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

Sincerely yours,

/s/
Julio de Brun
President
Central Bank of Uruguay

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

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

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INTERNATIONAL MONETARY FUND

URUGUAY

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

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

Approved by Markus Rodlauer and Liam P. Ebrill

March 12, 2003

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I. Introduction and Background

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

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

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

II. The Debt Proposal

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

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

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

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

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

- **The debt exchange would cover most foreign-currency government securities** (both international-law and domestic-law governed bonds). The total amount of debt that could be exchanged is around US$4 to US$5 billion. Detailed information on Uruguay's market debt is presented in Table 1.
- **The operation would offer to exchange the old securities for a mix of new securities with longer maturities.** The maturity extension would be consistent with an elimination of the financing gaps in 2003-07 and achieving a sustainable debt service profile thereafter.
- **There could also be a small upfront cash payment to investors in bonds with the shortest maturities** (2003 and 2004). Given their cash constraint, the authorities estimate that the total amount of the cash payments would be small in comparison with the amount of outstanding bonds with these maturities.
- **Participation in the exchange would be voluntary**, for both international-law and domestic-law governed bonds. Completion of the international and domestic parts of the exchange would be made contingent on each other to preserve inter-creditor equity.
- **The authorities are developing a variety of features and mechanisms designed to deliver a high investor participation rate.**

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

[2] Uruguay was investment grade until February 2002.

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Figure 1. Uruguay: Debt Service

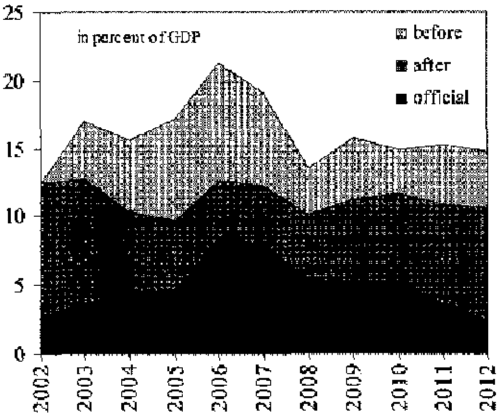
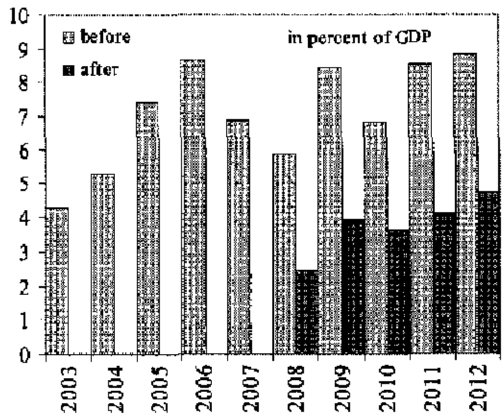


Figure 2. Uruguay: Residual Financing Needs



III. Financing Assurances and Medium-Term Outlook

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

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

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

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

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

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

IV. Risks and Program Monitoring

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

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

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

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

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

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

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

Table A. Uruguay: Sensitivity of Debt Analysis

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

Source: Fund staff estimates.

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V. Staff Appraisal

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

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

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

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

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

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

Sources: Central Bank of Uruguay and Fund staff estimates.

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

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

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

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

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

(In millions of U.S. dollars)

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

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

1/ After debt operation.

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

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

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Table 3. Uruguay: Public Sector Debt Sustainability 1/

			Projections									
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
A. Assumptions												
Real GDP growth (percent)	-3.1	-11.0	-2.0	4.5	4.0	4.0	3.0	3.0	3.0	2.5	2.5	2.5
Real U.S. dollar exchange rate (change in percent)	-13.8	-26.8	-12.4	4.5	4.5	2.9	2.8	1.3	0.1	0.0	0.0	0.0
Primary balance: Consolidated public sector	**-1.2**	**0.3**	**3.2**	**3.2**	**3.3**	**3.3**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**	**3.8**
Non-financial public sector	-0.9	0.5	3.4	3.4	3.5	3.5	4.0	4.0	4.0	4.0	4.0	4.0
BCU	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Overall Balance: Consolidated public sector	**-4.2**	**-4.3**	**-3.1**	**-2.5**	**-1.8**	**-1.7**	**-0.8**	**-0.4**	**-0.3**	**-0.7**	**-0.9**	**-1.1**
Non-financial public sector	-3.9	-4.0	-2.4	-1.7	-1.0	-0.9	0.0	0.4	0.5	0.1	-0.1	-0.3
BCU	-0.3	-0.3	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
B. Debt Dynamics (In percent of GDP)												
Gross non-financial public sector debt	**45**	**83**	**100**	**92**	**82**	**76**	**69**	**64**	**61**	**58**	**55**	**53**
C. Cash Flow (in millions of U.S. dollars)												
Gross borrowing needs	**2,092**	**3,443**	**996**	**684**	**523**	**519**	**490**	**670**	**763**	**873**	**1,025**	**1,270**
Public sector deficit	715	532	261	201	136	121	-4	-70	-82	-20	26	67
Amortization	1,377	2,911	736	483	387	399	494	740	845	893	1,000	1,203
Market debt 2/	1,208	2,675	481	236	184	240	308	507	590	638	724	915
IDB/WB and other official debt	169	236	255	247	203	158	186	234	255	255	275	288
Gross Financing	**2,092**	**3,443**	**996**	**684**	**523**	**519**	**490**	**274**	**101**	**231**	**267**	**361**
Market debt	1,035	1,088	249	184	76	120	93	277	296	316	338	363
IDB/WB and other official debt	349	800	707	316	203	158	186	234	255	255	275	288
Other 3/	708	1,555	40	184	244	241	211	-237	-450	-340	-346	-290
Residual financing needs	...	...	**0**	**0**	**0**	**0**	**0**	**396**	**662**	**642**	**759**	**910**
D. Other Indicators												
Total debt service (in percent of GDP)												
Before debt exchange		12.4	16.9	15.6	17.1	21.3	19.1	13.5	15.7	14.8	15.2	14.7
After debt exchange		14.9	12.7	10.3	9.6	12.6	12.2	10.1	11.1	11.6	10.8	10.6
o.w. official		2.8	3.6	4.4	4.6	8.5	8.0	5.3	5.1	5.1	3.7	2.4
Residual financing needs (in percent of GDP)												
Before debt exchange		...	4.3	5.3	7.4	8.7	6.9	5.9	8.4	6.8	8.5	8.8
After debt exchange		...	0.0	0.0	0.0	0.0	0.0	2.4	3.9	3.6	4.1	4.7
Average interest rate (in percent)		7.2	5.9	5.6	5.5	5.7	5.6	5.5	5.7	6.7	7.5	8.2

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

1/ After debt operation.

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

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

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Table 4. Uruguay: Medium-Term Outlook

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

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