been better than expected.** Based on preliminary data, the primary surplus of the consolidated public sector was 3.4 percent of GDP in the first 9 months of the year, 0.3 percent of GDP higher than programmed. Revenues were slightly lower than projected in nominal terms, but higher relative to GDP. Tax and social security collections were above program, and while the contribution of public enterprises was weaker in Q1–Q3, it is expected to improve in Q4 after recent gasoline tariff adjustments and lower world oil prices. Spending was lower than programmed, owing to initial delays in implementing the Social Emergency Program and underexecution of capital spending.

3. **Public support for the program remains solid, although social and political pressures persist.** After a near-cabinet crisis in August on the budget, pressures have focused on the effect of peso appreciation on export competitiveness, as well as demands for more government spending and forbearance on the still large amount of domestic debts in distress. The authorities are confident, however, that the core program elements are well understood and supported by a broad domestic consensus.

II. Outlook and Risks

4. **The macro framework for 2006–10 is broadly unchanged from the last review**. Real GDP growth in 2006 remains projected at 4 percent, with large FDI projects in the forestry sector (more than 8 percent of GDP, to be executed over 4 years) expected to contribute to medium-term investment and growth prospects (Box 2). The inflation objective for 2006 remains at 5½ percent, while for subsequent years the authorities now envisage a slightly more gradual disinflation path toward the medium-term objective of 3½ percent.

5. **Near-term vulnerabilities have declined, with growing buffers against shocks.** International reserves have risen to pre-crisis levels and are above program targets, partly reflecting further efforts to prefinance amortization payments coming due in 2006. Favorable external financing conditions have also reduced public debt rollover risks and the debt's average maturity has been further increased.[3]

6. **Although the debt outlook remains a major source of risk, robust growth, a stronger fiscal position, and peso appreciation have resulted in a faster decline of the public debt-to-GDP ratio than envisaged earlier (Appendix I).** Compared with the outlook at the time of the 2002 crisis, the public debt-to-GDP ratio is already below the level envisaged for 2012. The outlook is also better than right after the 2003 debt exchange. Nevertheless, continued high primary surpluses, capital market access, and economic growth are needed to ensure medium-term debt sustainability. Debt-service payments due in the next few years remain large, and a reversal in emerging market sentiment and higher U.S. interest rates could rekindle financing risks. In addition, as noted in the last review, ambitious medium-term revenue targets and spending pressures heighten the vulnerability of the fiscal outlook and put pressure on the program fiscal targets. The highly dollarized financial system

[3] The recently issued global bond has a maturity of 17 years with amortizations in equal installments in its last three years of life.

Box 2: Economic Impact of the Pulp Mill Projects[1]

Uruguay has attracted large-scale foreign projects in the forestry sector, with plans by two international groups (Botnia and ENCE) to have pulp mills fully operational by 2007/08.[2] The projects would increase Uruguayan value added by manufacturing pulp locally, instead of exporting raw materials. The overall investment would amount to over 8 percent of GDP, with a sizeable impact on the economy:

Uruguay: Macroeconomic Impact of the Pulp Mill Projects 1/
(in percent of GDP, unless otherwise stated)

	2005	2006	2007	2008	2009	2010
Real GDP (annual percent change) 2/	0.1	1.0	0.8	2.4	2.6	2.6
Direct	0.1	0.5	0.2	1.6	1.8	1.9
Indirect	0.0	0.4	0.6	0.8	0.8	0.8
Employment (in thousands)	0.9	10.1	3.7	5.7	5.6	5.5
Direct (construction and operations)	0.5	5.3	2.0	0.6	0.6	0.6
Indirect	0.4	4.7	1.7	5.1	5.0	4.9
FDI	0.4	4.6	1.7	1.4	0.0	0.0
External current account	-0.3	-3.8	-0.9	0.1	1.3	1.2
Net exports (operational phase)	0.0	0.0	0.6	1.3	1.3	1.2
Capital imports (construction)	0.3	3.8	1.5	1.1	0.0	0.0

1/ Botnia and ENCE.
2/ Cumulative beginning 2005.

- **Private foreign investment** would increase by over 4½ percent of GDP in 2006 and about 1½ percent of GDP per year in 2007–08.

- **The projects are expected to permanently lift GDP up by some 2½ percent,** mainly as a result of increased value-added from pulp processing.

- **The direct employment impact of the pulp mill factories with some 600 jobs at the production facilities will be small.** However, the projects should have a sizeable indirect employment impact in the forestry sector with the creation of some 5,000 additional jobs (0.4 percent of the labor force).

- **The external current account would widen in the construction phase**, fully financed by FDI. Once operational, the plants would generate additional net export revenues of about 1¼ percent of GDP per year.

- **The direct fiscal impact of the projects would be limited,** as the projects are exempt from most taxation, except social security contributions. However, there would be an indirect effect through the second-round impact of higher domestic demand and the need for infrastructure investment.

[1] Based on economic impact studies prepared by Deloitte &Touche (2004) for ENCE, by Botnia (2004), and IFC Economic Impact Assessment (2005).
[2] A possible third large forestry project has been announced.

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

					Projections				Country Report /05/431			
	2001	2002	2003	2004	2005	2006	2007	2008	2005	2006	2007	2008
Real GDP (percentage change)	-3.4	-11	2.2	12.3	6.0	4.0	3.5	3.0	6.0	4.0	3.5	3.0
CPI (eop, percentage change)	4.4	25.9	10.2	7.6	5.9	5.5	4.9	4.4	6.5	5.5	4.5	3.5
Revenue	33.8	31.1	31.1	30.0	32.0	33.0	33.5	33.6	31.2	31.6	32.3	32.5
Non-interest expenditure	35.0	31.1	28.4	26.3	28.4	29.3	29.5	29.6	27.6	27.9	28.3	28.5
Primary balance	-1.2	0	2.7	3.8	3.6	3.7	4.0	4.0	3.6	3.7	4.0	4.0
Overall fiscal balance	-4.2	-4.6	-3.2	-2.2	-1.2	-1.1	-0.6	-0.5	-1.3	-1.5	-0.9	-0.9
Public sector debt 1/	46	96	104	92	73	68	65	62	73	67	64	61
External current account balance	-2.7	3.2	-0.5	-0.7	-2.4	-5.8	-2.5	-1.6	-2.8	-6.4	-2.8	-1.5
excluding: pulp mill projects 2/					-2.1	-2.1	-1.1	-0.5	-2.5	-2.4	-0.8	0.2
Official reserves (millions of U.S. dollars)	3099	772	2,087	2,512	3,110	3,255	3,418	3,593	2,762	2,977	3,185	3,254
As a % of ST debt + FX deposits	18.0	7.7	20.0	27.7	29.7	28.8	29.5	31.4	27.1	26.7	27.3	27.9

Sources: Uruguayan authorities; and Fund staff estimates.

1/ Includes debt of the nonfinancial public sector and the central bank.
2/ Current account balance excluding imports related to the construction of planned pulp mill projects (Botnia and ENCE).

also needs to be further strengthened; while current projections already incorporate the likely cost of addressing BHU, the banking sector could harbor additional contingent fiscal costs. The program is focused on addressing these risks, through maintaining fiscal discipline, pushing ahead with financial sector reform, and improving the investment climate to promote growth.

III. Policy Discussions

7. The review discussions centered on the financial and structural program for 2006, including a comprehensive tax reform, restructuring the ailing BHU, pension reform and reforms of the central bank, deposit insurance, and the bank resolution framework.

A. Fiscal and Debt Management Policy

8. **The authorities reaffirmed their commitment to the primary surplus targets under the program.** They also noted their continued commitment to use higher-than-programmed revenues toward achieving a 4 percent of GDP primary surplus already in 2006. The 2006–10 budget submitted in August (see Country Report No. 05/431) has been approved by congress without major changes. Nevertheless, compared with the last review, revenue and expenditure projections for 2006 are higher by about 1.4 percent of GDP. On the expenditure side, about 1 percent of GDP reflects the lower nominal GDP, with another 0.2 percent due to higher social security outlays tied to higher contributions.[4] Revenues (as a percentage of GDP) are projected to be higher than previously estimated because of a higher

[4] The remaining 0.2 percent reflects technical adjustment for the (cash) spending projections, based on the (unchanged) appropriations budget.

base[5] and improved revenue administration, and by sustaining improvements in public enterprises' operational results.

9. **Staff expressed concern that the increase in spending relative to GDP would further strain the already ambitious revenue targets.** It reiterated that more conservative revenue and expenditure objectives would have been preferable to safeguard the program's fiscal targets. In addition, it stressed the need to carefully phase in intended tax rate reductions, to avoid possible temporary revenue losses arising from potential difficulties in administering new taxes. The authorities explained that they were taking decisive steps to ensure observance of the 2006 and medium-term fiscal targets. In particular, they pointed to the good progress with tax reform and strengthening revenue administration, which was already yielding a notably increased tax/GDP ratio. Moreover, they reiterated their readiness to adjust nonpriority current and capital expenditure, should revenues be lower than projected. They explained that, in preparation for such a contingency, the budget provides for semi-annual revenue performance assessments and explicitly authorizes executive spending cuts if revenues are lower than budgeted.

10. **The authorities intend to improve the public debt structure further.** Staff welcomed progress in lengthening average maturity, smoothing the amortization profile, and issuing inflation-indexed bonds, and encouraged further efforts to reduce the level of dollarization of public debt. Preparations for the creation of a debt-management unit at the Ministry of Finance by end-December are well advanced (in line with ICM/MFD recommendations), including by allocating resources in the budget and appointing its head. The authorities also submitted to congress draft legislation to strengthen the statutory public debt ceilings, expanding the coverage of debt subject to the ceilings (now including, among other things, debt to multilateral organizations), and applying the ceilings on net rather than gross debt.

11. **The government has announced the broad parameters of the planned tax reform (Box 3).** The reform was presented to the public in early November for consultation, in preparation for submitting the final draft to congress in February 2006. In line with previous discussions with Fund staff (including an FAD technical assistance mission), it would simplify the tax system, reduce distortions, and improve equity. Because the reform is designed to be broadly revenue neutral, based on current projections a gap of about ½ percent of GDP would remain in 2007 and 2008 toward the 4 percent primary surplus target. Measures needed to achieve this target will be discussed in the context of the program for 2007 (in late 2006).

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[5] The tax/GDP ratio in 2005 is projected to be 0.8 percentage points higher than programmed.

Box 3. Proposed Tax Reform

The reform aims at promoting equity and growth, by better distributing the tax burden across the economy through lower rates and reduced exemptions, and simplifying the system. The package, which is estimated to be broadly revenue neutral, is to be finalized and submitted to congress by February 2006, for implementation by June 2006. The announced measures would:

- **Introduce a personal income tax on all domestic sources of income** (increasing revenues by an estimated 1.3 percent of GDP). Labor income would be taxed at rates ranging from 0 to 25 percent with no deductions allowed, but with about 60 percent of the population below the taxable threshold. Capital income would be taxed at 10 percent (excluding government bonds and the return on pension funds), with the exception of interest on peso deposits exceeding 1 year, which would be taxed at 3 percent. Nonresidents' income generated in Uruguay would be taxed at 10 percent, excluding dividend remittances and interest income from public debt. This tax would replace the current tax on wages.
- **Rationalize the corporate income tax** (reducing revenue by 0.2 percent of GDP). Four taxes affecting corporate income in different sectors would be consolidated into a new corporate income tax, with a rate of 25 percent.
- **Reduce the value added tax (VAT) rates and broaden its base** (reducing revenue by 0.6 percent of GDP). The two VAT rates would be reduced from 23 to 21 percent and from 14 to 10 percent, respectively, while eliminating COFIS (a tax that acts as a 3 percent surcharge of the VAT at the wholesale level). The base would expand by incorporating the currently exempt tobacco products, fruits and vegetables, and financial services at the 21-percent rate, and health services, public transportation, and first sale of real estate properties at the 10-percent rate.
- **Unify the employer's social security contribution rate and eliminate sectoral exemptions** (broadly revenue neutral). The contribution rate, now ranging from zero to 15 percent across the private sector would be unified at 7.5 percent. The current exemptions for employers' contributions in the rural, industrial, and transportation sectors would be eliminated; in the case of the rural sector through the adoption of a special regime.
- **Eliminate small taxes** (expected to reduce revenues by 0.5 percent of GDP), including the current taxes on corporate income and wages, COFIS, and the taxes on banking assets, health services, and telecommunications.

12. **Reforms to improve revenue administration are being deepened.**[6] The program assumes an increase in tax collections as a result of administration improvements equivalent to ½ percent of GDP in 2006, and 1 percent of GDP by 2008. In support of this objective (i) the ministry of finance and the tax administration authority have signed a memorandum of understanding setting tax collection objectives and performance incentives for 2006 (BM for end-2005); and (ii) the social security bank (BPS) will design, with FAD assistance, a strategy to strengthen its collection and auditing functions (proposed BM for end-June 2006).

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[6] Revenue administration reforms were discussed in more detail during the first program review (see Box 2 in Country Report No. 05/431).

In addition, a committee has been set up to design a reform plan for the customs authority (BM for end-August 2006).

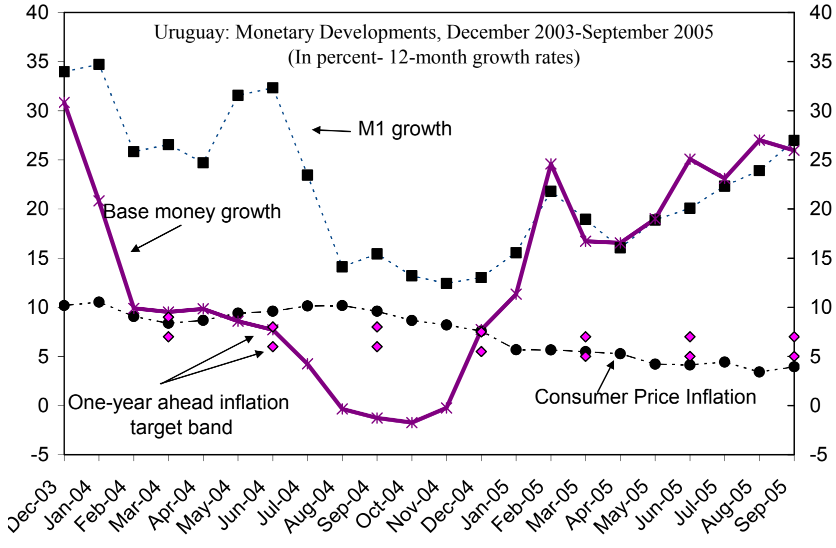
13. **Reform of the police pension fund is going forward.** Draft legislation has been submitted to congress, although its approval, originally expected by end-November 2005 (PC), is now proposed to be reset for end-May 2006 (waiver of nonobservance of this PC is being requested). The reform aims to improve equity and incentives, while reducing the fund's deficit over time by, inter alia, incorporating all wage components in the computation of contributions and benefits and increasing the contribution and computation periods. Planned reforms to the military and bank employees' pension funds will be submitted to congress by November 2006, for implementation in mid-2007 (proposed PCs). In addition, the authorities are working with the World Bank on possible reforms to the general pension system to improve its actuarial fairness and ensure fiscal sustainability; a commission is to issue recommendations by end-2006, for implementation beginning in 2007.

14. **The government is exploring options for private participation in infrastructure investment.** Specifically, it is considering a project with private participation to improve railroad freight transportation (a bottleneck, including for the new large forestry projects). Staff welcomed these efforts and urged them to create sound institutional and legal frameworks for project design and evaluation. The authorities noted that they were still studying possible implementation modalities, and agreed with the staff on the importance of ensuring transparency and sound project evaluation, while avoiding contingent fiscal liabilities. It was agreed to discuss any concrete projects during the next reviews.

15. **Work on improving the budgetary framework is continuing.** A committee will formulate a reform strategy, with Fund technical assistance (proposed BM for end-August 2006). Key goals of the reform are to expand coverage of the budget, improve classification, and enhance transparency and controls in budget execution.

B. Monetary and Exchange Rate Policy

16. **The authorities reiterated their commitment to further gradual disinflation, with a flexible exchange rate regime and base money operational targets.** They explained that, with inflation consistently below the target range and indications of a recovery in money demand (including continued peso appreciation), they had gradually eased the monetary policy stance in recent months through unsterilized foreign exchange purchases. Following a decision in November to allow base money to move to the upper end of the target range, the authorities raised in mid-December the end-year target range by another 3 percent to accommodate higher-than-anticipated seasonal money demand from the non-financial sector. The new ceiling provided room for base money to grow by up to 29 percent on average (y/y) during the last quarter of 2005. While inflation was still likely to close 2005 below the target range and inflation expectations for 2006 have been declining, the authorities and staff concurred that monetary policy should not be further eased until the impact of the recent measures can be assessed.



Source: Central Bank of Uruguay

17. **Monetary policy in 2006 will aim at an inflation target range of 4.5–6.5 percent and further strengthening the international reserve position, in line with previous understandings, but a slightly more gradual disinflation path over the medium term.** The staff urged the authorities to maintain the previously envisaged medium-term inflation path. However, the authorities indicated that they had decided that, after achieving low inflation rates in 2005–06, they would prefer to pursue a more cautious approach to further disinflation over the medium term to minimize possible output losses. For 2006, the central bank's monetary program assumes base money growth of 10 percent (broadly in line with expected nominal GDP growth). It also targets an increase in NIR equivalent to US$230 million, building on the significant overperformance expected for 2005 (about US$640 million, of which some US$400 million correspond to prefinancing operations). The authorities intend to continue prefinancing future obligations, should market conditions permit. The authorities also intend to continue monitoring conditions and adjusting policies, as necessary, to ensure meeting the inflation objectives.

18. **The authorities noted that, while the exchange rate remained broadly competitive, significant further appreciation could pose important risks.** Staff concurred

that most indicators suggest that the exchange rate level remained appropriate, including exports, which continue to grow at robust rates, and the REER is still well below its pre-crisis levels. The authorities stressed that managing sustained large capital inflows would be challenging, and expressed concern that continued appreciation could affect competitiveness. Against this background, they would conduct further foreign exchange purchases to lean against appreciation pressures and contribute to international reserves, while sterilizing their monetary impact, as necessary, to ensure meeting the inflation objectives. Staff noted that productivity growth could offset some of the adverse impact of real appreciation and encouraged the authorities to move aggressively in enhancing the investment climate to this end.

19. **The authorities have expressed interest in developing foreign exchange futures markets to help market participants hedge their exchange rate risk.** To jump-start the forward market, they have started to participate in it, in limited amounts, while hedging the exchange rate risk through (sterilized) spot market purchases. They intend to request Fund TA for the development of a futures market in Uruguay to ensure that it is in line with international best practices.

C. Financial Sector Reforms

20. **Important reforms of the sector's institutional framework are under way (Box 4).** As programmed, draft legislation to strengthen the central bank, the superintendency of banks, the deposit insurance agency, and the bank resolution framework will be submitted to congress by year's end (end-2005 PC). While the inflation objective would be set jointly with the ministry of finance, the authorities indicated that the central bank would have operational independence to achieve the objective. The independence of the central bank would be increased by setting and staggering the terms of its Board members,[7] while strengthening its accountability to congress. In addition, a plan to improve the BCU's financial position will be prepared by September 2006 (proposed BM). The new bank resolution framework would follow international best practices, and the deposit insurance scheme would be run by an agency outside the central bank.[8] Staff concurred with the authorities that in the case of Uruguay, keeping the supervisory authority for the financial system within the central bank has advantages in terms of institutional strength and independence.[9] A joint World Bank-IMF FSAP is under way, which will identify key elements for a medium-term structural reform agenda in the financial sector.[10]

[7] While the Constitution will still allow the Executive to dismiss central bank board members, this is subject to congressional approval.

[8] The deposit insurance scheme will be financed by the government with a US$20 million capital transfer in 2005 and a US$40 million loan in 2006.

[9] Since this PC required that the financial supervision agency be established outside the central bank, this modification would trigger nonobservance of the PC. This deviation does

(continued)

Box 4. Financial Sector Reforms

The authorities have decided on the key elements of draft legislation to strengthen central bank independence, financial sector supervision, and the bank resolution framework and deposit insurance.

Central Bank Independence

- Establish price stability as the main central bank objective.
- Create a macroeconomic coordinating committee with representatives of the central bank and the Ministry of Economy that will set the exchange rate regime and the monetary policy target.
- Clarify the central bank's independence in setting policies and conducting operations for achieving the monetary policy target.
- Stagger the terms in office of board members (fixed at eight years).[1]

Financial Sector Supervision

- Create a single superintendency within the central bank for all regulated financial institutions, encompassing banking, securities markets, pensions, and insurance.
- Grant the superintendent increased autonomy in decision making regarding individual institutions and certain regulatory measures, while reporting to the BCU board.

Deposit Insurance and Bank Resolution

- Create a new deposit insurance agency outside the central bank to implement the deposit insurance scheme introduced in March 2005. The agency will be independent and governed by a three-member board. Deposit insurance is limited to US$5,000 per depositor for dollar accounts and the peso equivalent of about US$16,000 for peso accounts.
- Grant the deposit insurer responsibility for bank resolutions and liquidations.
- Provide the bank resolution framework with a range of options that are less disruptive than straight liquidations and payouts to insured depositors.

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[1] Board members currently do not have fixed terms in office; their terms typically coincide with the government's term in office.

21. **Significant steps are being taken to advance the restructuring of public banks.**

- **BHU action plan.** Significant progress toward the adoption of an action plan to address the bank's deteriorating financial situation has been made (PC for end-2005);

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not affect program implementation; staff therefore would support the authorities' request for a waiver.

[10] The first mission visited Montevideo in October and the second mission is scheduled for January–February 2006. The findings will be presented with the Article IV consultation in mid-2006.

a detailed implementation plan will follow in February 2006 (proposed new BM). The draft action plan envisions the removal of problem assets from BHU's balance sheet to a fiduciary trust, while the government cancels its deposits at the bank and assumes many of the liabilities of BHU, including the note to BROU and a US$100 million bond. The cleaned-up BHU will operate on commercial terms with a leaner staff, and limit its activities to mortgage lending funded by savings for home purchase down payments and the securitization of its mortgages.

- **BROU's trust funds.** To ensure continued servicing of the funds' government-guaranteed notes, the authorities have recently changed the funds' governance structure, and appointed a Board member to represent the ministry of economy. The authorities reiterated their commitment to honor the government's guarantee if the trusts cannot service their debt according to the agreed schedule.

22. **The situation at COFAC remains a concern.** The (previously intervened) small cooperative bank has continued to lose deposits and the risk of failure remains significant. In response, the authorities are preparing a strategy to address risks of liquidity shortages and capital insolvency. As the first line of action against capital insolvency, the Superintendency for Banking Supervision continues to work with COFAC on measures to improve the bank's financial situation. Should these measures fail to produce the necessary improvements in earnings, various contingency scenarios are being prepared, including injection of capital by new shareholders. The authorities are also exploring options to ensure prompt payment to depositors in the event COFAC has insufficient liquidity to meet its obligations. In all cases, the authorities are committed not to use public funds, while covering insured deposits through the deposit insurance scheme.

IV. Financing Assurances and Extension of Repurchase Expectations

23. **Staff supported the authorities' request for an extension of repurchase expectations arising in February–December 2006**. International reserves have improved faster than expected when the repurchase expectations originated in 2002 and external financing conditions are expected to remain benign in 2006. However, the financing requirements for 2006 are large; the difference between the expectations and obligations schedules during February–December 2006 is substantial (SDR 540,862,500, or 25 percent of gross reserves); it is premature to judge whether the observed improvements in external financing conditions prove permanent; and Uruguay's reserve position is still relatively weak. Staff concurred that, on balance, the external position does not appear sufficiently strong to warrant repurchases on the expectations schedule without hardship or undue risk. The authorities reiterated their commitment to consider treating the arrangement as precautionary in the future, or making advanced repurchases, should external developments permit.

Uruguay: Indicators of External Position, 2004-06

	2004	2005 Projections		2006 Projections	
	Prel.	June 2002	Latest	June 2002	Latest
	(In US$ million, unless otherwise indicated)				
Gross official reserves	2,512	2,566	3,110	2,467	3,255
In months of imports 1/	8.2	8.4	8.0	7.3	6.8
In percent of short-term debt					
Incl. non-resident deposits	61.6	59.3	64.6	54.5	62.4
Incl. foreign exchange deposits	27.7	...	29.7	...	28.8
	(In percent of GDP)				
Current account	-0.7	-0.6	-2.4	-1.4	-5.8
Underlying current account 2/	-0.7	-0.6	-2.1	-1.4	-2.1
Financial and capital account	1.2	3.7	3.9	5.2	6.9
Of which: FDI (net)	2.5	2.3	2.6	2.5	6.6
Overall balance	3.4	3.2	3.7	3.8	0.8
External debt	87.4	77.1	71.0	70.3	62.9
External public debt	76.9	57.8	63.1	52.1	55.9

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

1/ Imports include goods and services.

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

24. **Program financing for 2006 is well in hand.** With large amortization payments from the 2003 debt exchange falling due, the 2006 program is challenging. The program is expected to be financed through continued strong access to international capital markets and World Bank and IDB disbursements (about US$430 million), which will require firm implementation of associated donor conditionality, and in case of shortfall, through up to US$400 million of higher-than-programmed bond placements in 2005. Staff welcomed the authorities' intention to take advantage of current favorable market conditions to further pre-finance 2007 financing needs.

V. Program Monitoring and Other Issues

25. **Program monitoring.** PCs, BMs, and indicative targets are specified in the supplementary MEFP and TMU (Attachments II and III).

- **New quarterly quantitative PCs through end-June 2006 (through December 2006 in the case of the fiscal targets) are proposed.** While the monetary and debt PCs cover half a year ahead, the authorities preferred to set fiscal PCs through

December, reflecting their full-year commitment under the budget. Although the existing systems for measuring floating debt have improved, they are not yet ready to allow for timely and accurate monitoring. Therefore, it is proposed to monitor the combined public sector primary balance including floating debt as an indicative target, and to adopt it as a performance criterion by 2007.

- **Two new structural PCs and four new BMs are proposed.** Two structural PCs are proposed in the area of the specialized pensions systems (paragraph 13). BMs would focus on strengthening tax administration (paragraph 12), the institutional budget framework (paragraph 15), recapitalization of the BCU (paragraph 20) and restructuring BHU (paragraph 21).

26. **Safeguards assessment**. The authorities are committed to implementing the recommendations of the September 2005 safeguards assessment (see Appendix II); several of them have already been adopted, including incorporation of all Fund liabilities in the BCU's balance sheet and amending the criteria for selection and appointment of the external audit firm.

VI. Staff Appraisal

27. **The program remains on a strong path, but important challenges lie ahead.** Strong policies coupled with a favorable external environment have allowed for an impressive economic recovery, low inflation, and a significant buildup in international reserves. Staff commends the authorities for their strong ownership of the program, maintaining the policy framework despite intense social and political pressures. Although vulnerabilities have declined, they remain substantial, leaving little room for policy slippages. Key structural reforms lie ahead, particularly to help sustain strong growth over the medium term. In the next months, the government faces many important tasks, including implementing key tax and financial sector reforms and developing a comprehensive growth agenda.

28. **Monetary policy has been managed prudently, and needs to remain focused on achieving the program's inflation objective.** Consistent with the floating exchange rate regime, the central bank's main goal remains to achieve the inflation objective, and it will be important that the authorities follow up on their commitment to adjust policies, if necessary to contain inflationary pressures. Within this framework, it is appropriate to use the opportunity of the strong external position to add to international reserves. Central bank participation in the forward foreign exchange market should remain limited and adequately hedged.

29. **The fiscal program is on track, but revenue performance needs to be closely monitored.** Higher spending/GDP ratios than previously expected call for stronger revenue efforts to achieve the all-important primary surplus objective, and thus increased risks. To address these risks, caution needs to be exercised in the execution of spending, particularly in the first half of 2006, and firm progress on tax policy and administration reforms, and maintaining tariffs consistent with the financial objectives of public enterprises, are therefore essential. The authorities' commitment to adjust expenditure, as needed, in case of revenue

shortfalls is welcome, as is their commitment to save any revenue overperformance toward achieving the 4 percent of GDP medium-term primary surplus target already in 2006.

30. **Fiscal reforms are progressing.** The draft tax reform announced in November would broaden the tax base and improve the efficiency of the tax system. It will be now important that the reform be implemented on time and in line with the principles contained in the announced package. Staff encourages the authorities to consider a gradual phase-in of tax rate cuts in order to minimize risks of potential gaps in 2007–08. On tax administration, significant and commendable efforts are being made to improve performance of the three revenue collection agencies; it is critical to sustain this momentum, especially in light of the ambitious revenue goals embodied in the medium-term fiscal framework. Staff welcomes progress in the creation of the new debt office in the Ministry of Finance, and encourages the authorities to focus their debt strategy on further dedollarizing and improving the maturity profile of the public debt.

31. **Longer-term fiscal sustainability also depends on moving ahead with pension reforms.** The police pension reform submitted to congress is now expected to be approved by May 2006. While regretting the delay and non-observance of this structural PC, staff supports the waiver of its nonobservance because it is temporary and does not jeopardize the achievement of the 2006 fiscal targets. Staff welcomes the commitment to proceed with reforms in the pension funds of the military and bank employees in 2006/07, and urges the authorities to adopt a reform plan for the general pension system, in collaboration with the World Bank.

32. **Planned institutional reforms in the financial sector are well placed.** Draft laws are to be submitted to congress by end-December on the deposit insurance and bank restructuring framework, supervisory institutions, and the central bank, which are designed to improve the institutional framework and stability of the financial sector. A waiver of nonobservance would be needed, as these draft laws are expected to maintain the superintendency of financial institutions within the central bank. Staff supports the authorities' request for this waiver and modification of the associated June 2006 PC, as it agrees that in the Uruguayan case, the supervision of financial institutions would be more effective staying within the central bank. In implementing these reforms, it will be particularly important to further strengthen the independence and institutional capacity of the central bank and financial supervisory authorities. The planned recapitalization of the central bank will also be important to this end.

33. **The restructuring of public banks must move ahead to ensure a resumption of sound credit flows and contain contingent fiscal costs.** Progress in strengthening BROU's credit procedures needs to continue, and should be underpinned by strengthened cash recoveries of the *fideicomisos* to ensure timely servicing of their notes to BROU. Pressures for forbearance of distressed domestic debts should continue to be firmly resisted. The plan to transform BHU into a scaled-down mortgage lending institution is appropriate and needs to be implemented strictly given its precarious financial situation. Staff welcomes the authorities' efforts to set up a contingency plan for COFAC in order to minimize systemic risks.

34. **The staff supports the authorities' request for extension of repurchase expectations for the period February–December 2006, consistent with Fund policy.** While the external position has strengthened, reserve coverage remains low, upcoming amortization payments—including to the Fund—are very high, and repurchases on an expectation basis would create undue hardship and risks. Staff welcomes the authorities' intention to consider treating the arrangement as precautionary in the future should market access turn out higher than envisaged, and to continue to take advantage of favorable market conditions to cover future financing needs.

35. **Given the strong performance under the program, staff recommends completion of the second review.** Firm program implementation has yielded excellent macroeconomic results and good progress on the structural front. All but two structural performance criteria for this review are expected to be observed. As noted above, staff supports waivers of the nonobservance of these PCs. Approval of an action plan for BHU and submission of financial sector legislation are expected before end-2005. All end-September quantitative PCs have been observed and with recent information pointing at continued good performance, all end-2005 quantitative PCs are expected to be met. However, a waiver of applicability will need to be considered, as information to assess observance of quantitative PCs will not be available by the time of the review. Staff will update the Executive Board prior to the discussion. Although important risks and vulnerabilities remain, the authorities' strong ownership of, and commitments to, the program as demonstrated by their readiness to adjust policies as needed, provides a solid basis for continued strong performance and a lasting exit from Fund financial support.

Table 1. Uruguay: Selected Economic and Social Indicators

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

				2005		2006		Proj.	
	2002	2003	2004	Report 05/431	Proj.	Report 05/431	Proj.	2007	2008
				(Percent change)					
I. Output, prices, and employment									
Real GDP	-11.0	2.2	12.3	6.0	6.0	4.0	4.0	3.5	3.0
Contributions to real growth (percent)									
Consumption	-15.2	-1.0	9.2	6.2	6.2	4.8	2.4	1.7	1.4
Investment	-5.0	2.7	2.9	1.9	1.9	4.6	5.7	-1.7	0.6
Net exports	9.1	0.9	-1.2	-2.1	-2.2	-5.4	-4.0	3.5	0.9
GDP (Ur$ billions)	261	315	379	416	406	461	448	487	524
GDP (US$ billions)	12.1	11.2	13.3	16.8	16.5	18.4	18.3	19.5	20.6
Investment	3.9	20.1	18.9	25.1	23.3	43.0	43.7	-4.1	8.0
Consumption	-11.7	32.1	30.6	9.9	6.6	9.8	7.9	7.2	6.1
GDP deflator	18.7	18.4	7.0	3.5	1.0	6.6	5.5	4.7	4.3
CPI inflation (average)	14.0	19.4	9.2	5.1	4.9	6.5	6.2	4.9	4.4
CPI inflation (eop)	25.9	10.2	7.6	6.5	5.9	5.5	5.5	4.7	4.4
Exchange rate change (Ur$/US$)(average)	62.1	30.4	-10.8	...	...	...	...	...	...
Exchange rate change (Ur$/US$) (eop)	84.2	7.3	-2.8	...	...	...	...	...	...
Average public sector wage (end-of-period)	0.5	7.9	9.7	10.2	10.2	10.5	10.5	9.6	8.6
Unemployement (in percent)	17.0	16.9	13.1	...	...	...	...	...	...
II. Monetary indicators									
BCU monetary liabilities	-7.4	25.3	30.0	20.3	25.9	...	7.8	6.2	5.6
Base Money 1/	...	24.9	11.0	22.1	21.5	...	11.1	8.6	7.5
Currency issued	5.8	22.4	15.7	11.4	21.5	...	11.1	8.6	7.5
M-2	0.8	20.7	9.9	8.1	16.7	...	11.1	8.6	7.5
M-3	21.3	24.2	-9.5	4.0	6.0	...	9.0	6.1	6.3
Credit to the private sector (constant exch. rate) 2/	-13.7	-25.5	-20.1	0.0	-4.0	...	9.9	10.8	6.9
				(Percent of GDP, unless otherwise indicated)					
III. Public sector operations									
Revenue	32.1	32.0	30.9	31.1	32.0	31.6	33.0	33.5	33.6
Non-interest expenditure (incl. discrepancy)	32.1	29.3	27.2	27.5	28.4	27.9	29.3	29.5	29.6
Primary balance	0.0	2.7	3.8	3.6	3.6	3.7	3.7	4.0	4.0
Interest	4.7	6.0	6.0	4.9	4.8	4.8	4.8	4.6	4.5
Overall balance	-4.6	-3.2	-2.3	-1.3	-1.2	-1.2	-1.1	-0.6	-0.5
Public sector debt 3/	96	104	92	73	73	67	68	65	62
Public debt service (as a percent of GDP)	13	14	19	16	15	16	16	14	11

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

				2005		2006		Proj.	
	2002	2003	2004	Report 05/431	Proj.	Report 05/431	Proj.	2007	2008
				IV. Savings and investment					
Gross domestic investment	11.5	12.6	13.3	15.5	15.7	20.0	20.6	18.2	18.3
Gross national savings	14.7	12.1	12.6	12.8	13.3	13.7	14.7	15.7	16.7
Foreign savings	-3.2	0.5	0.7	2.8	2.4	6.4	5.8	2.5	1.6
				V. External indicators					
Merchandise exports, fob (US$ millions)	1,922	2,281	3,021	3,496	3,490	3,724	3,769	4,130	4,512
Merchandise imports, fob (US$ millions)	1,874	2,098	2,990	3,852	3,840	4,878	4,854	4,677	4,884
Merchandise terms of trade (percentage change)	4.3	2.9	-3.1	-9.6	-9.3	-5.6	-3.8	-0.3	0.2
Current account balance	3.2	-0.5	-0.7	-2.8	-2.4	-6.4	-5.8	-2.5	-1.6
Of which: Excluding cellulose projects	3.2	-0.5	-0.7	-2.5	-2.1	-2.4	-2.1	-1.1	-0.5
Foreign direct investment	1.5	3.6	2.5	2.3	2.6	6.3	6.6	3.7	3.5
Overall balance of payments (US$ millions)	-2,328	1,380	454	297	620	215	145	163	175
External debt 4/	87.5	98.2	87.4	69.7	71.0	62.2	62.9	58.0	53.9
Of which: External public debt	68.9	85.3	76.9	61.8	63.1	54.9	55.9	51.4	47.7
External debt service (percent of exports of goods and services)	55.0	52.3	40.9	49.4	50.6	52.2	53.7	49.7	37.5
Gross official reserves (US$ millions) 5/	772	2,087	2,512	2,762	3,110	2,977	3,255	3,418	3,593
In months of imports of goods and services	3.7	9.2	8.2	7.0	8.0	6.1	6.8	7.3	7.3
In percent of short-term debt	25.1	86.8	158.0	124.9	135.8	118.5	125.2	135.3	182.1
In percent of short-term debt plus bank non-resident deposits	14.3	45.1	61.6	58.9	64.6	58.5	62.4	65.1	74.9
In percent of short-term debt plus FX deposits	7.0	20.0	27.7	27.1	29.7	26.7	28.8	29.5	31.4
REER (percentage depreciation -, e.o.p.)	-20.3	-13.2	9.3	...	...	...	...	...	...

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

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

Table 2. Uruguay: Performance under the 2005 Program 1/

	Dec. 31	June 30				Sept. 30				Dec. 31
	2004 Stock	PC	PC (adjusted)	Actual	Margin (+)	PC	PC (adjusted)	Actual	Margin (+)	PC
A. Quantitative performance criteria										
(In millions of Uruguayan pesos)										
1. Combined public sector primary balance (floor) 2/	...	5,471	5,372	6,394	**1,022**	9,687	9,490	10,351	**861**	14,647
2. General government noninterest expenditure (ceiling) 2/	...	23,561	23,539	22,080	**1,459**	34,643	34,665	32,996	**1,670**	46,561
3. Net domestic assets of the BCU (ceiling) 2/	74,079	3,983	3,983	-302	**4,284**	4,572	4,572	-16,424	**20,995**	-3,910
(In millions of U.S. dollars)										
4. Net international reserves of the BCU (floor) 2/	-2,218	-130	-130	18	**148**	-110	-110	592	**702**	280
5. Nonfinancial public sector gross debt (ceiling) 3/	12,189	12,510	12,495	12,229	**266**	12,575	12,566	12,490	**76**	12,550
6. Accumulation of external payment arrears of the public sector (on a continuous basis) 2/	0	0	0	0	**0**	0	0	0	**0**	0
B. Indicative targets										
(In millions of Uruguayan pesos)										
7. Combined public sector overall balance (floor) 2/	...	-5,086	-5,186	-2,794	**2,391**	-7,459	-7,656	-4,597	**3,059**	-7,072
8. Monetary base (ceiling) 2/	15,648	557	557	1,070	**-513**	1,673	1,673	498	**1,175**	3,468
9. Floating debt of the central government (ceiling)	3,081	3,081	3,081	2,567	**514**	3,081	3,081	2,298	**783**	3,081

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

Area	Structural Conditionality	Date	Status
A. Prior actions for the approval of the Stand-by Arrangement			
Tax administration	Issue a decree to implement the DGI's modernization law.		Observed.
Tax administration	Establish a large taxpayers unit at the DGI.		Observed.
Tax administration	Formulate a plan to coordinate tax audits between the DGI, the BPS, and the Ministry of Labor.		Observed.
Financial sector	Appoint a Board of Directors for NBC with appropriate professional experience and an interim CEO with banking experience.		Observed.
B. Structural performance criteria			
Fiscal	Submit to congress a five-year spending plan, complemented with revenue projections and deficit targets consistent with the program's fiscal targets.	August 31, 2005	Observed.
Fiscal	Have in place a five-year spending plan, complemented with revenue projections and deficit targets consistent with the program's fiscal targets.	February 28, 2006	Observed.
Pension	Begin to implement reform of the pension fund for the police.	November 30, 2005	Not observed.
Central Bank	Submit simultaneously three laws to congress to: (i) give appropriate autonomy to the central bank (as described in paragraph 12 of the MEFP); (ii) strengthen the regulation of the financial system (as described in paragraph 13 of the MEFP); and (iii) provide a suitable bank resolution framework (as described in paragraph 14 of the MEFP).	December 31, 2005	Not observed.4/
BROU & BHU	Government to ensure timely service of BHU note and BROU fiduciary notes to BROU in accordance with the current payment schedules.	Continuous	Observed.
BHU	Adopt action plan to address the financial situation of BHU consistent with minimizing systemic risks and contingent fiscal costs.	December 31, 2005	
C. Structural benchmarks			
Tax administration	Sign a memorandum of understanding between the Ministry of Finance and the DGI agreeing on quantitative targets and indicators for 2006 on tax collections, audit coverage, tax services, and information systems.	December 31, 2005	Observed.
Fiscal	Establish quarterly revenue collection targets (floors) at the social security bank (BPS).	June 30, 2005	Observed.
Debt management	Create a debt management unit at the Ministry of Finance.	December 31, 2005	

PC= performance criterion; IT=Indicative target.
Sources: Ministry of Economy and Finance; and Central Bank of Uruguay.

1/ As defined in the Technical Memorandum of Understanding.
2/ Cumulative changes from end-December of the previous calendar year.
3/ All maturities.
4/ Nonobservance due to authorities' decision to keep the financial sector supervisory authority within the BCU. Fund staff supports this decision.

Table 3. Uruguay: Balance of Payments

(In millions of US$, unless otherwise stated)

			Prel.	2005		2006		Proj.	
	2002	2003	2004	Report 05//431	Proj.	Report 05//431	Proj.	2007	2008
				1. Balance of Payments					
Current account	**382**	**-56**	**-98**	**-467**	**-399**	**-1,176**	**-1,100**	**-506**	**-336**
Trade balance	48	183	31	-356	-351	-1,154	-1,084	-547	-372
Exports, f.o.b.	1,922	2,281	3,021	3,496	3,490	3,724	3,769	4,130	4,512
Imports, f.o.b.	1,874	2,098	2,990	3,852	3,840	4,878	4,854	4,677	4,884
Services	153	167	304	283	300	387	381	474	495
Exports, f.o.b.	771	803	987	1,159	1,148	1,326	1,291	1,437	1,540
Imports, f.o.b.	618	636	683	875	849	939	910	964	1,045
Income (net)	109	-489	-522	-481	-437	-500	-489	-531	-563
Transfers (net)	72	83	89	87	89	91	93	98	104
Financial and capital account	**-2,234**	**1,039**	**163**	**454**	**650**	**1,391**	**1,296**	**669**	**511**
Foreign direct investment	180	401	337	381	429	1,153	1,250	746	734
Portfolio investment	415	-541	-416	274	575	-99	39	481	130
Government securities	171	-5	266	380	547	-116	181	320	152
Issues	710	613	532	739	992	242	597	459	305
Amortization 1/	539	618	266	358	445	358	416	139	152
Banks	244	-537	-682	-106	28	16	-142	160	-22
Other capital flows (net)	-2,828	1,179	242	-202	-354	337	6	-558	-353
Loans	1,290	375	-92	-245	-285	-127	-161	-574	-356
Of which: WB, IDB, commercial (net)	633	237	-36	-41	6	5	-73	-130	39
Disbursements	792	472	217	335	370	496	432	442	420
Amortization	159	235	253	376	364	491	505	572	381
Of which: IMF (net)	883	671	152	-130	-177	-133	-88	-444	-395
Disbursements	1,989	840	552	348	303	500	544	393	89
Amortization	1,105	169	400	478	480	632	632	837	485
Deposits, net	-1,693	267	180	23	-239	0	0	0	0
Other flows, net	-2,426	537	154	20	170	464	167	16	4
Errors and omissions 2/	-476	397	388	311	419	0	0	0	0
Overall balance	-2,328	1,380	454	297	620	215	145	163	175
Reserve assets (- increase)	**2,328**	**-1,380**	**-454**	**-297**	**-620**	**-215**	**-145**	**-163**	**-175**
				2. Reserve Adequacy and External Indicators					
Gross official reserves	**772**	**2,087**	**2,512**	**2,762**	**3,110**	**2,977**	**3,255**	**3,418**	**3,593**
In months of imports of goods and services	3.7	9.2	8.2	7.0	8.0	6.1	6.8	7.3	7.3
In percent of short-term debt excluding nonresidential deposits	25.1	86.8	158.0	124.9	135.8	118.5	125.2	135.3	182.1
In percent of short-term debt including nonresidential deposits	14.3	45.1	61.6	58.9	64.6	58.5	62.4	65.1	74.9
Net international reserves 3/	**-1,088**	**-763**	**-2,218**	**-1,938**	**-1,303**	**-1,692**	**-1,071**	**-527**	**-32**
				(As percent of GDP)					
Exports	15.9	20.3	22.8	20.8	20.9	20.2	19.9	20.6	21.3
Imports	15.5	18.7	22.5	22.9	23.0	26.5	25.7	23.3	23.0
Current account	3.2	-0.5	-0.7	-2.8	-2.4	-6.4	-5.8	-2.5	-1.6
Underlying current account 4/	3.2	-0.5	-0.7	-2.5	-2.1	-2.4	-2.1	-1.1	-0.5
Financial and capital account	-18.5	9.3	1.2	2.7	3.9	7.5	6.9	3.3	2.4
Of which: foreign direct investment (net)	1.5	3.6	2.5	2.3	2.6	6.3	6.6	3.7	3.5
Of which: government securities (net)	1.4	0.0	2.0	2.3	3.3	-0.6	1.0	1.6	0.7
Of which: IMF (net)	7.3	6.0	1.1	-0.8	-1.1	-0.7	-0.5	-2.2	-1.9
Overall balance	-19.3	12.3	3.4	1.8	3.7	1.2	0.8	0.8	0.8
Changes in GIR	19.3	-12.3	-3.4	-1.8	-3.7	-1.2	-0.8	-0.8	-0.8
External debt	87.5	98.2	87.4	69.7	71.0	62.2	62.9	58.0	53.9
Short-term debt (residual maturity)	25.5	21.4	12.0	13.2	13.7	13.6	13.7	12.6	9.3
External public debt	68.9	85.3	76.9	61.8	63.1	54.9	55.9	51.4	47.7
External debt + NR deposits	106.8	118.1	106.1	84.5	86.1	76.2	76.8	71.5	67.2
				(As percent of annual exports of goods and services)					
Total external debt	392.8	357.1	289.3	251.4	256.1	226.9	235.1	209.1	189.0
Total external debt (including nonresidential deposits)	479.2	429.3	351.3	304.7	310.4	278.0	286.9	258.0	235.7
Debt service	55.0	52.3	40.9	49.4	50.6	52.2	53.7	49.7	37.5
Of which: interest payments	24.5	19.2	18.0	18.3	17.6	18.6	18.8	18.0	17.2
				(Annual percent changes)					
Exports	-10.2	18.7	32.4	15.7	15.5	6.5	8.0	9.6	9.2
Imports	-35.7	12.0	42.5	28.8	28.4	26.6	26.4	-3.6	4.4
Export prices in US$ (year-on-year percent change) 4/	-7.7	7.4	6.5	4.0	4.5	-0.4	0.5	0.3	0.5
Import prices in US$ (year-on-year percent change) 4/	-10.8	5.1	9.2	11.8	11.6	2.9	2.5	-0.2	-0.1
Terms of trade 4/	3.5	2.2	-2.5	-7.0	-6.3	-3.2	-1.9	0.5	0.6
Export volume 4/	-2.1	9.4	23.6	12.5	12.3	9.5	9.5	7.5	6.0
Import volume 4/	-26.9	6.2	29.0	12.1	11.9	5.5	6.6	6.5	6.5

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

1/ Includes secondary market transactions between residents and non-residents.

2/ 2005: Projection is based on preliminary actual for Jan-Sep of US$419 million.

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

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

Table 4. Uruguay: Public Sector Operations
(In millions of pesos)

						2005 1/															
						Q1+Q2+Q3			Q4	2005			2006	2006 1/				Proj.			
	2000	2001	2002	2003	2004	Report 05/235	Report 05/431	Actual	Proj.	Report 05/235	Report 05/431	Proj.	Report 05/431	Q1	Q2	Q3	Q4	2006	2007	2008	2009
									(In millions of Uruguayan pesos)												
Revenue	**70,095**	**83,516**	**83,891**	**101,081**	**117,367**	**95,894**	**96,247**	**95,362**	**34,486**	**129,891**	**129,586**	**129,840**	**145,663**	**35,867**	**35,617**	**37,402**	**37,946**	**146,832**	**161,857**	**174,186**	**187,414**
Taxes	70,095	54,007	57,832	70,096	83,002	67,140	68,061	68,081	23,703	91,070	91,980	91,787	102,661	25,019	24,778	25,230	26,743	101,770	113,093	121,263	129,714
VAT and excise taxes	50,164	29,437	29,708	37,667	47,200	39,279	38,755	38,880	14,136	53,513	52,891	53,015	59,414	14,717	14,048	15,401	16,278	60,444	64,138	68,912	73,573
On income and profits	27,409	12,719	14,302	15,621	17,683	14,131	14,829	15,037	4,839	18,864	19,693	19,873	22,173	5,051	5,853	5,126	5,250	21,280	28,110	31,234	33,724
On foreign trade	12,640	2,428	2,730	3,780	4,958	3,966	3,800	3,721	1,373	5,456	5,216	5,099	5,405	1,186	1,222	1,315	1,367	5,090	4,195	3,829	4,103
On property and other	1,968	9,424	11,091	13,028	13,161	9,764	10,676	10,444	3,356	13,237	14,180	13,800	15,669	4,064	3,655	3,388	3,848	14,955	16,650	17,287	18,314
Social security contributions 1/	8,147	17,031	15,589	14,696	16,657	14,875	15,636	15,895	5,045	19,361	20,142	20,941	22,317	5,890	5,545	6,324	5,434	23,192	25,067	27,027	28,918
Nontax revenue	15,085	5,250	5,274	6,200	7,831	6,031	6,048	6,090	2,179	8,115	8,125	8,259	9,313	2,157	2,498	2,656	2,507	9,818	10,339	11,050	11,742
Current surplus of public enterprises	0	7,227	5,196	10,090	9,876	7,848	6,502	5,295	3,559	11,345	9,339	8,854	11,372	2,801	2,796	3,192	3,263	12,052	13,359	14,846	17,041
Noninterest expenditure	**22,223**	**86,603**	**83,819**	**92,431**	**103,082**	**86,207**	**85,446**	**85,045**	**30,428**	**115,244**	**114,624**	**115,179**	**128,652**	**33,216**	**33,072**	**32,164**	**31,907**	**130,360**	**142,547**	**153,437**	**165,262**
Current	73,766	77,520	77,405	84,623	93,780	77,718	77,737	78,020	28,013	104,709	105,062	105,757	115,191	29,001	29,457	28,771	30,014	117,243	126,156	135,935	146,250
Wages	65,336	18,074	18,158	19,701	23,409	18,839	18,834	18,750	7,015	25,639	25,878	25,768	28,819	6,780	7,452	6,771	7,718	28,722	31,869	34,941	38,141
Goods and services	17,219	12,833	12,057	15,031	17,015	15,155	14,529	14,062	5,234	20,273	19,840	19,319	22,089	5,909	5,635	5,626	5,471	22,642	23,359	24,703	26,645
Of Which: SEP		0	0	0	0	1,174	423	222	667	1,812	1,023	879	2,526	780	660	600	513	2,553	1,548	0	0
Social security benefits 1/	11,298	41,907	42,818	44,218	47,702	38,505	38,960	39,222	13,797	51,914	52,367	53,019	56,129	14,223	14,279	14,407	14,716	57,626	62,558	67,236	71,781
Other 1/	41,120	4,706	4,371	5,673	5,654	5,220	5,414	5,985	1,967	6,884	6,976	7,651	5,627	2,089	2,090	1,967	2,108	8,254	6,821	9,055	9,684
Capital (Government and enterprises)	-4,301	9,083	6,413	7,808	9,303	8,489	7,708	7,025	2,415	10,535	9,562	9,422	13,461	4,215	3,615	3,393	1,894	13,117	16,391	17,502	19,011
Primary balance	**-3,671**	**-3,088**	**72**	**8,651**	**14,284**	**9,687**	**10,802**	**10,317**	**4,058**	**14,647**	**14,962**	**14,662**	**17,011**	**2,651**	**2,546**	**5,238**	**6,039**	**16,473**	**19,311**	**20,748**	**22,152**
Interest	6,308	7,276	12,163	18,881	22,666	17,146	15,907	14,948	4,409	21,719	20,471	19,402	22,342	5,726	4,998	5,965	4,766	21,455	22,276	23,285	24,293
Overall balance	**-9,979**	**-10,364**	**-12,091**	**-10,231**	**-8,382**	**-7,459**	**-5,105**	**-4,631**	**-351**	**-7,072**	**-5,510**	**-4,741**	**-5,332**	**-3,076**	**-2,452**	**-728**	**1,272**	**-4,983**	**-2,966**	**-2,537**	**-2,141**

Table 4. Uruguay: Public Sector Operations (concluded)
(In percent of GDP)

						2005																
						Q1+Q2+Q3			Q4	2005			2006	2006				Proj.				
	2000	2001	2002	2003	2004	Report 05/235	Report 05/431	Actual	Proj.	Report 05/235	Report 05/431	Proj.	Report 05/431	Q1	Q2	Q3	Q4	2006	2007	2008	2009
									(In percent of GDP 4/)												
Revenue	**28.8**	**33.8**	**32.1**	**32.0**	**30.9**	**30.6**	**30.8**	**31.3**	**34.0**	**31.0**	**31.1**	**32.0**	**31.6**	**32.2**	**32.0**	**33.6**	**34.1**	**33.0**	**33.5**	**33.6**	**33.8**
Taxes	20.6	21.8	22.2	22.2	21.9	21.4	21.8	22.4	23.3	21.8	22.1	22.6	22.3	22.5	22.3	22.7	24.0	22.8	23.4	23.4	23.4
VAT and excise taxes	11.3	11.9	11.4	11.9	12.4	12.5	12.4	12.8	13.9	12.8	12.7	13.1	12.9	13.2	12.6	13.8	14.6	13.6	13.3	13.3	13.3
On income and profits	5.2	5.1	5.5	5.0	4.7	4.5	4.8	4.9	4.8	4.5	4.7	4.9	4.8	4.5	5.3	4.6	4.7	4.8	5.8	6.0	6.1
On foreign trade	0.8	1.0	1.0	1.2	1.3	1.3	1.2	1.2	1.4	1.3	1.3	1.3	1.2	1.1	1.1	1.2	1.2	1.1	0.9	0.7	0.7
On property and other	3.4	3.8	4.3	4.1	3.5	3.1	3.4	3.4	3.3	3.2	3.4	3.4	3.4	3.6	3.3	3.0	3.5	3.4	3.4	3.3	3.3
Social security contributions 1/	6.2	6.9	6.0	4.7	4.4	4.7	5.0	5.2	5.0	4.6	4.8	5.2	4.8	5.3	5.0	5.7	4.9	5.2	5.2	5.2	5.2
Nontax revenue	0.0	2.1	2.0	2.0	2.1	1.9	1.9	2.0	2.1	1.9	2.0	2.0	2.0	1.9	2.2	2.4	2.3	2.2	2.1	2.1	2.1
Current surplus of public enterprises	2.0	2.9	2.0	3.2	2.6	2.5	2.1	1.7	3.5	2.7	2.2	2.2	2.5	2.5	2.5	2.9	2.9	2.7	2.8	2.9	3.1
Noninterest expenditure	**30.4**	**35.0**	**32.1**	**29.3**	**27.2**	**27.5**	**27.4**	**27.9**	**30.0**	**27.5**	**27.5**	**28.4**	**27.9**	**29.8**	**29.7**	**28.9**	**28.7**	**29.3**	**29.5**	**29.6**	**29.8**
Current	26.9	31.4	29.7	26.8	24.7	24.8	24.9	25.6	27.6	25.0	25.2	26.0	25.0	26.0	26.5	25.8	27.0	26.3	26.1	26.2	26.4
Wages	7.1	7.3	7.0	6.2	6.2	6.0	6.0	6.2	6.9	6.1	6.2	6.3	6.2	6.1	6.7	6.1	6.9	6.4	6.6	6.7	6.9
Goods and services	4.6	5.2	4.6	4.8	4.5	4.8	4.7	4.6	5.2	4.8	4.8	4.8	4.8	5.3	5.1	5.1	4.9	5.1	4.8	4.8	4.8
Of Which: SEP						0.4	0.1	0.1	0.7	0.4	0.2	0.2	0.5	0.7	0.6	0.5	0.5	0.6	0.3	0.0	0.0
Social security benefits 1/	16.9	17.0	16.4	14.0	12.6	12.3	12.5	12.9	13.6	12.4	12.6	13.1	12.2	12.8	12.8	12.9	13.2	12.9	13.0	13.0	13.0
Other 1/	-1.8	1.9	1.7	1.8	1.5	1.7	1.7	2.0	1.9	1.2	1.7	1.9	1.2	1.9	1.9	1.8	1.9	1.9	1.4	1.7	1.7
Capital (Government and enterprises)	3.5	3.7	2.5	2.5	2.5	2.7	2.5	2.3	2.4	2.5	2.3	2.3	2.9	3.8	3.2	3.0	1.7	2.9	3.4	3.4	3.4
Primary balance	**-1.5**	**-1.2**	**0.0**	**2.7**	**3.8**	**3.1**	**3.5**	**3.4**	**4.0**	**3.5**	**3.6**	**3.6**	**3.7**	**2.4**	**2.3**	**4.7**	**5.4**	**3.7**	**4.0**	**4.0**	**4.0**
Interest	2.6	2.9	4.7	6.0	6.0	5.5	5.1	4.9	4.3	5.2	4.9	4.8	4.8	5.1	4.5	5.4	4.3	4.8	4.6	4.5	4.4
Overall balance	**-4.1**	**-4.2**	**-4.6**	**-3.2**	**-2.2**	**-2.4**	**-1.6**	**-1.5**	**-0.3**	**-1.7**	**-1.3**	**-1.2**	**-1.2**	**-2.8**	**-2.2**	**-0.7**	**1.1**	**-1.1**	**-0.6**	**-0.5**	**-0.4**
Memorandum																					
Augmented Balance 2	**-9,979**	**-10,364**	**-56,106**	**-10,231**	**-1,229**	**-7,459**	**-5,105**	**-4,631**	**-817**	**-7,072**	**-5,510**	**-5,207**	**-5,332**	**-4,020**	**-2,452**	**-728**	**1,272**	**-5,927**	**-2,966**	**-2,537**	**-2,141**
In percent of GDP	-4.1	-4.2	-21.5	-3.2	-0.3	-2.4	-1.6	-1.5	-0.8	-1.7	-1.3	-1.3	-1.2	-3.6	-2.2	-0.7	1.1	-1.3	-0.6	-0.5	-0.4
GDP (billions of pesos)	243	**247**	**261**	**315**	**379**	...	...	...	...	**418**	**416**	**406**	**461**	...	...	...	...	**445**	**483**	**519**	**554**

Sources: Ministry of Finance; and Fund staff estimates.
1/ This line was amended at the time of the second review to incorporate contributions collected by the BPS transferred to the AFAPs previously excluded.
2/ In 2002 this includes the following bank-restructuring costs: US$33 million of capital transfers for bank recapitalization, US$564 million of liquidity supplied by BCU, US$444 million for the Fondo de Fortalecimiento del Sistema Bancario (FFSB), and US$993 million for the FSBS. Asset recoveries are credited in 2004. In 2005 and 2006 this includes US$60 million for the financing of the deposit insurance scheme. Contingent liabilities of BHU will be included once the restructuring plan has been finalized.
3/ For quarters, amounts as percentage of one-fourth of annual GDP.

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

	2002	2003	2004	2005 Report 05/235	2005 Report 05/431	2005 Proj.	2006 (Proj.) Q1	2006 (Proj.) Q2	2006 (Proj.) Q3	2006 (Proj.) Q4
1. Banco Central del Uruguay										
Net foreign assets	-689	-52	-51	228	520	1,005	939	1,020	1,104	1,244
Net international reserves 2/	-1,014	-321	-164	115	218	766	693	775	855	995
Gross international reserves	772	2,087	2,512	2,656	2,762	3,110	3,207	3,301	3,262	3,255
Reserve liabilities 2/	-1,786	-2,407	-2,675	-2,541	-2,544	-2,344	-2,514	-2,527	-2,407	-2,260
Other net foreign assets	325	269	113	113	302	239	245	245	249	249
Net domestic assets	1,123	532	652	470	186	-295	-287	-330	-491	-455
Net credit to the public sector	1,541	2,464	2,626	2,391	2,418	2,023	2,099	2,006	1,928	1,777
Net credit to the financial system	-340	-2,112	-1,905	-1,986	-2,113	-1,879	-1,879	-1,870	-1,870	-1,865
Credit to the private sector	80	71	62	62	59	56	51	51	46	46
Securities issued by the BCU	-34	-243	-563	-643	-724	-667	-739	-720	-815	-663
Other	-124	352	431	645	546	172	181	203	220	249
Peso Monetary liabilities	434	480	600	698	706	710	652	691	612	789
Memorandum items:										
Monetary base (average)	...	...	594	698	725	725	732	736	693	798
NIR program definition	...	...	-2,218	-1,938	-1,938	-1,303	-1,375	-1,292	-1,211	-1,071
NDA program definition	...	...	2,811	2,636	2,663	2,030	2,107	2,029	1,904	1,869
2. Public and Private Banks 3/										
Net foreign assets	551	1,213	1,887	1,718	1,905	2,271	2,434	2,512	2,508	2,413
Net domestic assets	5,254	5,331	5,090	5,532	5,275	5,272	5,379	5,485	5,592	5,699
Net credit to the public sector 1/	399	219	437	336	-34	345	345	350	324	222
Net credit to the financial system	947	2,612	2,256	2,300	2,562	2,317	2,345	2,369	2,423	2,553
Credit to the private sector	6,319	4,726	4,307	4,813	4,508	4,527	4,618	4,709	4,800	4,892
Other	-2,411	-2,226	-1,909	-1,916	-1,761	-1,918	-1,930	-1,943	-1,955	-1,968
Liabilities to the private sector (residents)	5,805	6,544	6,977	7,250	7,180	7,543	7,812	7,997	8,100	8,112
Public banks	3,140	3,409	3,670	3,775	3,770	3,896	3,995	4,091	4,137	4,156
Local currency	339	394	520	574	617	598	547	580	514	663
Foreign currency	2,801	3,016	3,149	3,201	3,175	3,299	3,447	3,511	3,622	3,494
Private banks	2,666	3,135	3,307	3,475	3,367	3,647	3,818	3,906	3,963	3,956
Local currency	357	349	405	450	456	477	439	465	412	531
Foreign currency	2,309	2,785	2,902	3,025	2,911	3,169	3,379	3,441	3,551	3,424
3. Banking System										
Net foreign assets	-138	1,161	1,835	1,945	2,426	3,276	3,372	3,532	3,612	3,657
Net domestic assets	6,288	5,788	5,738	5,700	5,450	4,755	4,887	4,939	4,909	5,093
Credit to the public sector	1,940	2,684	3,063	2,728	2,384	2,369	2,444	2,356	2,252	1,999
Credit to the rest of financial system	-218	-173	-165	12	439	216	262	283	361	538
Credit to the private sector	6,398	4,797	4,369	4,875	4,567	4,583	4,669	4,761	4,847	4,938
Other	-1,831	-1,519	-1,529	-1,914	-1,939	-2,413	-2,488	-2,460	-2,550	-2,381
Broad money (M3)	6,150	6,949	7,573	7,646	7,876	8,030	8,260	8,471	8,520	8,750

Sources: Central Bank of Uruguay; and Fund staff estimates and projections.
1/ Presentation used for program monitoring. May differ from presentation and definitions used in IFS.
2/ Includes all outstanding liabilities to the IMF, but excludes liabilities to resident financial institutions.
3/ The Banco de la Republica Oriental de Uruguay (BROU), Banco Hipotecario de Uruguay (BHU; mortgage institution), private banks, and cooperatives.

Table 6. Uruguay: Vulnerability Indicators

	2002	2003	2004	Proj. 2005	Proj. 2006
(Percent change, unless otherwise indicated)					
Financial sector indicators					
Broad money	21.3	24.2	-9.5	-4.0	9.9
Credit to the private sector (const. exch. rate)	-13.7	-25.5	-20.1	0.0	8.7
Share of nonperforming loans in total loans (in percent) 1/	31.5	8.6	3.8	3.0	...
Capital adequacy ratio (in percent) 1/	-9.6	9.2	10.9	12.5	...
Interbank interest rates (percent, end of period) 1/	45.0	2.5	1.3	1.0	...
FX deposits held by residents (in percent of total deposits)	88.3	88.8	87.6	85.0	85.0
FX loans to residents (in percent of total loans)	80.4	77.6	73.3	73.2	70.0
Public debt indicators					
Public sector gross debt (PSGD, in percent of GDP)	95.5	104.5	92.5	73.4	68.3
of which: Exposed to rollover risk (in percent of total PSGD)	17.2	12.1	13.5	16.0	...
Exposed to exchange rate risk (in percent of total PSGD)	96.0	94.3	90.2	87.0	...
Exposed to interest rate risk (in percent of total PSGD)	57.0	45.5	44.6	40.0	...
External indicators					
Merchandise exports	-10.2	18.7	32.4	15.5	8.0
Merchandise imports	-35.7	12.0	42.5	28.4	26.4
Merchandise terms of trade	4.3	2.9	-3.1	-9.3	-3.8
REER appreciation (+)	-20.3	-13.2	9.3	...	...
(Percent of GDP, unless otherwise indicated)					
Current account balance	3.2	-0.5	-0.7	-2.4	-5.8
Capital and financial account balance	-18.5	9.3	1.2	3.9	6.9
of which : Net foreign direct investment	1.5	3.6	2.5	2.6	6.6
Government securities	1.4	0.0	2.0	3.3	1.0
Other net inflows	-21.4	5.7	-3.3	-1.9	-0.7
Total gross external debt (ED) in percent of GDP	87.5	98.2	87.4	71.0	62.9
of which: Short-term ED (original maturity, in percent of total ED)	12.5	6.7	7.6	5.4	5.5
ED to foreign official sector (in percent of total ED)	44.9	51.1	50.7	47.6	46.2
External interest payments (in percent of exports of GNFS)	24.5	19.2	18.0	17.6	18.8
External amortization payments (in percent of exports of GNFS)	30.5	33.1	22.8	33.0	34.9
(U.S. million, unless otherwise indicated)					
Central Bank reserve liabilities 2/	1,786	2,407	2,675	2,334	2,260
Short term foreign assets of the banking system	3,140	4,989	5,988	6,604	6,919
Short term foreign liabilities of the banking system 2/	4,916	4,597	4,389	4,504	4,517
Gross official reserves	772	2,087	2,512	3,110	3,255
In months of imports GNFS	3.7	9.2	8.2	8.0	6.8
In percent of short-term external debt excl. nonres FX deposits	25.1	86.8	158.0	135.8	125.2
In percent of short-term external debt plus bank NR deposits	14.3	45.1	61.6	64.6	62.4
In percent of short-term debt plus FX deposits	7.0	20.0	27.7	29.7	28.8
In percent of broad money	12.2	28.7	34.3	37.9	38.0
In percent of base money	175.4	427.3	418.1	386.3	372.9
Banking system foreign assets as percent of short-term external debt plus all FX deposits 3/ 4/	46.6	56.9	68.1	74.5	71.5
Financial market indicators					
Foreign currency debt rating (Moody's) 5/	B3	B3	B3	B3	…
Foreign currency debt rating (S&P) 5/	B-	B-	B	B	…
EMBI secondary market spread (bps, end of period) 5/	1,228	624	388	308	…
Exchange rate (per U.S. dollar, period average)	21.6	28.2	28.6	…	…

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

1/ As of September 30, 2005.

2/ Includes all use of Fund credit.

3/ By remaining maturity.

4/ Excludes nonreserve assets from the BCU.

5/ As of December 15, 2005.

Table 7. Uruguay: Public Sector Financing Outlook 2005 and 2006 1/

(In millions of U.S. dollars)

	2005			2006				
	Actual	Proj.	Proj.	Proj.				
	Q1-Q3	Q4	Year	Q1	Q2	Q3	Q4	Year
Public sector gross borrowing requirements	**2,096**	**466**	**2,562**	**673**	**507**	**473**	**747**	**2,399**
o/w: IMF repurchases	480	0	480	0	113	245	271	630
o/w: World Bank/IDB	259	91	350	144	115	144	103	505
o/w: Bond amortizations	662	44	705	230	49	57	407	743
Gross financing	**2,298**	**664**	**2,962**	**673**	**507**	**473**	**747**	**2,399**
o/w: IMF disbursements	297	0	297	169	124	124	124	543
o/w: World Bank/IDB	146	208	354	68	18	68	278	432
o/w: Bond placements	1,422	325	1,747	383	324	312	394	1,412
o/w: >10 year maturity international issuance	895	200	1,095	243	204	195	274	916
o/w: >UI bonds	276	66	342	81	62	62	66	271
o/w: Short-term debt	92	0	92	31	0	0	0	92
Pre-financing 2/	**202**	**198**	**400**	**0**	**0**	**0**	**0**	**0**
Memorandum items:								
Fund credit outstanding		...	2,387	...	...	...	...	2,259
(as a share of quota)		...	526	...	...	...	...	506
Net World Bank/IDB	-112	117	5	-76	-97	-76	176	-73
Net bond placements	760	281	1042	153	275	254	-13	669

Source: Central Bank of Uruguay and Fund staff estimates.

1/ Excludes the assumption of net liabilities from BHU in 2006.

2/ Reflected in the buildup of reserves.

Table 8. Uruguay: Schedule of Purchases Under the Stand-By Arrangement, 2005–08

Availability Date	Amount of Purchase SDR	Amount of Purchase Percent Quota	Conditions
June 8, 2005	30.65	10.0	Program approval
September 28, 2005	30.65	10.0	Completion of first review and observance of structural PCs and end-June quantitative PCs
January 18, 2006	30.65	10.0	Completion of second review and observance of structural PCs and end-December quantitative PCs 1/
March 7, 2006	85.82	28.0	Completion of third review and observance of structural PCs and end-December quantitative PCs
May 31, 2006	85.82	28.0	Completion of fourth review and observance of structural PCs and end-March quantitative PCs
August 31, 2006	85.82	28.0	Completion of fifth review and observance of structural PCs and end-June quantitative PCs
November 30, 2006	85.82	28.0	Completion of sixth review and observance of structural PCs and end-September quantitative PCs
February 28, 2007	67.43	22.0	Completion of seventh review and observance of structural PCs and end-December quantitative PCs
May 31, 2007	67.43	22.0	Completion of eighth review and observance of structural PCs and end-March quantitative PCs
August 31, 2007	67.43	22.0	Completion of ninth review and observance of structural PCs and end-June quantitative PCs
November 30, 2007	67.43	22.0	Completion of tenth review and observance of structural PCs and end-September quantitative PCs
February 28, 2008	30.65	10.0	Completion of eleventh review and observance of structural PCs and end-December quantitative PCs
May 31, 2008	30.65	10.0	Completion of twelfth review and observance of structural PCs and end-March quantitative PCs
Total access	**766.25**		
Percent of quota	**250.0**		

Source: Fund staff estimates.

1/ A waiver of applicability has been requested.

Table 9. Uruguay: Projected Payments to the Fund
and Indicators of Capacity to Repay the Fund

	2003	2004	2005	2006	2007	2008	2009	2010
				(In SDR million)				
Fund disbursements (existing and prospective)								
Principal disbursements	364.2	372.8	201.1	373.9	269.7	61.3	0.0	0.0
Existing	364.2	372.8	201.1	0.0	0.0	0.0	0.0	0.0
Prospective	0.0	0.0	0.0	373.9	269.7	61.3	0.0	0.0
Fund repurchases and charges (existing and prospective)								
Principal (repurchases) 1/	57.1	270.3	317.3	434.3	574.4	332.3	310.4	274.2
On existing purchases	57.1	270.3	317.3	434.3	574.4	332.3	234.5	36.6
On prospective purchases	0.0	0.0	0.0	0.0	0.0	0.0	75.9	237.5
Charges and interest 2/	45.9	64.0	78.2	91.9	74.0	58.2	41.1	25.7
On existing purchases	45.9	64.0	78.2	81.9	45.3	21.6	8.9	1.6
On prospective purchases	0.0	0.0	0.0	10.0	28.8	36.6	32.3	24.1
Total payments to Fund 1/	103.0	334.4	395.5	526.2	648.4	390.5	351.5	299.8
In millions of U.S. dollars	144.3	495.2	585.6	766.0	945.0	569.6	512.8	437.2
In percent of exports of goods and NFS	4.7	12.4	12.6	15.1	17.0	9.4	8.0	6.4
In percent of GDP	1.3	3.7	3.5	4.0	4.7	2.7	2.3	1.9
In percent of quota	33.6	109.1	129.0	171.7	211.6	127.4	114.7	97.8
In percent of overall external debt service	8.9	30.2	24.9	28.2	34.2	25.1	22.5	18.8
In percent of gross reserves	6.9	19.7	18.8	23.5	27.6	15.9	14.1	11.7
Fund credit outstanding				(End-of-period)				
In millions of SDRs	1,625.9	1,728.4	1,612.2	1,551.8	1,247.1	976.1	665.7	391.6
In millions of U.S. dollars	2,385.9	2,662.3	2,344.3	2,260.0	1,818.2	1,423.9	970.9	570.8
In percent of exports of goods and NFS	77.4	66.4	50.5	44.7	32.7	23.5	15.1	8.4
In percent of GDP	21.3	20.1	14.0	11.9	9.1	6.7	4.4	2.4
In percent of quota	530.5	563.9	526.0	506.3	406.9	318.5	217.2	127.8
In percent of public sector external debt	25.0	26.1	22.2	21.4	17.6	14.1	9.8	5.9
In percent of overall external debt	21.7	23.0	19.7	19.0	15.6	12.4	8.7	5.2
In percent of gross reserves	114.3	106.0	75.4	69.4	53.2	39.6	26.7	15.3
Memorandum items:				(In millions of U.S. dollars unless otherwise noted)				
Exports of goods and NFS	3,084	4,008	4,638	5,060	5,568	6,052	6,412	6,821
Quota (millions of SDRs)	306.5	306.5	306.5	306.5	306.5	306.5	306.5	306.5
GDP	11,211	13,267	16,724	18,913	20,081	21,208	22,252	23,424
U.S. dollar per SDR, e.o.p.	1.47	1.54	1.45	1.46	1.46	1.46	1.46	1.46
U.S. dollar per SDR, average	1.40	1.48	1.48	1.46	1.46	1.46	1.46	1.46
Public sector debt	11,705	12,272	12,269	12,919	13,022	13,102	13,159	13,267
Public sector external debt 3/	9,557	10,206	10,546	10,567	10,313	10,109	9,861	9,667
Overall external debt service	1,614	1,638	2,349	2,717	2,765	2,272	2,281	2,323
Overall external debt	11,012	11,594	11,878	11,899	11,645	11,441	11,193	10,999
Gross foreign reserves	2,087	2,512	3,110	3,255	3,418	3,593	3,640	3,737

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

1/ Projections on obligations basis.
2/ Includes charges for GRA credit outstanding and other charges (for example, SDR charges). Projections are based on a basic rate of charge in the GRA of 4.10 percent plus burden-sharing of 14 basis points.
3/ Excluding public commercial banks.

I. URUGUAY: ASSESSING PUBLIC SECTOR DEBT SUSTAINABILITY

1. **Uruguay's public debt outlook has improved significantly from that right after the 2002 crisis.** At that time, the debt-to-GDP ratio was over 105 percent of GDP, projected to decline gradually to 75 percent by 2012. After the 2003 debt exchange, the outlook strengthened further, with the projected debt-to-GDP ratio down to 63 percent by 2012 (Country Report No. 03/247). Since then, the debt-to-GDP ratio has declined by some 30 percentage points, to an estimated 73 percent by end-September 2005, and it is now envisaged to decline to 52 percent of GDP by 2012. The improved outlook reflects mainly stronger than previously envisaged growth, recovery of the real exchange rate, and lower interest rates.

Uruguay: Debt Sustainability Outlooks
(in percent of GDP, unless indicated otherwise)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Public sector debt stock											
Revised projections	96	104	92	73	68	65	62	59	57	54	52
Post debt exchange 1/	96	112	103	94	85	78	74	70	67	65	63
2002 Crisis (Best case scenario)	95	111	93	82	76	75	74	73	73	74	75
Assumptions:											
Revised projections											
Real growth (percent)	-11.0	2.2	12.3	6.0	4.0	3.5	3.0	3.0	3.0	3.0	3.0
Spreads	1400	900	600	387	450	450	450	450	450	450	450
Real exchange rate 2/	-11	-33	-33	-21	-14	-13	-12	-12	-12	-12	-12
Primary fiscal balance	0.0	2.7	3.8	3.6	3.7	4.0	4.0	4.0	4.0	4.0	4.0
Post-debt exchange											
Real growth (percent)	-10.8	-1.0	4.5	4.0	4.0	3.0	3.0	3.0	2.5	2.5	2.5
Spreads	1400	1200	1000	800	700	600	500	500	500	500	500
Real exchange rate 2/	-27	-41	-38	-33	-29	-24	-23	-23	-23	-23	-23
Primary fiscal balance	0.3	3.0	3.2	3.3	3.3	3.8	3.8	3.8	3.8	3.8	3.8
2002 Crisis											
Real growth (percent)	-11.1	-4.5	4.0	4.5	4.0	3.0	3.1	3.1	3.0	3.0	3.0
Spreads	1400	1400	1300	1000	700	700	700	700	700	700	700
Real exchange rate 2/	-39	-49	-30	-26	-26	-26	-26	-26	-26	-26	-26
Primary fiscal balance	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0

1/ Debt levels adjusted to include the debt to the Fund.
2/ Percentage change relative to end-2001.

2. **In the current baseline projection, the debt-to-GDP ratio increases in 2006 as a result of the cost of resolving BHU and the financing of the deposit insurance scheme, but the medium-term outlook remains close to the levels envisaged during the previous review (Table 1).** The government will need to finance the deposit insurance scheme with some US$60 million and may have to take on net debt of some US$0.4 billion (2 percent of GDP) in 2006 from BHU,[11] leaving the debt ratio at about 62 percent of GDP in 2008 (the end of the program) and just above 50 percent of GDP by 2012 (compared to 48 percent of GDP at the time of the last review).

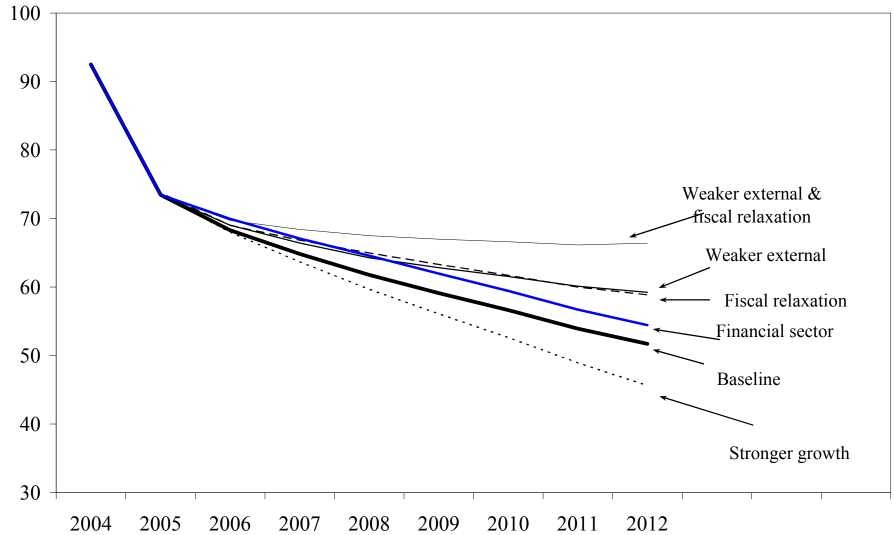
[11] This assumes that gross debt of some US$1 billion would be partly offset by the estimated net worth of BHU's assets of some US$640 million. This assumes that two-thirds of BHU's loan portfolio (after current provisioning) can be recovered and that cash payment on leases and proceeds from the sale of properties would increase by about half, as a result of improved management.

3. **Although the structure of Uruguay's public debt has improved, it remains highly vulnerable to interest rate, exchange rate, and rollover risks.** Of the total debt, about 87 percent is exposed to exchange rate risk (mainly the U.S. dollar and SDR) and about 40 percent to interest rate risk. While projected debt-service has declined further since the approval of the current program in June 2005, reflecting lower interest costs and refinancing at longer maturities, it remains high (16 percent of GDP in 2006, declining to 11 percent of GDP by 2010).

4. **In the Fund's standard DSA template, the no-policy change scenario and standardized bound tests remain broadly unchanged from the last review (Table 2).** The scenarios show that public debt remains on a declining path under the no-policy change scenario, but becomes unsustainable when key economic variables are set at their historical averages. The standardized bound tests illustrate that Uruguay's debt outlook is highly vulnerable to exchange rate movements, but also to interest rate and growth rate shocks. Vulnerability to shocks to the primary fiscal balance is also important, but less pronounced.

5. **Tailored scenarios are used to assess Uruguay's overall debt vulnerabilities.** The figures below presents illustrative scenarios of financial sector, external, fiscal and growth shocks to Uruguay's debt outlook.

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



- **Contingent financial sector liabilities.** While the baseline scenario already assumes a fiscal cost to resolve BHU, more pessimistic scenarios imply additional debt accumulation from contingent liabilities. For example, the debt-to-GDP ratio in 2012 could be some 3 percent higher than in the baseline under the assumption that the acquired assets from BHU have no recovery value, the government guarantee on the debt of trust funds for the recovery of nonperforming loans with BROU would be called (US$350 million), and the court-ordered payments to the former owners of NBC would come due (US$120 million).

- **A deterioration in the external environment.** This scenario assumes a sharper-than-currently-envisaged increase in U.S. interest rates (by 100 bps), leading to a slowdown in world demand and higher costs of external financing. This in turn would result in a slower growth in Uruguay. The scenario also assumes that the real appreciation of some 2 percent over the medium term assumed in the baseline will not take place, and that the spread on the Uruguay's debt increases by some 50 basis points. This would lead to a debt-to-GDP ratio by 2012 of some 7 percent higher than in the baseline.

- **A weakened fiscal outlook.** This scenario assumes that higher domestic spending needs would weaken the fiscal position, implying a primary surplus of 3 percent of GDP (compared to 4 percent of GDP in the baseline). While this may raise near-term growth somewhat, the higher financing needs would drive up interest rate spreads by an assumed 50 bps. As a result, the debt-to-GDP ratio in 2012 would be at 58.5 percent of GDP, 7½ percentage points above baseline projections.

- **Combined external deterioration and weakened fiscal outlook.** Combining scenarios one and two, the debt-to-GDP ratio is projected to remain 14 percent above baseline in 2012.

- **A strengthening of the overall growth outlook.** This scenario assumes that the government accelerates the implementation of a comprehensive structural reform agenda, leading to substantial increases in private investment and an increase of potential growth by 1 percentage point, to 4 percent. This in turn is assumed to strengthen the primary surplus to 4½ percent of GDP and reduce spreads by 50 basis points. As a result, the debt-to-GDP ratio would decline to 46 percent by 2012.

Table 1. Uruguay:Public Sector Debt Sustainability 1/ 2/
(Includes costs of bank restructuring)

					Projections							
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
A. Assumptions												
Real GDP growth (percent)	-3.4	-11.0	2.2	12.3	6.0	4.0	3.5	3.0	3.0	3.0	3.0	3.0
Interest rate spread (bps)	284	1400	900	600	387	450	450	450	450	450	450	450
Real U.S. dollar exchange rate (avg.) (change in percent)	-13.7	-11.0	-22.1	-0.2	12.6	6.9	1.0	0.7	0.2	0.0	0.0	0.0
Primary balance: Consolidated public sector	**-1.2**	**0.0**	**2.7**	**3.8**	**3.6**	**3.7**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**
Non-financial public sector	-1.0	0.2	2.9	4.0	3.7	3.9	4.2	4.2	4.2	4.2	4.2	4.2
BCU	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Overall Balance: Consolidated public sector	**-4.1**	**-4.6**	**-3.2**	**-2.2**	**-1.0**	**-1.1**	**-0.6**	**-0.5**	**-0.4**	**-0.6**	**-0.5**	**-0.6**
Non-financial public sector	-3.8	-4.3	-2.9	-1.2	-0.8	-0.8	-0.3	-0.2	-0.1	-0.3	-0.2	-0.4
BCU	-0.3	-0.3	-0.4	-1.0	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
B. Debt Dynamics (in percent of GDP)												
Gross non-financial public sector debt	**46**	**96**	**104**	**92**	**73**	**68**	**65**	**62**	**59**	**57**	**54**	**52**
Of which:												
Contribution from REER (cum since 2004)	...	...	...	0	9	14	14	14	13	13	12	12
Contribution from Growth (cum since 2004)	...	...	...	0	10	15	19	23	27	31	34	38
C. Cash Flow (in millions of U.S. dollars)												
Gross borrowing needs	**1,210**	**3,209**	**1,251**	**2,504**	**2,562**	**2,749**	**2,099**	**1,530**	**1,497**	**1,621**	**2,191**	**1,484**
Augmented public sector deficit	707	2524	324	161	150	558	67	48	31	86	67	102
Public sector deficit	707	526	324	161	130	158	57	38	21	77	60	96
Bank assistance 2/	0	1998	0	0	20	400	10	10	10	8	7	6
Buildup in free reserves at the central bank	-7	-364	6	631	581	159	100	100	100	100	100	100
Amortization	510	1,049	921	1,711	1,832	2,032	1,932	1,382	1,367	1,435	2,024	1,282
Long-term bonds and inflation-indexed bonds	403	349	221	29	284	633	156	210	176	309	909	392
Letras (2 years)	...	...	...	...	421	110	310	225	250	250	250	250
Peso bonds (short-term)	0	209	209	637	126	45	31	50	50	50	50	50
Commercial bank loans	0	214	217	307	89	74	101	106	118	84	78	79
Supplier credits	0	0	0	0	42	35	26	31	37	36	35	25
IDB/WB and other official debt	97	205	234	339	390	505	471	276	283	306	316	319
IMF	10	72	40	400	480	630	837	485	453	400	387	168
Gross Financing 2/	**1,209**	**3,209**	**1,251**	**2,504**	**2,562**	**2,749**	**2,099**	**1,530**	**1,497**	**1,621**	**2,191**	**1,484**
Long-term bonds (external)	1292	143	405	371	1095	916	688	439	458	638	1193	494
Inflation-indexed instruments	...	...	...	...	342	271	250	250	250	250	250	250
Letras (2 years)	...	...	...	...	310	225	250	250	250	250	250	250
Peso bonds (short-term)	-15	677	637	544	92	31	50	50	50	50	50	50
Commercial bank	33	-16	-475	365	11	-9	101	106	118	84	78	79
Use of deposits	26	-21	-543	200	-111	84	0	0	0	0	0	0
Loans	7	5	68	165	122	74	101	106	118	84	78	79
IDB/WB and other official debt	198	789	461	366	354	432	341	314	333	313	335	336
IMF	0	1,603	484	552	297	543	393	89	0	0	0	0
Central bank credit (net) (net of IMF disbursments)	0	0	0	0	0	0	0	0	0	0	0	0
Other inflows (net) 3/	-299	13	-261	307	62	340	26	31	37	36	35	25
Residual financing needs	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
D. Other Indicators												
Total debt service (in percent of GDP)	5.6	13.1	14.0	18.1	15.5	15.6	14.2	11.0	10.5	10.7	12.7	9.5
Average interest rate (in percent)	12.6	5.5	5.7	6.6	6.2	7.2	7.1	7.3	7.4	8.1	8.4	9.0
Memorandum items:												
GDP (millions of dollars)	18,561	12,089	11,211	13,267	16,724	18,913	20,081	21,208	22,252	23,424	24,759	26,071
Nominal debt (millions of dollars)	8,538	11,551	11,705	12,272	12,269	12,919	13,022	13,102	13,159	13,267	13,356	13,480
Commerical bond placements (net) (millions of dollars)	889	-207	184	342	1,042	669	722	504	532	578	535	352
World Bank/IDB (net)	...	...	...	...	49	-37	-121	47	57	14	25	22
Rollover of Fund obligations (in percent)	...	...	...	...	62	86	47	18	0	0	0	0
Fund credit outstanding (millions of dollars)	145	1,754	2,386	2,662	2,387	2,259	1,817	1,424	971	571	184	17
Fund credit outstanding (in percent of GDP)	0.8	14.5	21.3	20.1	14.3	11.9	9.1	6.7	4.4	2.4	0.7	0.1
Fund credit outstanding (as a share of quota)	0.5	5.5	530.5	563.9	526.0	506.3	406.9	318.5	217.2	127.8	41.3	3.7

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

1/ Net of free reserves and monetary policy instruments.
2/ Includes the funding of the deposit insurance scheme (US$20 million in 2005 and US$40 million in 2006) and the assumption of the BHU liabilities of US$400 (net) in 2006, of which US$990 million are in form of liabilities and US$640 in form of financial assets.
3/ In 2006: assumption of BHU financial obligations and cancellation of BHU deposits.

Table 2. Uruguay: Public Sector Debt Sustainability Framework, 2000-2010

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	primary balance 1/
Baseline: Public sector debt 2/	38.5	46.0	95.5	104.4	92.5	**73.4**	**68.3**	**64.9**	**61.8**	**59.1**	**56.6**	**1.6**
Of whch: foreign-currency denominated	35.7	43.2	76.6	94.7	83.4	66.2	61.6	58.5	55.7	53.3	51.1	
Change in public sector debt	0.5	7.5	49.5	8.9	-11.9	-19.1	-5.1	-3.5	-3.1	-2.6	-2.5	
Identified debt-creating flows (4+7+12)	5.9	10.3	57.5	-8.3	-14.0	-5.1	-5.4	-4.7	-4.0	-3.5	-3.2	
Primary deficit	1.5	1.2	-0.1	-2.7	-3.8	-3.6	-3.7	-4.0	-4.0	-4.0	-4.0	
Revenue and grants	28.8	33.2	31.1	31.1	30.1	30.3	29.3	29.3	29.1	29.1	29.1	
Primary (non-interest) expenditure	30.4	34.4	31.1	28.4	26.3	26.7	25.6	25.3	25.1	25.1	25.1	
Automatic debt dynamics 3/	4.4	9.2	40.7	-5.6	-10.3	-1.5	-1.7	-0.7	0.0	0.5	0.8	
Contribution from interest rate/growth differential 4/	1.7	2.3	2.2	-10.7	-11.6	-1.5	-1.7	-0.7	0.0	0.5	0.8	
Of which: contribution from real interest rate	1.1	1.0	-2.6	-8.9	-0.9	3.7	1.0	1.5	1.8	2.2	2.5	
Of which: contribution from real GDP growth	0.5	1.3	4.8	-1.7	-10.7	-5.2	-2.7	-2.2	-1.8	-1.7	-1.7	
Contribution from exchange rate depreciation 5/	2.7	6.9	38.5	5.1	1.3	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	16.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	16.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 6/	-5.4	-2.8	-8.0	17.1	2.1	-14.0	0.3	1.2	1.0	0.9	0.7	
Public sector debt-to-revenue ratio 2/	133.4	138.5	306.9	336.2	307.6	242.4	233.2	221.3	212.3	203.2	194.6	
Gross financing need 7/	8.2	7.3	12.0	14.0	13.8	11.8	12.1	10.2	7.0	6.5	6.7	
(in billions of U.S. dollars)	1.6	1.4	1.4	1.6	1.8	2.0	2.3	2.0	1.5	1.4	1.6	
Debt service-to-GDP ratio						15.4	15.8	14.2	11.0	10.5	10.7	
Debt service-to-fiscal revenue ratio						50.8	54.0	48.5	37.7	36.1	36.8	
Scenario with key variables at their historical averages 8/						**73.4**	**76.2**	**80.3**	**84.4**	**88.8**	**93.2**	**5.2**
Debt service-to-GDP ratio						15.4	19.1	18.1	15.1	15.0	15.8	
Scenario with no policy change (constant primary balance) in 2005-2010						**73.4**	**68.5**	**65.5**	**62.8**	**60.7**	**58.7**	**1.6**
Debt service-to-GDP ratio						16.5	17.4	15.5	12.0	11.5	11.8	
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	-1.4	-3.4	-11.0	2.2	12.3	6.0	4.0	3.5	3.0	3.0	3.0	
Average nominal interest rate on public debt (in percent) 9/	7.0	7.8	10.7	7.5	6.8	5.3	7.2	7.3	7.4	7.6	8.3	
Average real interest rate in U.S. dollar value (nominal rate minus change in GDP deflator, in percent)	8.8	15.9	36.2	-5.6	-0.5	4.3	1.7	2.6	3.1	3.9	4.6	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-7.2	-15.3	-45.7	-6.8	-1.5	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	4.0	5.3	18.7	18.4	7.0	1.0	5.5	4.7	4.3	3.7	3.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	-3.6	9.4	-19.6	-6.6	4.0	7.6	-0.3	2.3	2.2	3.0	3.0	
Primary deficit	1.5	1.2	-0.1	-2.7	-3.8	-3.6	-3.7	-4.0	-4.0	-4.0	-4.0	

1/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

2/ Framework covers the public sector (net of free reserves and monetary policy instruments).

3/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

4/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.

5/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

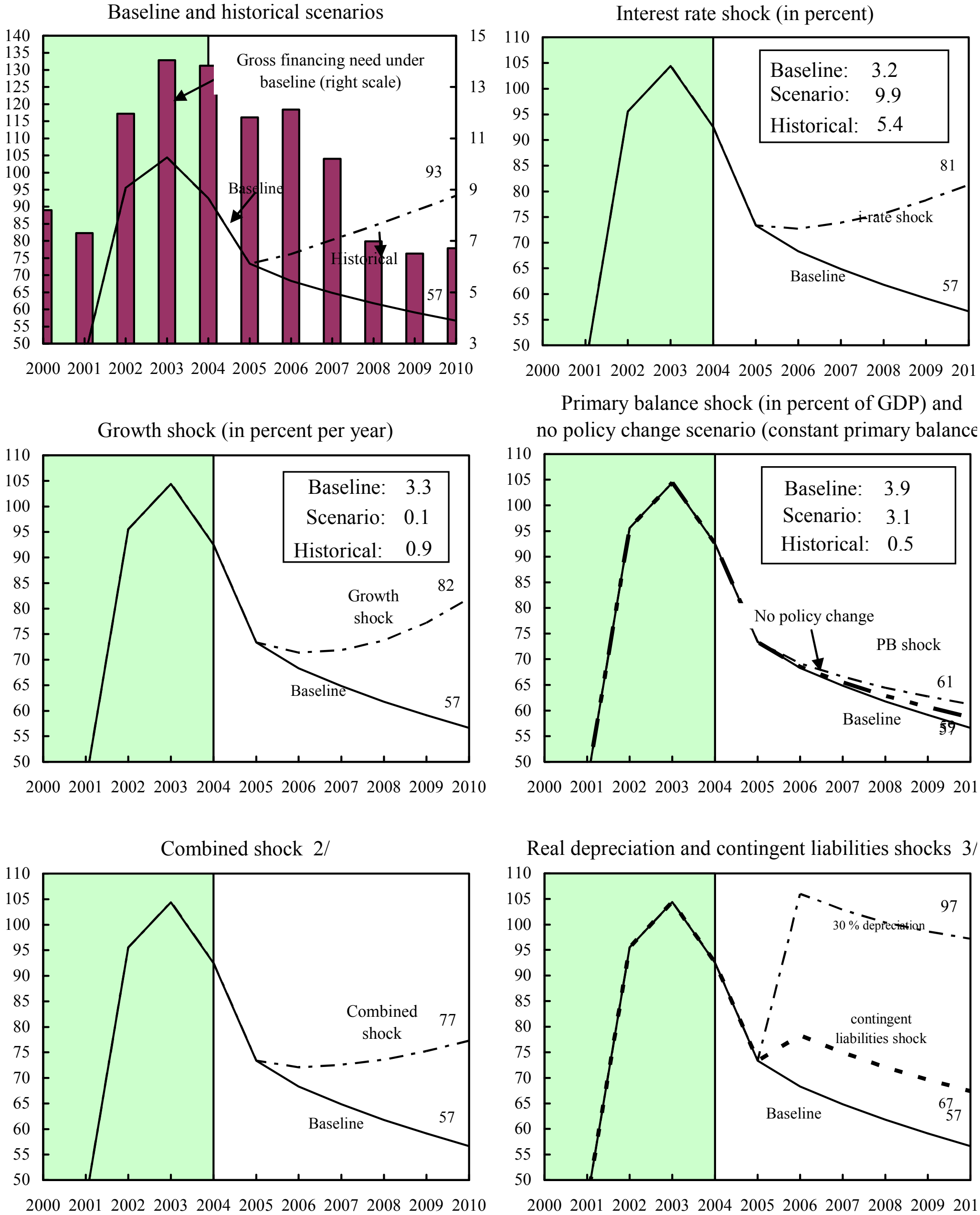
6/ For projections, this line includes exchange rate changes.

7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

9/ Derived as nominal interest expenditure divided by previous period debt stock.

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



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

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

		Actual					Projections						
		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	44.3	48.1	87.5	98.2	87.4	**71.0**	**62.9**	**58.0**	**53.9**	**50.3**	**47.0**	**-0.7**
2	Change in external debt	4.8	3.9	39.4	10.7	-10.8	-16.4	-8.1	-4.9	-4.0	-3.6	-3.3	
3	Identified external debt-creating flows (4+8+9)	3.1	4.8	21.1	3.8	-16.9	-4.3	-3.3	-3.3	-3.5	-3.1	-3.0	
4	Current account deficit, excluding interest payments	1.3	0.2	-7.8	-2.6	-4.4	-2.1	1.3	-2.0	-2.9	-3.7	-3.5	
5	Deficit in balance of goods and services	2.7	2.4	-1.7	-3.1	-2.5	0.3	3.7	0.4	-0.6	-1.6	-1.5	
6	Exports	18.2	17.6	22.3	27.5	30.2	27.7	26.8	27.7	28.5	28.8	29.1	
7	Imports	20.9	20.1	20.6	24.4	27.7	28.0	30.5	28.1	28.0	27.2	27.6	
8	Net nondebt creating capital inflows (negative)	-1.4	-1.7	-1.5	-3.6	-2.5	-2.6	-6.6	-3.7	-3.5	-2.2	-2.3	
9	Automatic debt dynamics 1/	3.1	6.3	30.4	9.9	-9.9	0.3	2.1	2.5	2.8	2.8	2.8	
10	Contribution from nominal interest rate	1.5	2.7	4.6	3.1	5.2	4.5	4.6	4.5	4.4	4.4	4.2	
11	Contribution from real GDP growth	0.6	1.6	8.2	-2.1	-10.2	-4.2	-2.5	-2.1	-1.6	-1.5	-1.4	
12	Contribution from price and exchange rate changes 2/	1.0	2.0	17.6	8.9	-4.9	...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	1.7	-0.9	18.2	6.9	6.1	-12.0	-4.8	-1.7	-0.5	-0.5	-0.4	
	External debt-to-exports ratio (in percent)	243.1	272.8	392.8	357.1	289.3	256.1	235.1	209.1	189.0	174.6	161.2	
	Gross external financing need (in billions of U.S. dollars) 4/	3.2	3.5	3.8	3.0	2.0	2.8	3.3	2.7	2.0	1.7	1.8	
	(in percent of GDP)	15.8	19.0	31.3	26.4	14.8	16.6	17.4	13.5	9.3	7.7	7.7	
	Scenario with key variables at their historical averages 5/						**71.0**	**74.4**	**77.0**	**81.0**	**84.8**	**89.4**	**5.3**
	Key Macroeconomic Assumptions Underlying Baseline												
	Real GDP growth (in percent)	-1.4	-3.4	-11.0	2.2	12.3	6.0	4.0	3.5	3.0	3.0	3.0	
	GDP deflator in US dollars (change in percent)	-2.6	-4.4	-26.8	-9.2	5.2	18.9	8.7	2.6	2.5	1.9	2.2	
	Nominal external interest rate (in percent)	3.6	5.6	6.2	3.2	6.2	6.4	7.3	7.6	8.1	8.5	8.9	
	Growth of exports (US dollar terms, in percent)	5.2	-10.5	-17.8	14.5	30.0	15.7	9.1	10.0	8.7	6.0	6.4	
	Growth of imports (US dollar terms, in percent)	4.9	-11.2	-33.1	9.7	34.3	27.7	22.9	-2.1	5.1	2.2	6.8	
	Current account balance, excluding interest payments	-1.3	-0.2	7.8	2.6	4.4	2.1	-1.3	2.0	2.9	3.7	3.5	
	Net nondebt creating capital inflows	1.4	1.7	1.5	3.6	2.5	2.6	6.6	3.7	3.5	2.2	2.3	

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

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

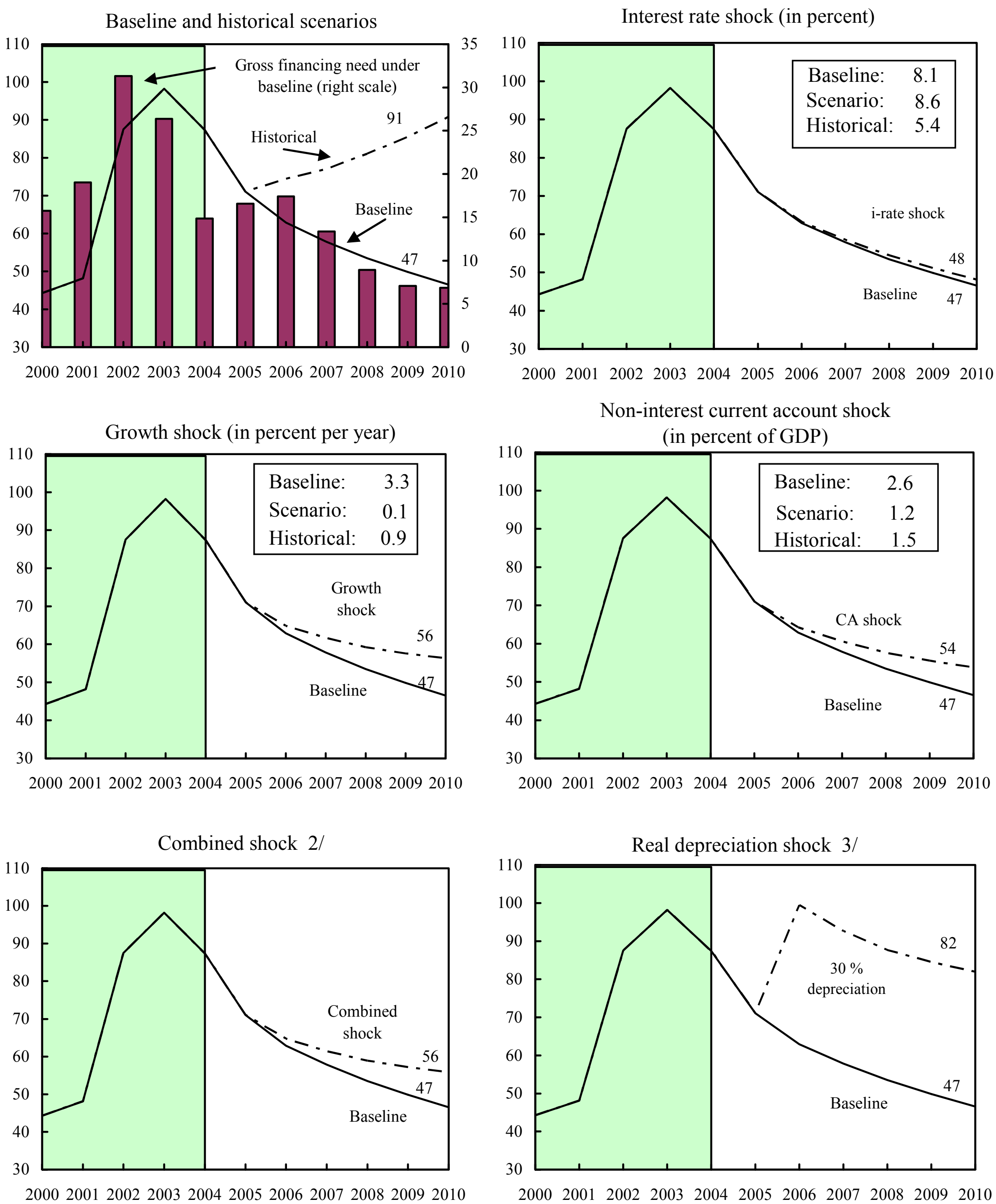
3/ For projection, line includes the impact of price and exchange rate changes.

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

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

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

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



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

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

	Actual					Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Baseline Projections											
Gross financing need 1/	8.2	7.3	12.0	14.0	13.8	11.8	12.1	10.2	7.0	6.5	6.7
(in billions of U.S. dollars)	1.6	1.4	1.4	1.6	1.8	2.0	2.3	2.0	1.5	1.4	1.6
II. Stress Tests											
Gross financing need 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						11.8	19.2	18.7	15.8	16.0	17.3
A2. No policy change (constant primary balance) in 2006-10						11.8	12.3	10.7	7.6	7.2	7.5
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						11.8	17.3	16.4	13.7	14.2	15.8
B2. Real GDP growth is at baseline minus one-half standard deviations						11.8	13.6	13.2	11.4	12.7	15.3
B3. Primary balance is at baseline minus one-half standard deviations						11.8	13.1	11.4	8.3	7.9	8.4
B4. Combination of B1-B3 using 1/4 standard deviation shocks						11.8	15.5	14.4	11.6	11.9	13.1
B5. One time 30 percent real depreciation in 2006 5/						11.8	17.9	18.4	13.7	13.3	14.2
B6. 10 percent of GDP increase in other debt-creating flows in 2006						11.8	13.7	12.4	8.8	8.3	8.7
Gross financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						2.0	3.5	3.6	3.1	3.2	3.6
A2. No policy change (constant primary balance) in 2006-10						2.0	2.3	2.2	1.6	1.6	1.8
B. Bound Tests											
B1. Real interest rate is at baseline plus one-half standard deviations						2.0	3.3	3.3	2.9	3.2	3.7
B2. Real GDP growth is at baseline minus one-half standard deviations						2.0	2.5	2.5	2.2	2.5	3.1
B3. Primary balance is at baseline minus one-half standard deviations						2.0	2.5	2.3	1.8	1.8	2.0
B4. Combination of B1-B3 using 1/4 standard deviation shocks						2.0	2.9	2.8	2.3	2.5	2.8
B5. One time 30 percent real depreciation in 2006 4/						2.0	2.1	2.3	1.8	1.9	2.1
B6. 10 percent of GDP increase in other debt-creating flows in 2006						2.0	2.6	2.5	1.9	1.9	2.0

1/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period. Excludes assumption of BHU liabilities for 2006.
2/ Gross financing under the stress test scenarios is derived by assuming the same ratio of short-term to total debt as in the baseline scenario and the same average maturity on medium- and long-term debt. Interest expenditures are derived by applying the respective interest rate to the previous period debt stock under each alternative scenario.
3/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
4/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

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

	Actual					Projections					
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
I. Baseline Projections											
Gross external financing need in billions of U.S. dollars 1/	3.2	3.5	3.8	3.0	2.0	2.8	3.3	2.7	2.0	1.7	1.8
in percent of GDP	15.8	19.0	31.3	26.4	14.8	16.6	17.4	13.5	9.3	7.7	7.7
II. Stress Tests											
Gross external financing need in billions of U.S. dollars 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						2.8	2.6	2.7	2.2	2.3	2.4
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						2.8	3.4	2.8	2.1	1.8	1.9
B2. Real GDP growth is at baseline minus one-half standard deviations						2.8	3.3	2.7	2.0	1.8	2.0
B3. Non-interest current account is at baseline minus one-half standard deviations						2.8	3.6	3.1	2.4	2.2	2.5
B4. Combination of B1-B3 using 1/4 standard deviation shocks						2.8	3.5	3.0	2.3	2.1	2.3
B5. One time 30 percent nominal depreciation in 2006						2.8	3.2	2.9	2.2	2.1	2.3
Gross external financing need in percent of GDP 2/											
A. Alternative Scenarios											
A1. Key variables are at their historical averages in 2006-10 3/						16.6	16.0	17.0	14.1	14.7	16.2
B. Bound Tests											
B1. Nominal interest rate is at baseline plus one-half standard deviations						16.6	17.8	14.0	9.8	8.2	8.3
B2. Real GDP growth is at baseline minus one-half standard deviations						16.6	17.9	14.5	10.5	9.4	9.9
B3. Non-interest current account is at baseline minus one-half standard deviations						16.6	18.9	15.4	11.4	10.1	10.5
B4. Combination of B1-B4 using 1/4 standard deviation shocks						16.6	18.6	15.2	11.2	10.0	10.5
B5. One time 30 percent nominal depreciation in 2006						16.6	26.9	22.7	16.8	15.2	15.6

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

II. FUND RELATIONS

(As of November 30, 2005)

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

I. FINANCIAL RELATIONS

II. **General Resources Account**:	In millions of SDRs	In percent of Quota
Quota	306.50	100.0
Fund holdings of currency	1,918.66	625.99
Reserve position	0.0	0.0

III. **SDR Department**:	In millions of SDRs	Percent of Allocation
Net cumulative allocation	49.98	100.0
Holdings	4.37	8.75

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

V. **Financial Arrangements**:

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

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

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	0.00	434.33	574.40	332.27	234.53
Charges/interest	0.00	82.48	45.94	22.19	9.53
Total	0.00	516.81	620.34	354.45	244.06

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

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	0.00	1008.73	332.27	234.53	25.14
Charges/interest	0.00	67.56	22.81	9.53	2.23
Total	0.00	1076.29	355.08	244.05	38.86

II. NONFINANCIAL RELATIONS

VII. **Safeguards Assessment:** The authorities have already implemented many of the recommendations from the safeguards assessment conducted under the current SBA, completed in September 2005. In particular, (i) Uruguay's total obligations to the Fund are now included in the BCU's financial statements; (ii) data submitted to the Fund is periodically reviewed for consistency with the Technical Memorandum of Understanding; and (iii) the criteria for the selection and appointment of the BCU's external audit firm have been amended in line with the safeguards recommendation

VIII. **Exchange Rate Arrangement**: The currency is the Uruguayan peso (Ur$). Uruguay has followed an independently floating exchange rate regime since July 29, 2002. On December 15, 2005, buying and selling interbank rates for the U.S. dollar, the intervention currency, were Ur$23.17 and Ur$23.22, respectively. Uruguay's exchange

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

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

IX. **Article IV Consultation:** The 2003 Article IV consultation was concluded by the Executive Board on July 11 (Country Report 03/247). Uruguay is on the standard consultation cycle governed by the provisions approved by the Executive Board on July 15, 2002. The next Article IV discussions will be held in June 2006, together with the FSAP (see below).

X. **Ex Post Assessment:** The Ex Post Assessment of Longer-Term Program Engagement was considered by the Executive Board on March 18, 2005 (Country Report No. 05/202 and Corr. 1).

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

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

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

RELATIONS WITH THE WORLD BANK GROUP
(As of November 30, 2005)

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

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

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

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

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

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

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

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

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

III. IBRD Loan Transactions (calendar year)

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

[1] As of August 31, 2005

RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK
(As of December 16, 2005)

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

The Bank's new strategy proposes a target lending scenario of US$1.2 million for the five-year period 2005–2009, which together with a normal implementation of the loan portfolio, mainly investment projects, will allow for the net lending flows to remain relatively neutral. The lending program for 2005–2006 and a tentative program for the later years—2007-2009– was agreed with the new authorities during the Bank's Programming Mission on August 22, 2005. This program includes lending to support the Government in the key policy areas of the social sectors, competitiveness and public sector management. To this end, a social sector loan for US$250 million was approved on August 3, 2005, to support the development and implementation of Government's social policy aimed at reducing poverty, improving the human resource base among the poor, and strengthening the sector's institutional framework. A sectoral program to improve competitiveness for US$100 million is under preparation with approval expected in 2006. Within the public sector management area, a three-year programmatic loan, to support improvements in tax administration and public sector management, is under preparation, with expected approval in 2006; the estimated financing for the first year amounts to US$50 million while for the next two years the amount is to be determined. The lending program also includes investment projects with new operations planned in support of transport infrastructure, sanitation in Montevideo and social programs such as a neighborhood improvement programs. During 2005 a loan for a program to support the productivity and development of new livestock products, for US$15.8 million, was approved in July and financing in support of the debt management unit, for US$2.5 million, was approved in November.

As of December 15, 2005 the Bank's current portfolio in Uruguay includes 17 loans for the financing of investment projects; two sector loans, for strengthening the banking sector and for the social sectors; and 29 nonreimbursable technical cooperation operations for US$16.7 million. The lending portfolio amounts to US$1,192.1 million, of which US$537.5 million are pending disbursement. Portfolio performance was affected by the Government's fiscal constraint, which entailed cuts in budgetary allocations to levels below the required amounts in order to maintain a normal pace of project implementation. A main

challenge ahead will be to increase the pace of project execution while setting the stage for a normal implementation of the new projects.

FINANCIAL RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(In millions of U.S. dollars)

Total outstanding loans: US$2,115.2[1]

Loan transactions:

	1999	2000	2001	2002	2003	2004	2005[2]
Disbursements	358.5	162.9	214.2	558.6	367.2	53.1	240.2
Amortization	57.0	59.4	60.7	73.1	103.7	113.3	220.4
Net Loan Flows	**301.5**	**103.5**	**153.5**	**485.5**	**263.6**	**-60.2**	**19.8**

Source: Inter-American Development Bank.

[1] IDB, as of October 31, 2005.
[2] IDB, as of December 16, 2005

December 27, 2005

Dear Mr. de Rato:

Since the last program review in September, the Uruguayan economy continued to perform strongly, with robust growth, low inflation and good fiscal indicators—underpinned by sound macroeconomic policies. All end-September quantitative PCs and targets have been met with solid margins, and we anticipate that all end-December quantitative PCs will also be met. The 2005–09 budget adopted in December reflects our priorities on social and infrastructure spending geared toward achieving lasting growth, social progress, and debt sustainability.

We have also made important progress in advancing our structural reform agenda, with a view to entrenching financial stability and boosting growth prospects. The end-December benchmark on tax administration has been observed. In addition, we are preparing comprehensive reforms for the tax and financial system, with relevant draft legislation soon to be submitted to Congress. While the reform proposal for the police pension system has been submitted to Congress, we now expected it to be approved by end-May 2006. We are also advancing well with developing an agenda of growth-supporting structural reforms, a key pillar of our program.

The attached supplement to the memorandum of economic policies of May 24 outlines our economic and financial program for 2006, consistent with our medium-term strategy and the policy framework being supported by the current SBA. In this connection, we request: (i) completion of the second review under the SBA; (ii) a waiver of nonobservance of the end-November PC on reform of the police pension system and establishment of a PC in the same terms for end-May 2006; (iii) a waiver of nonobservance of the December PC on financial sector reform and modification of the corresponding June PC related to its implementation, reflecting the decision to keep the supervisory authority within the central bank, in line with Fund advice; and (iv) the establishment of quantitative and structural performance criteria and indicative targets for 2006, as specified in Tables 1 and 2. Moreover, due to lack of availability of final data by the time of this review, we request waivers of applicability for the end-December 2005 performance criteria on the combined public sector primary balance, general government noninterest expenditure, net domestic assets of the BCU, net international reserves of the BCU, and nonfinancial public sector gross debt.

We request the extension of repurchase expectations for February–December 2006, consistent with established IMF policy. Should the external position turn out significantly stronger than we currently anticipate, we will consider reducing the net use of Fund resources by treating the arrangement as precautionary in the future or making advanced repurchases.

As usual, we will maintain a close policy dialogue with the Fund and stand ready to take additional measures as appropriate to ensure the achievement of the program's objectives.

Sincerely,

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

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

SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. This memorandum supplements the Memorandum of Economic and Financial Policies (MEFP) of May 24 and its supplement of September 14, 2005.

A. Performance under the 2005 Program

2. Performance under the program has continued to be strong. Economic growth has remained robust, and the 6 percent objective for 2005 is well within reach. Inflation is still below the central bank's (BCU) target range for end-2005 (5½–7½ percent), aided by a significant strengthening of the peso against the dollar. Fiscal performance through the third quarter has remained in line with the program, reflecting continued strong tax revenues offsetting weaker performance by public enterprises, and prudent expenditure management. The Social Emergency Program is now operational, assisting those in greatest need, including through direct income transfers, free preventive health care, and a temporary employment program.

3. Vulnerabilities have further decreased, including through a significant strengthening of the international reserves position. This was aided by higher-than-programmed international bond placements and renewed foreign exchange purchases by the BCU in light of strong money demand and sustained capital inflows.

B. Macroeconomic Outlook and Policies

4. We remain committed to the medium-term fiscal framework set out in our letters of May 24, 2005 and September 14, 2005, aimed at achieving a primary surplus of 4 percent of GDP from 2007 onward. The 2005 primary surplus target of 3½ percent of GDP is well in hand, and we are confident that our policies are adequate to achieve the 2006 primary surplus target of 3.7 percent of GDP. The five-year budget, consistent with this medium term-framework, has been adopted.

5. Our fiscal strategy targets increases in revenues of about one percent of GDP in 2006 and of 1½ percent of GDP during 2006-08 to ensure meeting the primary surplus targets and finance higher spending in priority areas. To achieve these objectives, we are pressing ahead with revenue administration reforms and are finalizing a comprehensive tax reform. In the case of public enterprises, we are targeting an improvement in the current primary surplus as a result of the recovery from the drought in 2005, lower transfers to the central government, and adjusting tariffs to maintain appropriate margins and reflect cost developments. These policies will create the necessary fiscal space for our planned spending increases in infrastructure, social and other priority programs, within the envelope of the program's fiscal targets.

6. We will monitor closely both revenue and expenditure developments, and are prepared to take measures as needed to ensure meeting the program targets. To this end, the budget law allows for semi-annual revenue performance assessments and authorizes the

executive to lower spending should revenues be lower than budgeted. In addition, should revenue turn out stronger than envisaged in the program, we reiterate our commitment to save any overperformance to achieve a primary surplus of 4 percent of GDP.

7. We will maintain the current monetary framework of base money targeting within a flexible exchange rate regime. We have set an indicative inflation target range for end-December 2006 at 4½ -6½ percent and we will continue with our policy of reducing the inflation rate consistent with the program's gradual disinflation objective. We will set base money target ranges for consistency with the inflation target, will monitor inflation developments very closely and stand ready to adjust policies to ensure meeting the inflation objective.

8. We expect NIR to exceed the original program objectives for end-2005 by about US$640 million, of which some US$400 million represent pre-financing operations for 2006. For next year, we anticipate continued strength in the external accounts, with underlying NIR (excluding the unwinding of the pre-financing operations) targeted to increase by US$230 million. If market conditions allow, we intend to continue to conduct pre-financing operations for 2007. The BCU has started to participate in the forward foreign exchange market to jump-start it, while hedging the exchange rate and interest rate risks of its forward position, which will remain of limited size. We also plan to develop a futures foreign exchange market and will request Fund TA for this, with a view to phasing out BCU's participation in the foreign exchange derivative markets.

C. Structural Reforms

Fiscal reforms

9. **Tax reform.** We are preparing draft legislation on a comprehensive tax reform for submission to Congress by end-February, and implementation by end-June 2006. The key objectives of the reform are to improve equity and growth prospects, and ensure attainment of the revenue targets of our fiscal program. While we will only finalize the draft legislation after completing the ongoing consultation process with the Uruguayan society, the reform is envisaged to include: (i) introducing a personal income tax; (ii) revamping the corporate income tax; (iii) lowering the VAT rates, while expanding its base to broadly maintain its yield; (iv) eliminating sectoral exemptions to employers' social security contributions and unifying the rates for the non-rural private sector, excluding education; and (v) eliminating several low-yield taxes. The tax rates will be set consistent with our revenue objectives. Also, we will be careful not to reduce the burden of indirect taxation until the revenue gains from the reform are well in hand.

10. **Revenue administration.** We are taking strong steps in this area, building on the recent recommendations of Fund and World Bank technical assistance missions. We have signed a memorandum of understanding between the MEF and the DGI to ensure meeting our goals for improvements in tax collection, and have made appropriate allocations in the proposed budget to support the DGI. We have also recently established a committee in

charge of designing a reform plan for the customs authority (benchmark for end-August 2006). To ensure successful implementation of the tax reform, and in particular of the personal income tax, we intend to: (i) formulate a plan to strengthen the auditing and enforced collection functions of the BPS (new benchmark for June 2006) and have requested technical assistance from the Fund for this purpose; (ii) continue improving the coordination between the DGI, the BPS and the customs authority; and (iii) establish quarterly minimum collection targets for 2006 for the BPS.

11. **Public Investment.** Beyond increases in public investment, our agenda for sustained rapid growth aims at improving the quality of investment by strengthening procedures for planning, selection, and implementation; and seeking private sector participation in infrastructure projects. As a pilot case, we are currently exploring public investment in railroad infrastructure, complemented with privately-managed joint public-private investment on freight transportation services, to satisfy the increased demand derived from the large forestry projects. We are currently evaluating financing modalities for this investment, while minimizing its contingent fiscal costs.

12. **Pension reform.** We have submitted to Congress a reform proposal for the police pension fund, aiming to enhance fairness and to improve its financial viability, and expect its passage by end-May. Preparations for the reforms of the pension funds of the military and the banking sector are proceeding, with the goal of ensuring their financial sustainability. We will submit our reform proposal for the military pension fund and for the banking pension fund to Congress by end-November 2006, with implementation slated for end-May 2007 (new PCs). Moreover, we have established a committee to study reforms to improve the actuarial fairness and ensure long-term fiscal sustainability of the general pension plan. This group will be working closely with the World Bank to adopt a reform agenda by end-2006 for implementation beginning in 2007.

13. **Budget process.** By end-March 2006 we will establish a committee to steer reforms to improve the budgetary process in line with best international practices. We will also request Fund TA to assist the committee, which will prepare recommendations with a timetable to improve legislation, coverage, classification, formulation, controls, and transparency of the budget process, consistent with our constitution) by August 2006 (new benchmark). Among the possible measures, we are considering creating a budget office at the MEF to coordinate the formulation of the budget and to strengthen the monitoring of its execution. Once the tax reform has been implemented we plan to complete as part of the annual budget execution assessment a tax expenditure analysis to make transparent the costs of any remaining exemptions. At the same time we are working with the World Bank on improving government procurement. We have made significant progress in improving our records of floating debt, with a view to include them as part of our fiscal targets. As an initial step, we propose to monitor the fiscal primary balance, including floating debt, as an indicative target. We intend to make this a PC as soon as we are confident of the proper recording and internal control systems working of our systems and no later than end-2006.

14. **Debt management.** We have made preparations for a debt management unit at the MEF, including by allocating resources in the budget. The unit will be established by end-December 2005, with the adoption of its terms of reference and the appointment of its head. The unit will work on the design of a debt management strategy aimed at lengthening average maturity, smoothing the amortization profile, and reducing the share of foreign currency-denominated debt by issuing peso or inflation-indexed domestic and international bonds. In addition, we have submitted to congress a draft law to modify the statutory debt ceilings, which would facilitate debt management operations by expanding the coverage of debt instruments and applying the ceilings on net (rather than gross) debt.

Monetary and financial system reforms

15. The draft legislation to improve the operational framework of the financial system is about to be completed, for submission to Congress by end-December as planned. The broad outline of the reform of the central bank includes establishing its operational independence to conduct monetary policy, including by staggering the appointments of board members, and delinking them from the political cycle. The new legislation would also strengthen financial sector supervision and improve the bank resolution framework by providing alternatives to outright liquidation and strengthening the deposit insurance scheme. While the deposit insurance and bank liquidation functions will be placed in a separate institution, we are now keeping the supervisory authority within the central bank (to protect its institutional strength), but will put a governance structure in place that ensures its independence. We will also adopt a plan to strengthen the BCU's financial position by end-September 2006 (new benchmark), and have included adequate provisions for this in its proposed new charter.

16. Regarding the public bank BROU, credit granting policies and controls continue to be strengthened, in line with lending at commercial terms. While the trust managing BROU's nonperforming loans has continued to service its debt to BROU, new steps are needed to ensure that this continues. We have therefore recently changed the governance structure of the trust fund, appointing a Board member to represent the Ministry of Economy and providing it with greater independence from BROU; we will abstain from any interference in the collection efforts; and will transfer the effective management of fideicomiso II and III to the asset management company that manages fideicomiso I by December 2005. Moreover, we continue to honor the government's guarantee of the notes issued by the trust to BROU should the trust be unable to service the debt according to the agreed schedule.

17. To address the difficult situation in the housing bank BHU, we have prepared an action plan that aims to minimize contingent fiscal costs, while recognizing the need for a mortgage lending market in Uruguay. The plan foresees the removal of BHU's low quality assets into a fiduciary trust, a refocus of BHU's activities, and the implementation of an automated loan system. Under the plan, BHU will only be allowed to receive saving deposits for mortgage down payments and shall only resume its lending once the Superintendent concludes that sufficient progress has been made in implementing its restructuring that such lending does not pose a risk to the safety and soundness of the institution. The action plan will be adopted formally by Ministers of Economy and Housing and the Board of BHU soon

and will be followed by a detailed implementation plan by end-February (new benchmark). BHU will service the note to BROU on schedule, and if necessary, the government will honor its guarantee.

18. We expect the sale of NBC (the bank formed with the consolidated good assets from three failed banks) to be completed no later than the end of the first quarter of 2006. While we will maintain preferred shares, they have no voting rights and will be sold to the future owner of NBC over the next five years. Collection efforts by the asset manager for the liquidation funds for the bad assets of the failed private banks is proceeding on schedule and semi-annual financial statements are being published and audited annually. The transfer of information on non-performing borrowers of the liquidation funds into the credit registry will be completed by December 2005.

Boosting growth

19. Recognizing the importance of business environment to achieve sustained growth, reforms in this area are a priority for us. Once the private sector commission has published its results (expected by March 2006), we will incorporate some of its key recommendations into our program. Key areas under consideration by the commission for possible recommendations include: (i) public enterprise reforms; (ii) private sector participation in infrastructure projects; (iii) business start-up costs; (iv) the bankruptcy framework; (v) labor market issues; and (vi) international trade integration beyond Mercosur.

D. Program Financing and Safeguards

20. With a significant part of the financing needed in 2006 already secured in 2005, next year's program financing is well in hand. Nevertheless, we plan to continue to enhance our access to both domestic and international capital markets in anticipation of medium-term financing needs. We also expect significant flows from the World Bank and IDB (about US$430 million) next year, broadly in line with amortizations, and are strongly committed to firmly implement associated donor conditionality to ensure timely disbursements.

21. A new on-site safeguards assessment of the BCU was completed in September 2005, and we are fully committed to implementing its recommendations. As first steps, we have included all the Fund liabilities in our balance sheet, and have amended the criteria for selection and appointment of the external audit firm.

Table 1. Uruguay: Proposed Structural Conditionality for 2005-07

Area	Structural Conditionality	Date	Status
A. Structural performance criteria			
a) Country Report No. 05/431			
Fiscal	Have in place a five-year spending plan, complemented with revenue projections and deficit targets consistent with the program's fiscal targets.	February 28, 2006	Observed.
Pensions	Begin to implement reform of the pension fund for the police.	November 30, 2005	Not observed.
Tax reform	Submit to congress a comprehensive tax reform as described in paragraph 7 of the MEFP.	February 28, 2006	
Tax reform	Begin to implement the comprehensive tax reform.	June 30, 2006	
Central Bank	Submit simultaneously three laws to congress to: (i) give appropriate autonomy to the central bank (as described in paragraph 12 of the MEFP); (ii) strengthen the regulation of the financial system (as described in paragraph 13 of the MEFP); and (iii) provide a suitable bank resolution framework (as described in paragraph 14 of the MEFP).	December 31, 2005	Not observed. 1/
Central Bank	Begin to implement these laws. 2/	June 30, 2006	
BROU & BHU	Government to ensure timely service of BHU note and BROU fiduciary notes to BROU in accordance with the current payment schedules.	Continuous	Observed.
BHU	Adopt action plan to address the financial situation of BHU consistent with minimizing systemic risks and contingent fiscal costs.	December 31, 2005	Observed.
b) Proposed new PCs			
Pensions	Begin to implement reform of the pension fund for the police.	May 31, 2006	
Pensions	Submit to Congress reform of the pension fund for the military and bank employees as described in paragraph 12 of the SMEFP.	November 30, 2006	
Pensions	Begin to implement the reform of the pension fund for the military and bank employees as described in paragraph 12 of the SMEFP.	May 31, 2007	
B. Structural benchmarks			
a) Country Report No. 05/431			
Tax administration	Sign a memorandum of understanding between the Ministry of Finance and the DGI agreeing on quantitative targets and indicators for 2006 on tax collections, audit coverage, tax services, and information systems.	December 31, 2005	Observed.
Tax administration	Finalize the design of a comprehensive reform plan for the customs agency (including establishing collection targets consistent with the program).	August 31, 2006	
Debt management	Create a debt management unit at the Ministry of Finance.	December 31, 2005	
Growth	Publish agenda of growth-enhancing reforms (including timetable for implementation) prepared by the business environment commission.	March 31, 2006	
Growth	Submit to Congress bankruptcy law (to include Chapter-11 type corporate restructuring).	June 30, 2006	
Financial sector	Sell shares of NBC in amounts that yield managerial control to the private sector.	June 30, 2006	
b) Proposed new benchmarks			
Financial sector	Adopt a detailed schedule for the implementation of the BHU action plan.	Februrary 28, 2006	
Tax administration	Formulate a plan to strengthen the auditing and enforced collection functions of the BPS.	June 30, 2006	
Budget	Prepare recommendations, with a timetable, to improve legislation, coverage, classification, formulation, controls, and transparency of the budget process.	August 30, 2006	
Central Bank	Adopt plan to strengthen the central bank finances (outright capitalization or interest payment on government paper).	September 30, 2006	

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

1/ Nonobservance due to the decision to keep the financial sector supervisory authority within the BCU. Fund staff supports this decision.

2/ Proposed modification (see paragraph 3 of the LOI).

Table 2: Quantitative Performance Criteria and Indicative Targets of the 2005-08 Program 1/

	2004 Stock	2005								
		June 30				Sept. 30				
	Dec. 31	PC	PC (adjusted)	Actual	Margin (+)	PC	PC (adjusted)	Actual	Margin (+)	PC Dec. 31
A. Quantitative performance criteria										
		(In millions of Uruguayan pesos)								
1. Combined public sector primary balance (floor) 2/	...	5,471	5,372	6,394	**1,022**	9,687	9,490	10,351	**861**	14,647
2. General government noninterest expenditure (ceiling) 2/	...	23,561	23,539	22,080	**1,459**	34,643	34,665	32,996	**1,670**	46,561
3. Net domestic assets of the BCU (ceiling) 2/	74,079	3,983	3,983	-302	**4,284**	4,572	4,572	-16,424	**20,995**	-3,910
		(In millions of U.S. dollars)								
4. Net international reserves of the BCU (floor) 2/	-2,218	-130	-130	18	**148**	-110	-110	592	**702**	280
5. Nonfinancial public sector gross debt (ceiling) 4/	12,189	12,510	12,495	12,239	**255**	12,575	12,566	12,490	**76**	12,550
6. Accumulation of external payment arrears of the public sector (on a continuous basis) 2/	0	0	0	0	**0**	0	0	0	**0**	0
B. Indicative targets										
		(In millions of Uruguayan pesos)								
7. Combined public sector overall balance (floor) 2/	...	-5,086	-5,186	-2,794	**2,391**	-7,459	-7,656	-4,597	**3,059**	-7,072
8. Monetary base (ceiling) 2/	15,648	557	557	1,070	**-513**	1,673	1,673	498	**1,175**	3,468
9. Floating debt of the central government (ceiling)	3,081	3,081	3,081	2,567	**514**	3,081	3,081	2,298	**783**	3,081

Table 2: Quantitative Performance Criteria and Indicative Targets for the 2005-08 program (concluded)

	2005 Stock	2006 Targets				2007 IT	2008 IT
	Sept. 30	Mar. 31	Jun. 30	Sept. 30	Dec. 31	Dec. 31	Dec. 31
A. Quantitative performance criteria							
(In millions of Uruguayan pesos)							
1. Combined public sector primary balance (floor) 2/	n.a.	2,651	5,196	10,434	16,473	19,311	20,748
2. General government noninterest expenditure (ceiling) 2/	n.a.	13,409	27,050	39,870	53,558	57,735	63,095
3. Net domestic assets of the BCU (ceiling) 2/ 3/	51,525	-3,136	-4,195	-8,003	-7,130	-16,203	-9,522
(In millions of U.S. dollars)							
4. Net international reserves of the BCU (floor) 2/ 3/	-1,546	250	333	414 5/	554 5/	544	395
5. Nonfinancial public sector gross debt (ceiling) 4/	12,309	12,882	13,074	13,082	12,995	13,150	13,286
6. Accumulation of external payment arrears of the public sector (on a continuous basis) 2/	0	0	0	0	0	0	0
B. Indicative targets							
(In millions of Uruguayan pesos)							
7. Combined public sector overall balance (floor) 2/	n.a.	-3,076	-5,528	-6,255	-4,983	-2,966	-2,537
8. Combined public sector primary balance (extended) (floor) 2/	n.a.	2,651	5,196	10,434	16,473	19,311	20,748
9. Monetary base (ceiling) 2/ 3/	16,146	3,140	3,261	2,105	4,882	1,803	1,720

PC= Performance Criterion; IT=Indicative Target.

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

1/ As defined in the Supplementary Technical Memorandum of Understanding.
2/ Cumulative changes from the previous calendar year.
3/ 2006 targets are cumulative from end-September 2005.
4/ All maturities.
5/ Indicative targets.

SUPPLEMENTARY TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum supplements the technical memorandum of Sept. 14, 2005. It presents the definitions of the variables included in the performance criteria and indicative targets for the year 2006 annexed to the Memorandum of Economic and Financial Policies. Definitions for the targets for the remainder of 2005 will be monitored in accordance with the TMU of September 14, 2005.

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

> (a) The net financing of the NFPS would include the *sum* of: (i) increase in net claims of the domestic financial system on the NFPS (excluding government bonds and treasury bills); (ii) the increase in the net amount of NFPS bonds and treasury bills held outside the NFPS (excluding any debt issued for the capitalization of BCU and debt issued to finance the capitalization of the deposit insurance scheme up to a limit of US$20 million); plus (iii) external bank loans and external[3] supplier credits to the NFPS; plus (iv) the net increase in liabilities arising from the forward sale of NFPS assets; plus (v) the increase in net non-bank loans;[4] *minus* (vi) the net increase

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

[2] Excluding any cash outlays related to government guarantees (principal plus interest) on the BHU and BROU's fiduciary trusts notes; change in net debt associated with the assumption of financial liabilities of BHU and its recapitalization as part of its restructuring, and any cash inflows related to loan recoveries and sale of assets which were transferred from BHU to the government as the beneficiary in the restructuring; and the change in the net debt associated with the final outcome of the litigation/arbitration with the former shareholders of Banco Comercial.

[3] Based on the residency principle.

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

of NFPS financial assets held by the NFPS outside the domestic financial system (including the loan component of the deposit insurance scheme); plus (vii) gross revenues from the sale of public assets (net of associated fees and commissions); plus (viii) all upfront payments related to future concessions (including the sale of mobile phone licenses); plus (ix) recoveries of financial assistance provided to the banking system.

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

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

3. **Cumulative floor on the extended primary balance of the combined public sector.** The combined public sector extended primary balance will be calculated as the primary balance of the combined public sector defined in paragraph 2 minus the change in the stock of floating debt of the central government. Floating debt of the central government is defined as expenditures from**:** the general treasury account ("Rentas Generales"), "Rentas de Afectación Específica", payment obligations with domestic suppliers for which external and domestic debt has been earmarked, investment funds of the Ministry of Transportation and Public Works, and own funds from agencies outside the budget (Casinos). It includes debt registered in the integrated information system (SIIF), and that has been authorized for execution and confirmed by the respective central accountants, and for which no checks for payment have yet been issued. Excluded are obligations for utilities, obligations related to subsidies (except for the forestry fund), judiciary debt and obligations falling under "*Inciso 24"* of the accounting plan of the *"Contaduria General de la Nacion"* (excluding debt with international organizations), domestic suppliers' credits of the Ministry of Housing, and overdue payments for wages and salaries (including all related labor benefits) of public sector contractual and permanent employees, provided such overdue payments do not exceed 10 days following the date on which payments are due.

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

[5] Expenditures by local governments are not included.

security system, automatic transfers to the private pension funds (AFAPs), and earmarked revenue as of December 31, 2004.

- The ceiling on general government expenditure will be adjusted downward for any expenses arising from pension adjustments, which exceed the increase in the legal minimum adjustment.

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

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

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

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

(c) For the purpose of the NIR calculation, (i) the gold holdings of the BCU will be valued at the accounting rate of US$42 per troy ounce; (ii) liabilities to the IMF will be valued at the rate of US$1.44946 per SDR; (iii) gains or losses from gold swaps and other operations will be excluded; and (iv) non-U.S. dollar denominated foreign assets and liabilities will be converted into U.S. dollars at the market exchange rates of the respective currencies as of September 30, 2005.

- The NIR floor will be adjusted upward (downward) by any excess (shortfalls in) net financing of the NFPS defined as the difference between the stock of debt of the NFPS, as defined in para. 8 but excluding central government foreign currency deposits in domestic commercial banks and excluding any liabilities to the Fund, and schedule A below, and which is not explained by the adjustments specified in para. 8, bullet 1 (i-vii). The downward adjustment of the NIR floor will be limited to US$400 million.

Schedule A
(In millions of U.S. dollars)

	Sept.-05	Mar.-06	Jun.-06	Sept. 06	Dec.-06
Stock of debt of the NFPS, excl. CG FX deposits in domestic commercial banks and Fund liabilities	10,136	10,530	10,706	10,828	10,884

7. **Cumulative ceiling on net domestic assets (NDA) of the BCU.** NDA is defined as the difference between end-of-period monetary base and net international reserves (NIR) of the BCU as defined in paragraphs 5 and 6. The flow of NIR will be valued at the accounting exchange rate of Ur$23.9 per US$1.

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

8. **The overall nonfinancial public sector debt ceiling** refers to the outstanding stock of external debt[6] and domestic debt[7] measured on a *gross* basis[8] in domestic and foreign

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

currency *owed or guaranteed by the NFPS*, valued in U.S. dollars at the accounting rates of Ur$23.9 per U.S. dollar, U.S. dollar 1.2026 per Euro, Yen113.46 per U.S. dollar, U.S. dollar 1.44946 per SDR, and Ur$1.4882 per UI. If the Ur$ to UI rate exceeds 1.5916 the UI debt will be valued at Ur$ 1.4882 plus the difference between the actual rate and Ur$1.5916. The debt ceiling will exclude (i) the government guaranteed note of BHU to BROU (with outstanding obligations estimated at US$500.8 million at end-September 2005) and the government guaranteed notes issued by the fiduciary trusts associated with the transfer of BROU's nonperforming loans (with outstanding obligations estimated at US$400 million at end-September 2005); and (ii) net debt of the NFPS with the BCU. It will include the total stock of Fund credit outstanding to Uruguay.

- The NFPS debt ceiling will be adjusted (i) upward (downward) by revisions made to the actual nonfinancial public sector gross debt stock at end-September 2005; (ii) upward by a maximum of US$500 million for the amount of debt issued to recapitalize the BCU; (iii) upward by a maximum of US$133 million (downward) for the cumulative reduction (increase) in the net credit position of public enterprises with the BCU; (iv) upward by a maximum of US$150 million for the costs associated with the final outcome of the arbitration/litigation to the former shareholders of Banco Comercial; (v) upward by a maximum of US$82 million for debt issued to finance below-the-line operations of public enterprises (such as recapitalization of ANCAP's subsidiary abroad); (vi) upward by BHU restructuring costs related to the assumption of financial liabilities or capitalization up to a limit of US$1 billion; (vii) upward by a maximum of US$40 million for the amount of debt issued to onlend to the deposit insurance scheme; and (viii) upward (downward) by the amount that the unadjusted NIR floor is exceeded (falls short) with the upward adjustment limited to the amount of the upward revision of the NIR target, up to a limit of US$500 million.

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

10. **Continuous performance criterion on the timely service of bank restructuring debt to BROU in accordance with the current payment schedule**. The bank restructuring debt to BROU includes the notes to BROU guaranteed by the government and issued by the

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

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

BHU and the fiduciary trusts that own and manage the nonperforming loans formerly on the books of BROU. Timely service is defined as the payment of agreed principal and interest by the BHU, the trusts, or the government in accordance with the timetable (and no later than the 10th of the subsequent month) and terms presented in Schedule B.

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

	BHU Note				Fiduciary Trusts 1/			
	Service			Balance 2/	I	II	III	Balance 2/
	Principal	Interest 3/	Total		Service			
2005 M 09	0.8	0.9	1.7	500.8				
2005 M 10	0.8	0.9	1.7	499.9				
2005 M 11	0.8	0.9	1.7	499.1				
2005 M 12	0.8	0.9	1.7	498.2	82.2	5.3	8.9	254.2
2006 M 01	1.3	0.9	2.2	497.0				
2006 M 02	1.3	0.9	2.2	495.7				
2006 M 03	1.3	0.9	2.2	494.4				
2006 M 04	1.3	0.9	2.2	493.1				
2006 M 05	1.3	0.9	2.1	491.9				
2006 M 06	1.3	0.9	2.1	490.6	81.6	5.3	8.9	158.4
2006 M 07	1.3	0.9	2.1	489.3				
2006 M 08	1.3	0.9	2.1	488.1				
2006 M 09	1.3	0.9	2.1	486.8				
2006 M 10	1.3	0.9	2.1	485.5				
2006 M 11	1.3	0.9	2.1	484.3				
2006 M 12	1.3	0.9	2.1	483.0	81.0	5.3	8.8	63.4
2007 M 01	1.7	0.9	2.6	481.3				
2007 M 02	1.7	0.9	2.6	479.6				
2007 M 03	1.7	0.9	2.5	477.9				
2007 M 04	1.7	0.9	2.5	476.2				
2007 M 05	1.7	0.8	2.5	474.5				
2007 M 06	1.7	0.8	2.5	472.8	40.4	2.5	6.3	14.2
2007 M 07	1.7	0.8	2.5	471.1				
2007 M 08	1.7	0.8	2.5	469.4				
2007 M 09	1.7	0.8	2.5	467.7				
2007 M 10	1.7	0.8	2.5	466.0				
2007 M 11	1.7	0.8	2.5	464.3				
2007 M 12	1.7	0.8	2.5	462.6	8.1	0.3	5.8	0.0
2008 M 01	2.1	0.8	2.9	460.5				
2008 M 02	2.1	0.8	2.9	458.4				
2008 M 03	2.1	0.8	2.9	456.3				
2008 M 04	2.1	0.8	2.9	454.2				
2008 M 05	2.1	0.8	2.9	452.1				
2008 M 06	2.1	0.8	2.9	449.9				

1/ Fiduciary trusts that own and manage the debt formerly on the books of BROU.
2/ Estimated balance of outstanding principal and interest obligations.

3/ Estimate. The contractual interest rate is the 60-day U.S. dollar-denominated time deposit rate of BROU plus 50 basis points, and is revised on June 30 and December 31 every year based on the rate prevailing on that date.

Statement by the Staff Representative on Uruguay

January 18, 2006

1. Since the issuance of the staff report, the following additional information has become available. This information does not alter the thrust of the staff appraisal.

2. **Economic developments remain favorable**.

- Sustained rapid growth of industrial production and exports (at annual rates well above 20 percent) point to continued robust GDP growth. Inflation remains subdued, at 4.9 percent (y/y) in December, below the target range of 5½–7½ percent. Gross reserves stood at US$3.4 billion on December 31, US$920 million higher than at the start of the year. Standard & Poor's Ratings Services revised its outlook on its long-term sovereign credit ratings on Uruguay of B (noninvestment grade) from stable to positive.
- Staff supports the granting of waivers of applicability in relation to all the end-December 2005 quantitative PCs. Final data is not yet available on any of the quantitative PCs for end-2005, but based on available information staff considers that they are likely to have been observed. The indicative target on base money was exceeded (by 5.1 percent) as the central bank accommodated stronger than anticipated seasonal money demand, mainly through additional central bank foreign exchange purchases.

3. **Financial sector reforms are progressing broadly as envisaged.**

- **Institutional reform legislation (end-December PC).** On December 27, the authorities submitted a draft legislation to congress that would strengthen the central bank's (BCU) operational independence (including by raising the number of board members from three to five, and staggering their terms) and require its recapitalization. It would also create a single superintendency (within the BCU) with responsibility for financial sector supervision and regulation, and a separate deposit insurance agency with a broad range of instruments for bank resolution. While the relevant structural PC was formally not observed because it envisaged that the financial supervision agency would be established outside the central bank (as noted in the staff report), the staff believes that the draft law achieves the key objectives of the PC, and the decision to keep the agency within the central bank does not affect the program goals in this area. Staff therefore supports the authorities' request for a waiver.

- **Action plan for BHU (end-December PC).** The authorities have adopted a broad action plan for BHU, including key strategic decisions in line with the end-December

PC. They have also committed to the principles that will guide the development of a detailed implementation plan (proposed new benchmark for end-February).

- **COFAC.** The situation of the ailing cooperative bank (COFAC) remains fragile. Following the December 2005 release of US$9 million in reprogrammed deposits, foreign currency deposits have fallen by about US$6 million. Capital remains positive but has dropped below prudential norms, prompting the BCU to require a recapitalization plan. COFAC has proposed to transform itself into a stock company, which would allow equity investment by an identified new shareholder (the Venezuelan Development Bank). At the same time, the central bank is preparing contingency measures in case the recapitalization does not materialize.

4. **Debt management.** The structural benchmark for end-December of creating a debt management unit at the Ministry of Finance has been met. Moreover, both chambers of congress have approved the new law on public debt ceilings noted in the staff report (¶ 10).

5. **Monetary policy.** The monetary policy committee on December 29 reaffirmed the inflation target of 4.5–6.5 percent for end-2006 and the overall monetary policy framework. However, the committee has decided to announce an indicative growth rate for M1. For 2006, the BCU envisages an increase in M1 of 12.6 percent, in line with the projected growth of domestic demand and the monetary program agreed with the staff.

6. **The investment treaty with the U.S.** has been ratified by both chambers of congress.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 06/12
FOR IMMEDIATE RELEASE
January 18, 2006

International Monetary Fund
Washington, D.C. 20431 USA

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

The Executive Board of the International Monetary Fund (IMF) completed today the second review under the three-year, SDR 766.3 million (US$1.11 billion) Stand-By Arrangement for Uruguay (see Press Release No. 05/136). Completion of this review makes SDR 30.7 million (about US$44.3 million) immediately available to Uruguay.

In completing the review, the Board granted waivers for the nonobservance of the end-November 2005 performance criterion on reform of the police pension system, the nonobservance of the end-December performance criterion on financial sector reform based on the decision to keep the supervisory authority within the central bank supported by Fund staff, and a waiver of applicability for the end-December quantitative performance criteria, for which data was not available.

The Executive Board also approved Uruguay's request for extending repayment expectations arising between February and December 2006—in an amount equivalent to SDR 540.9 million (US$781.8 million)—to an obligation basis in 2007.

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

"Uruguay's performance under the Stand-By Arrangement continues to impress. Sound economic policies, adequate program ownership, and generally favorable external financial conditions have contributed to a strong recovery, low inflation, rising international reserves and an improved debt outlook. Still, some macroeconomic vulnerabilities persist, and continued focus on fiscal discipline, financial sector reforms, and strengthening the investment climate will be necessary to ensure sustained rapid growth and debt sustainability.

"The fiscal program is on track, and the medium-term fiscal outlook is anchored by the recently approved budget for 2005–09 which envisages sustained large primary surpluses. The authorities' plans for deep fiscal reforms, both on the revenue and expenditure sides, are well placed. In particular, the planned tax reform and ongoing efforts to strengthen tax administration will be critical to ensure achievement of the ambitious revenue targets in the budget. The authorities' renewed commitment to pension reform is equally welcome as an important pillar of long-term fiscal sustainability.

"Monetary policy has successfully contained inflation in the low single digits, and the central bank's focus on achieving the program's inflation objective is appropriate. Looking forward, incipient inflationary pressures need to be monitored carefully, and it will be important that the

authorities follow up on their commitment to adjust policies if necessary to safeguard the inflation objectives.

“Financial sector reforms are progressing as programmed. Draft legislation submitted to congress to enhance the central bank’s autonomy, strengthen financial supervision, and improve the bank resolution and deposit insurance frameworks will further upgrade policy capabilities and reduce financial sector vulnerabilities. An action plan to improve the ailing housing bank (BHU) has been developed and the state bank (BROU) has continued to advance its restructuring efforts. An ongoing financial sector assessment program (FSAP) is taking stock of the reform process, to help identify the priorities for the future reform agenda.

“Uruguay has made a strong start under the Fund-supported program adopted in mid-2005. Executive Directors look forward to a continued strong program implementation to ensure sustained rapid growth and a lasting exit from Fund financial support,” Mr. Carstens said.

Statement by Mr. Torres and Mr. Vogel on Uruguay

January 18, 2006

The Program's Distinctive: The Authorities' Ownership

1. The Uruguayan economy has been performing strongly over the recent year. GDP growth has been robust, finishing 2005 above the initial forecast; inflation has been subdued; exports have grown substantially; and fiscal performance has been in line with the authorities' targets. More importantly, the government has continued implementing its critical agenda of structural reforms, exhibiting the program's most important distinctive: the government's strong ownership of the reforms that goes well beyond the IMF's conditionality.

Starting to Reap the Fruits of Sound Policies and Reforms

2. As noted, economic activity is performing strongly, with a robust boost in exports (15 percent growth in real terms in the period January-September 2005, compared to the same period in 2004). Meanwhile, export markets continue to show an increasing diversification (for instance, the participation of NAFTA countries has grown up to 29 percent of the total exports in the last twelve months to October), which tends to strengthen the country's resilience to external shocks. Precisely, our authorities' view on trade underlines the critical need for the country to continue its efforts to diversify its product base and external markets by further integrating the Uruguayan economy onto the global economy. In order to achieve these objectives, the government has taken different measures, including those aimed at enhancing Uruguay's competitiveness by implementing many structural reforms –several of which will be discussed below–, and the efforts to make agreements with different countries. In this regard, in October 2005 Uruguay signed an investment agreement with the United States of America, which was ratified by Congress in December.

3. Currently, Uruguay is attracting significant capital inflows, a good part of them being foreign direct investment (this is reflected in the significant surge in capital good imports from the private sector of 53 percent in dollar terms in January-October/05 compared to the same period in 2004). Meanwhile, taking advantage of the external and domestic conditions, including the level of the exchange rate and the inflation below the Central Bank's envisaged targets, the authorities have strengthened the reserve position, driving to a significant overperformance of the net international reserves. Furthermore, the gross non-financial public sector debt (relative to GDP) exhibits a substantial decline from 92 percent in 2004 to

73 percent in 2005, while increasing the portion of peso-denominated debt. The authorities are fully aware of the need to keep working in diminishing debt vulnerabilities –for instance, those related to its maturity and dollarization–, having created a debt-management unit at the Ministry of Finance to continue addressing these vulnerabilities.

4. One of our authorities' main objectives is to enhance the level and quality of employment, and, although much remains to be done to achieve the objective, there have been very positive developments during the recent months. The employment rate (according to the latest labor report) has grown to its highest since 2001 and the number of contributors to the Banco de Prevision Social (BPS) has increased by 10 percent in 2005, which means better work conditions and more people with social coverage. Meanwhile, according to a report from a private university[1], the index of labor conflicts in 2005 was the lowest in the past ten years, which coincides with the introduction of the new labor framework (with tripartite wage councils) and, even before that, with the national agreement on employment, income and responsibilities launched by the government. It is important to reiterate that our authorities understand the term "economic stability" as a global concept that embraces the interests of investors, workers, and other social partners. In this regard, the authorities are committed to continue contributing to temper the normal distributional tensions, keeping in mind that social inclusion and equity are vital factors to improve the investment climate and Uruguay's human development.

5. Beyond global and emerging market developments, our authorities' commitment to sound macroeconomic policies and reforms has been rewarded by the investors' confidence in the country. For instance, in November, Uruguay placed in international markets US$ 200 million of seventeen-year bond at a yield of 8.2 percent. Having presented a declining trend of the yield, this issuance brought total international bond issues in 2005 to above US$ 1 billion. Likewise, sovereign spread has fallen from 400 basis points at the beginning of 2005 to around 270 basis points currently.

Promoting a Virtuous Cycle among Stability, Growth and Fiscal Position

6. The Uruguayan authorities strongly believe that their efforts towards the consolidation of the fiscal position are fully compatible and synergetic with higher and sustainable growth. As a minor example –although it may help to illustrate the situation–, some people have already stopped receiving benefits from the social emergency program after finding employment in the region where the pulp mill projects are being implemented. Meanwhile, as noted in the staff report, the authorities are exploring options for private participation in infrastructure investment that will support Uruguay's external trade and growth in general, being clear cases of this kind of investment those related to the revamping of the railways and the improvement of other communication facilities, including seaports. Obviously, before its implementation, the authorities will ensure that sound institutional and legal frameworks are in place according to the best international practices. Generally, on fiscal policy, the authorities would like to reiterate that the government's budget has been

[1] The report can be found on the website of the Catholic University of Uruguay www.ucu.edu.uy/Facultades/CienciasEmpresariales/ModernizacionRRLL/Informes2005.htm

prepared taking realistic targets, which are fully coherent with the implementation of prudent policies and our authorities' strong commitment to preserve macroeconomic stability, in particular by strictly adhering to the undertaken fiscal targets.

7. Tax reform is the centerpiece of the government's agenda. This reform aims to achieve three main objectives: distributing the tax burden more equitably; efficiency; and coherence with the government's goal of promoting productive investment. Among the main pillars of this reform, it is important to underline the introduction of a personal income tax, a substantial reduction of tax exemptions, and the streamlining of the tax system, including the elimination of fifteen taxes that generated only a very small part of the revenues but the collection of which proved to be a heavy burden on the revenue administration. In order to ensure transparency and improve ownership, the reform proposal was posted on the Ministry of Economy and Finances' website requesting feedback during November. Additionally, in the context of a comprehensive reform of the revenue administration, the Ministry of Finance already signed with the DGI a memorandum of understanding, establishing, among other things, quantitative targets for tax collection, which are compatible with a substantial decrease in the level of evasion.

8. The past year showed the lowest inflation rate (4.9 percent, end of period) since 2001. This rate was below the December 2005 Central Bank of Uruguay (BCU) target range (5.5-7.5 percent); accordingly the monetary authority could adopt a more expansive policy during the second semester of 2005, while the annual inflation rate has still been under the aforementioned target range. It is important to note that this inflation rate was achieved in a context of full pass-through of oil prices. Likewise, the Central Bank has announced a target range of 4.5-6.5 percent for 2006. This cautious approach to further disinflation should be viewed as part of the authorities' efforts to promote the above-referred virtuous cycle. Furthermore, according to the latest Central Bank monthly survey, inflation expectations have converged to the official target range, which, together with other positive developments in the monetary and financial areas, reflect confidence in the prudent monetary policy followed by the Central Bank. This confidence will be reinforced by the institutional reforms already submitted to the Congress. Thus, in essence, the performance criteria (PC) related to the financial system laws was fully observed with just one difference, which, as recognized by the staff, entails advantages from the previously planned.

9. The financial system has exhibited substantial improvements during 2005, which, for instance, is reflected by many indicators, including the level of deposits, the share of nonperforming loans in total loans, and capital adequacy ratio. It is expected that the reforms aimed at strengthening the financial sector supervision will reinforce the positive trend, and that all of these favorable developments will boost the amount and quality of credit available for the private sector. Meanwhile, the authorities have already prepared a comprehensive plan to address the financial situation of BHU, which will be implemented very soon. In general, all the authorities' measures and policies in the financial system have been fully coherent with their firm determination to establish a culture where debts have to be honored, regardless whether the creditor is a private or a public bank.

Looking Forward: Substantial Challenges and Favorable Perspectives

10. Finally, our authorities would like to reiterate their appreciation of the current arrangement with the Fund, which has been instrumental in achieving the strong performance in 2005. As has been mentioned since the beginning of the current administration, it is the authorities' intention to establish a well-articulated exit strategy from the Fund's financial support. Meanwhile, it is worthy to note that the BCU monthly expectation survey shows that economic growth forecast for 2006 is in line with the authorities' estimates, and that the forecast of private analysts has been increasingly positive as the government's structural agenda started to be implemented. Nevertheless, the authorities are fully aware of the remaining vulnerabilities and remain firmly committed to pursue their ambitious albeit achievable economic objectives within social stability and full respect for law.

Statement by the IMF Staff Representative
January 18, 2006

1. Since the issuance of the staff report, the following additional information has become available. This information does not alter the thrust of the staff appraisal.

2. **Economic developments remain favorable**.

- Sustained rapid growth of industrial production and exports (at annual rates well above 20 percent) point to continued robust GDP growth. Inflation remains subdued, at 4.9 percent (y/y) in December, below the target range of 5½–7½ percent. Gross reserves stood at US$3.4 billion on December 31, US$920 million higher than at the start of the year. Standard & Poor's Ratings Services revised its outlook on its long-term sovereign credit ratings on Uruguay of B (noninvestment grade) from stable to positive.

- Staff supports the granting of waivers of applicability in relation to all the end-December 2005 quantitative PCs. Final data is not yet available on any of the quantitative PCs for end-2005, but based on available information staff considers that they are likely to have been observed. The indicative target on base money was exceeded (by 5.1 percent) as the central bank accommodated stronger than anticipated seasonal money demand, mainly through additional central bank foreign exchange purchases.

3. **Financial sector reforms are progressing broadly as envisaged.**

- **Institutional reform legislation (end-December PC).** On December 27, the authorities submitted a draft legislation to congress that would strengthen the central bank's (BCU) operational independence (including by raising the number of board members from three to five, and staggering their terms) and require its recapitalization. It would also create a single superintendency (within the BCU) with responsibility for financial sector supervision and regulation, and a separate deposit insurance agency with a broad range of instruments for bank resolution. While the relevant structural PC was formally not observed because it envisaged that the financial supervision agency would be established outside the central bank (as noted in the staff report), the staff believes that the draft law achieves the key objectives of the PC, and the decision to keep the agency within the central bank does not affect the program goals in this area. Staff therefore supports the authorities' request for a waiver.

- **Action plan for BHU (end-December PC).** The authorities have adopted a broad action plan for BHU, including key strategic decisions in line with the end-December PC. They have also committed to the principles that will guide the development of a detailed implementation plan (proposed new benchmark for end-February).

- **COFAC.** The situation of the ailing cooperative bank (COFAC) remains fragile. Following the December 2005 release of US$9 million in reprogrammed deposits,

foreign currency deposits have fallen by about US$6 million. Capital remains positive but has dropped below prudential norms, prompting the BCU to require a recapitalization plan. COFAC has proposed to transform itself into a stock company, which would allow equity investment by an identified new shareholder (the Venezuelan Development Bank). At the same time, the central bank is preparing contingency measures in case the recapitalization does not materialize.

4. **Debt management.** The structural benchmark for end-December of creating a debt management unit at the Ministry of Finance has been met. Moreover, both chambers of congress have approved the new law on public debt ceilings noted in the staff report (¶ 10).

5. **Monetary policy.** The monetary policy committee on December 29 reaffirmed the inflation target of 4.5–6.5 percent for end-2006 and the overall monetary policy framework. However, the committee has decided to announce an indicative growth rate for M1. For 2006, the BCU envisages an increase in M1 of 12.6 percent, in line with the projected growth of domestic demand and the monetary program agreed with the staff.

6. **The investment treaty with the U.S.** has been ratified by both chambers of congress.

INTERNATIONAL MONETARY FUND
EXTERNAL RELATIONS DEPARTMENT

Press Release No. 06/12
FOR IMMEDIATE RELEASE
January 18, 2006

International Monetary Fund
Washington, D.C. 20431 USA

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

The Executive Board of the International Monetary Fund (IMF) completed today the second review under the three-year, SDR 766.3 million (US$1.11 billion) Stand-By Arrangement for Uruguay (see Press Release No. 05/136). Completion of this review makes SDR 30.7 million (about US$44.3 million) immediately available to Uruguay.

In completing the review, the Board granted waivers for the nonobservance of the end-November 2005 performance criterion on reform of the police pension system, the nonobservance of the end-December performance criterion on financial sector reform based on the decision to keep the supervisory authority within the central bank supported by Fund staff, and a waiver of applicability for the end-December quantitative performance criteria, for which data was not available.

The Executive Board also approved Uruguay's request for extending repayment expectations arising between February and December 2006—in an amount equivalent to SDR 540.9 million (US$781.8 million)—to an obligation basis in 2007.

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

"Uruguay's performance under the Stand-By Arrangement continues to impress. Sound economic policies, adequate program ownership, and generally favorable external financial conditions have contributed to a strong recovery, low inflation, rising international reserves and an improved debt outlook. Still, some macroeconomic vulnerabilities persist, and continued focus on fiscal discipline, financial sector reforms, and strengthening the investment climate will be necessary to ensure sustained rapid growth and debt sustainability.

"The fiscal program is on track, and the medium-term fiscal outlook is anchored by the recently approved budget for 2005–09 which envisages sustained large primary surpluses. The authorities' plans for deep fiscal reforms, both on the revenue and expenditure sides, are well placed. In particular, the planned tax reform and ongoing efforts to strengthen tax administration will be critical to ensure achievement of the ambitious revenue targets in the budget. The authorities' renewed commitment to pension reform is equally welcome as an important pillar of long-term fiscal sustainability.

"Monetary policy has successfully contained inflation in the low single digits, and the central bank's focus on achieving the program's inflation objective is appropriate. Looking forward, incipient inflationary pressures need to be monitored carefully, and it will be important that the

authorities follow up on their commitment to adjust policies if necessary to safeguard the inflation objectives.

"Financial sector reforms are progressing as programmed. Draft legislation submitted to congress to enhance the central bank's autonomy, strengthen financial supervision, and improve the bank resolution and deposit insurance frameworks will further upgrade policy capabilities and reduce financial sector vulnerabilities. An action plan to improve the ailing housing bank (BHU) has been developed and the state bank (BROU) has continued to advance its restructuring efforts. An ongoing financial sector assessment program (FSAP) is taking stock of the reform process, to help identify the priorities for the future reform agenda.

"Uruguay has made a strong start under the Fund-supported program adopted in mid-2005. Executive Directors look forward to a continued strong program implementation to ensure sustained rapid growth and a lasting exit from Fund financial support," Mr. Carstens said.

Statement by Hector Torres, Executive Director for Uruguay
and David Vogel, Advisor to Executive Director
January 18, 2006

The Program's Distinctive: The Authorities' Ownership

1. The Uruguayan economy has been performing strongly over the recent year. GDP growth has been robust, finishing 2005 above the initial forecast; inflation has been subdued; exports have grown substantially; and fiscal performance has been in line with the authorities' targets. More importantly, the government has continued implementing its critical agenda of structural reforms, exhibiting the program's most important distinctive: the government's strong ownership of the reforms that goes well beyond the IMF's conditionality.

Starting to Reap the Fruits of Sound Policies and Reforms

2. As noted, economic activity is performing strongly, with a robust boost in exports (15 percent growth in real terms in the period January-September 2005, compared to the same period in 2004). Meanwhile, export markets continue to show an increasing diversification (for instance, the participation of NAFTA countries has grown up to 29 percent of the total exports in the last twelve months to October), which tends to strengthen the country's resilience to external shocks. Precisely, our authorities' view on trade underlines the critical need for the country to continue its efforts to diversify its product base and external markets by further integrating the Uruguayan economy onto the global economy. In order to achieve these objectives, the government has taken different measures, including those aimed at enhancing Uruguay's competitiveness by implementing many structural reforms –several of which will be discussed below–, and the efforts to make agreements with different countries. In this regard, in October 2005 Uruguay signed an investment agreement with the United States of America, which was ratified by Congress in December.

3. Currently, Uruguay is attracting significant capital inflows, a good part of them being foreign direct investment (this is reflected in the significant surge in capital good imports from the private sector of 53 percent in dollar terms in January-October/05 compared to the same period in 2004). Meanwhile, taking advantage of the external and domestic conditions, including the level of the exchange rate and the inflation below the Central Bank's envisaged targets, the authorities have strengthened the reserve position, driving to a significant overperformance of the net international reserves. Furthermore, the gross non-financial public sector debt (relative to GDP) exhibits a substantial decline from 92 percent in 2004 to 73 percent in 2005, while increasing the portion of peso-denominated debt. The authorities are fully aware of the need to keep working in diminishing debt vulnerabilities –for instance, those related to its maturity and dollarization–, having created a debt-management unit at the Ministry of Finance to continue addressing these vulnerabilities.

4. One of our authorities' main objectives is to enhance the level and quality of employment, and, although much remains to be done to achieve the objective, there have

been very positive developments during the recent months. The employment rate (according to the latest labor report) has grown to its highest since 2001 and the number of contributors to the Banco de Prevision Social (BPS) has increased by 10 percent in 2005, which means better work conditions and more people with social coverage. Meanwhile, according to a report from a private university[1], the index of labor conflicts in 2005 was the lowest in the past ten years, which coincides with the introduction of the new labor framework (with tripartite wage councils) and, even before that, with the national agreement on employment, income and responsibilities launched by the government. It is important to reiterate that our authorities understand the term "economic stability" as a global concept that embraces the interests of investors, workers, and other social partners. In this regard, the authorities are committed to continue contributing to temper the normal distributional tensions, keeping in mind that social inclusion and equity are vital factors to improve the investment climate and Uruguay's human development.

5. Beyond global and emerging market developments, our authorities' commitment to sound macroeconomic policies and reforms has been rewarded by the investors' confidence in the country. For instance, in November, Uruguay placed in international markets US$ 200 million of seventeen-year bond at a yield of 8.2 percent. Having presented a declining trend of the yield, this issuance brought total international bond issues in 2005 to above US$ 1 billion. Likewise, sovereign spread has fallen from 400 basis points at the beginning of 2005 to around 270 basis points currently.

Promoting a Virtuous Cycle among Stability, Growth and Fiscal Position

6. The Uruguayan authorities strongly believe that their efforts towards the consolidation of the fiscal position are fully compatible and synergetic with higher and sustainable growth. As a minor example –although it may help to illustrate the situation–, some people have already stopped receiving benefits from the social emergency program after finding employment in the region where the pulp mill projects are being implemented. Meanwhile, as noted in the staff report, the authorities are exploring options for private participation in infrastructure investment that will support Uruguay's external trade and growth in general, being clear cases of this kind of investment those related to the revamping of the railways and the improvement of other communication facilities, including seaports. Obviously, before its implementation, the authorities will ensure that sound institutional and legal frameworks are in place according to the best international practices. Generally, on fiscal policy, the authorities would like to reiterate that the government's budget has been prepared taking realistic targets, which are fully coherent with the implementation of prudent policies and our authorities' strong commitment to preserve macroeconomic stability, in particular by strictly adhering to the undertaken fiscal targets.

7. Tax reform is the centerpiece of the government's agenda. This reform aims to achieve three main objectives: distributing the tax burden more equitably; efficiency; and coherence with the government's goal of promoting productive investment. Among the main

[1] The report can be found on the website of the Catholic University of Uruguay www.ucu.edu.uy/Facultades/CienciasEmpresariales/ModernizacionRRLL/Informes2005.htm

pillars of this reform, it is important to underline the introduction of a personal income tax, a substantial reduction of tax exemptions, and the streamlining of the tax system, including the elimination of fifteen taxes that generated only a very small part of the revenues but the collection of which proved to be a heavy burden on the revenue administration. In order to ensure transparency and improve ownership, the reform proposal was posted on the Ministry of Economy and Finances' website requesting feedback during November. Additionally, in the context of a comprehensive reform of the revenue administration, the Ministry of Finance already signed with the DGI a memorandum of understanding, establishing, among other things, quantitative targets for tax collection, which are compatible with a substantial decrease in the level of evasion.

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agenda started to be implemented. Nevertheless, the authorities are fully aware of the remaining vulnerabilities and remain firmly committed to pursue their ambitious albeit achievable economic objectives within social stability and full respect for law.