"Financial sector reforms are progressing as envisaged. The recently adopted restructuring plan for the ailing housing bank BHU should help to ensure sound new mortgage lending and minimize fiscal costs, while the recently intervened cooperative COFAC is being transformed into a new, financially sound, institution. The draft financial sector legislation submitted to congress in December, once approved, should also reduce financial sector vulnerabilities and improve the policy framework of the central bank.

"Continued strong macroeconomic polices and further progress with structural reforms will lay the basis for a lasting exit from Fund financial support, increase the economy's resilience to shocks, and raise Uruguay's growth prospects. Measures to improve the investment climate and enhance productivity will be particularly important. Also, Uruguay should continue to take advantage of favorable external conditions to further improve its debt structure," Mr. Carstens said.

Statement by Hector Torres, Executive Director for Uruguay
and David Vogel, Advisor to Executive Director
March 27, 2006

1. Over the last year, Uruguay's economy has evolved robustly. Prudent macroeconomic policies, together with the government's clear commitment to strictly follow the rule of law, have been sound pillars for this performance. Meanwhile, our authorities have been developing critical structural reforms. Some have already been submitted to Congress, while others will follow soon in the very near future. The government's broad agenda that comprises fiscal, monetary and financial reforms, as well as policies aimed at reducing and alleviating poverty conditions, increasing competence and further improving the rules of the game will pave the way for a higher, sustainable and more equitable growth.

2. Economic growth has exceeded the program's original projection, with significant boosting of private consumption, investment and exports. Regarding external sales, market diversification continues to show an increasing trend, and the Uruguayan authorities are working hard to negotiate new trade agreements as a way to further integrate Uruguay into the world economy. Furthermore, Uruguay is exhibiting a remarkable performance in the fiscal area, recording a primary fiscal surplus of 3.8 percent of GDP in 2005, thus exceeding the program's target. Likewise, the employment rate has increased, although it has not yet been fully reflected in the unemployment figures given the increasing number of people willing to enter into the formal labor market.

3. The inflation rate is now in line with the Central Bank of Uruguay's (BCU) target range and beyond the benign environment, financial markets are reflecting strong confidence in the country. During 2006, Uruguay placed in international markets US$ 500 million of sixteen-year bond in January, and US$ 500 million of thirty-year bond in March. The yields of both bonds showed a downward trend, compared to previous issuances. Since then, the country has closed the 2006 financial gap and prefinanced some portion of 2007, having made advance payments (some of which were due in 2007) to the World Bank and Inter-American Development Bank.

4. The authorities have already submitted a comprehensive tax reform to Congress, which will constitute a major change for the country. This reform, which will be effective by 2007, aims to improve equity and the efficiency of the tax system and to be consistent with the authorities' objective to attract productive investment. It is important to note that the government will proceed very carefully in order to avoid any revenue losses. Looking forward, and together with the authorities' goals in the expenditure area and the more efficient revenue administration, the tax reform will be critical to reduce Uruguay's high tax burden, which has historically posed a significant obstacle for private investment.

5. Regarding revenue collection, the tax administration agency (DGI) continues to display a very good performance, while the social security (BPS) and the custom administration agencies (where comprehensive plan reforms are expected this year) are attaining significant increases in their collections. The authorities are making substantial

efforts to reduce evasion levels, and beyond simplifying the tax system, and strengthening revenue administrations, as well as increasing audits and establishing the corresponding penalties for detected non-compliance, they are formulating educational campaigns -with effect more in the medium-term- aimed at raising awareness among the population -particularly among children from an early age- on the importance of paying taxes as a means to meet citizens responsibilities.

6. It is well known that citizens' ownership on expenditure composition can play an important role in the tax compliance behavior.[1] In this regard, the already approved five-year budget clearly reflects the government's priorities in education, health care, and infrastructure, while showing a downward trend in public spending with little or negligible incidence on growth and social development.

7. This sound and necessary fiscal trend will lead to substantial reduction in Uruguay's debt (in 2005 debt-to-GDP fell to 70 percent from 92 the year before). At the same time, the Debt Management Office aims to further reduce the debt cost, lengthen its maturity (6 years at end-2004 to 7 ½ years at end-2005, as noted in the staff report), progressively de-dollarize (there are already some positive indications in this respect, although, clearly, much more remains to be done), as well as to substitute part of the multilateral debt, thus continuing the authorities' commitment of undertaking a sustainable and successful exit strategy from the Fund's assistance.

8. As we have stated in previous statements, the Uruguayan authorities consider that growth and a sound fiscal position are fully compatible and synergetic. Clearly, low investment rates have been the Achilles' heel of Uruguay's growth, and, in this regard, beyond establishing the needed structural reforms with the objective of boosting potential growth, the authorities consider that well-targeted public investment in infrastructure is vital to support private investment. Thus, from July 2006 to June 2007 the authorities intend to establish one-time investment outlays which may, albeit temporarily, reduce the primary surplus (up to about a ¼ percent of GDP). These outlays will be fully financed by non-debt creating flows and used to finance high-quality projects which will be carefully selected and monitored, taking into account three pre-requisites; they should comprise purely investment in infrastructure; have a positive fiscal impact by reducing from an early stage recurrent spending and/or increasing public revenues; and have a direct impact on the country's competitiveness. The government is fully committed to select these projects only after the completion of a comprehensive cost-benefit study prepared by recognized firms, as well as to ensure the minimization of contingent fiscal risks by following the best international practices in this area. As indicated in the staff report, the authorities are fully committed to pursue the primary surplus goals (saving any revenue overperformance to reach their medium-term goal as soon as possible), and that the use of this one-time adjustor should be regarded as a safety valve to allow Uruguay to undertake some critical infrastructure projects.

---

[1] For instance, among other studies, James Alm, Betty Jackson, and Michael McKee ("Fiscal exchange, collective decision institutions, and tax compliance" in Journal of Economic Behavior and Organization 22, 1993) conclude that "there are strong evidence that individuals are more likely to respond positively –and so to increase their tax compliance- when faced with a public sector expenditure program that they select themselves and that they know enjoys widespread approval".