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Uruguay: 2007 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Uruguay

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2007 Article IV consultation with Uruguay, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on July 3, 2007, 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 July 31, 2007. 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 August 27, 2007 updating information on recent developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 29, 2007 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for Uruguay.

The document listed below has been or will be separately released.

Selected Issues Paper

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

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Uruguay

Approved by Ranjit Teja and Adnan Mazarei

July 31, 2007

- ***Scope and focus***. A key topic of the discussion was the policy mix to address rising inflation in the wake of vigorous growth and capital inflows. This year's consultation discussions gave special prominence to financial sector linkages. Thus, background studies include work on monetary credibility, determinants of sovereign spreads, bank lending behavior, the optimal level of reserves, and measuring credit risk of the banking sector (see the *Selected Issues* paper).

- ***Near-term policy mix***. To increase the effectiveness of recent money tightening, the exchange rate should be allowed to appreciate. Some tightening of the fiscal stance would also ease the burden on monetary policy.

- ***The monetary framework***. A priority is to clarify the objectives and instruments of monetary policy, including foreign exchange intervention.

- ***Financial sector***. There is a need to reduce further vulnerabilities from high dollarization and deepen financial intermediation. Implementing the FSAP recommendations is key, including reforming state banks and strengthening supervision. While reserve buildup would be desirable to increase further the resilience of the financial system to external shocks, reserve coverage is nearing adequate levels.

- ***Fiscal sustainability***. Large primary surpluses are still needed to trim public debt. To free up resources for public investment, among the lowest in the region, nondiscretionary spending should be reduced gradually. Private-public partnerships also provide a good opportunity for upgrading infrastructure, provided that contingent liabilities are contained. Reducing debt dollarization will help ensure debt sustainability.

- ***Other reforms***. There is scope for improving the business climate, including labor relations and bureaucratic impediments to investment.

- ***Staff team***. This report was prepared by M. Piñón (Head), A. López-Mejía, F. Gonçalves, R. Romeu (all WHD), G. Gelos (Resident Representative), G. Adler (PDR), and M. Souto (MCM).

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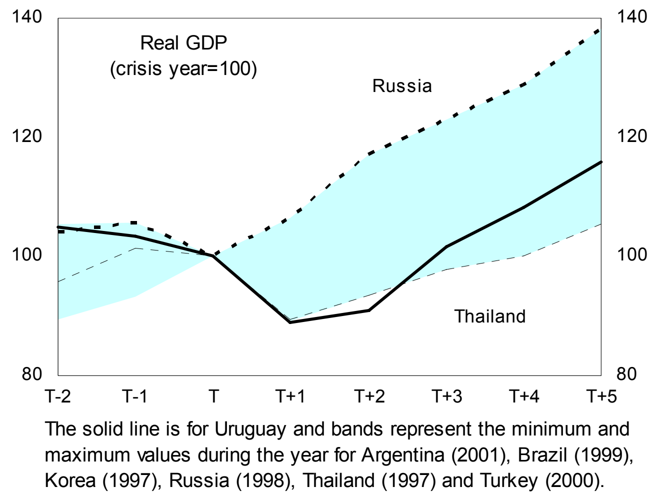
I. Key Challenges

A. Overview

1. ***Sound policies and favorable external conditions have led to a strong economic recovery since 2002, but important challenges lie ahead***. Since 2002, growth has averaged 7 percent, inflation has remained moderate, and poverty rates have declined considerably, remaining among the lowest in the region. Renewed market access and strong foreign direct investment have resulted in a substantial increase in international reserves (Figure 1). Strong primary fiscal surpluses have helped reduce debt ratios and debt management operations have improved the structure of the debt. Key reforms have been implemented since the crisis, including a comprehensive tax reform, bank restructuring and improved supervision. However, important elements of the government's reform agenda, which would further reduce vulnerabilities and help sustain high growth, still need to be implemented.

Uruguay's recovery is similar to the experience of other post-capital account crisis countries.



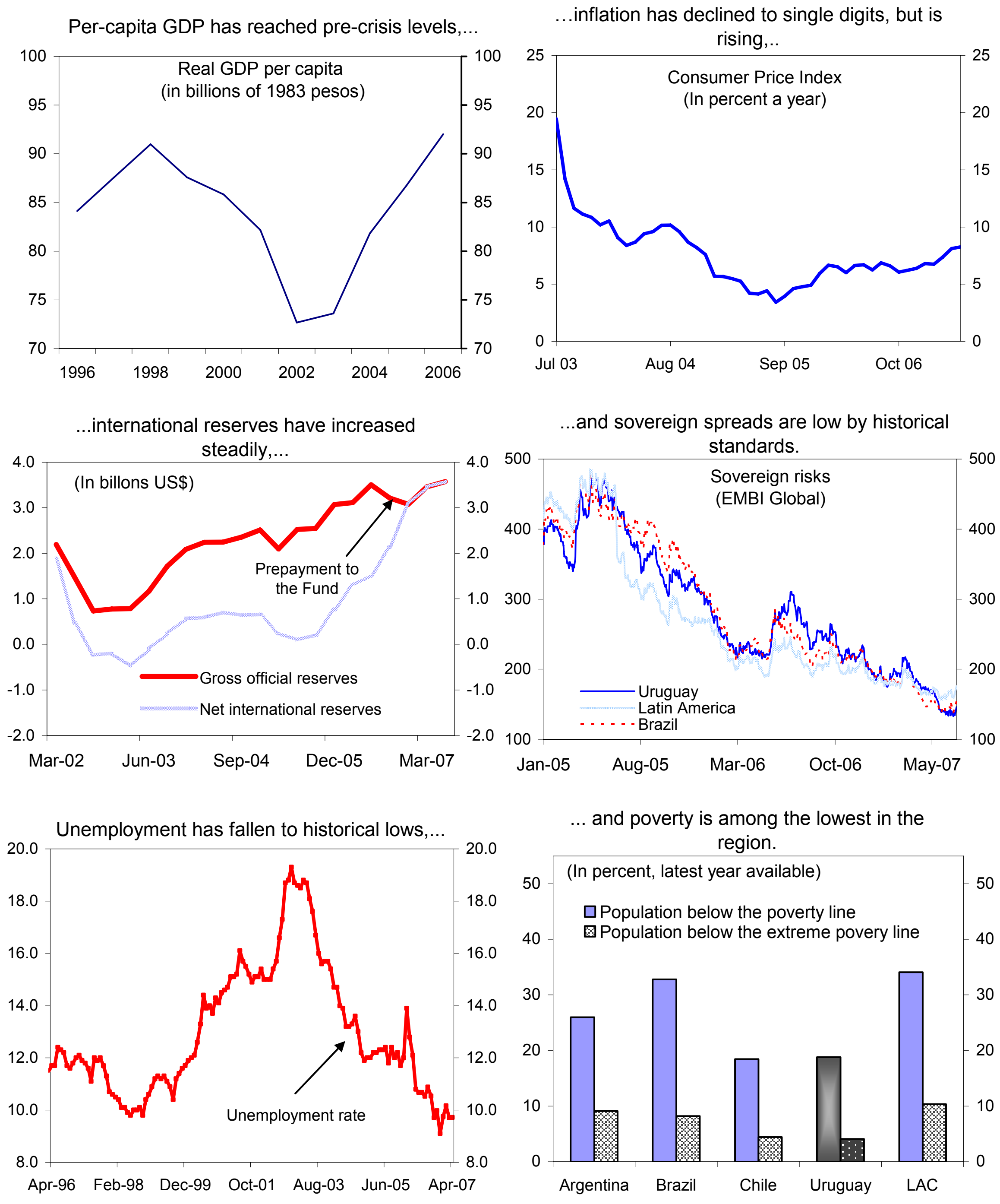
The solid line is for Uruguay and bands represent the minimum and maximum values during the year for Argentina (2001), Brazil (1999), Korea (1997), Russia (1998), Thailand (1997) and Turkey (2000).

2. ***Near-term prospects are generally positive, but inflation has been on the rise***. With high momentum behind and strong domestic demand, real GDP growth could reach 5¼ percent in 2007. Higher growth and the recovery of the energy sector from the 2006 drought have improved fiscal prospects in 2007, with the 4 percent of GDP primary surplus target likely to be met or surpassed. Inflation, however, has been rising and is likely to exceed the target range (4½–6½).

Macroeconomic Framework

	2005	2006	Proj. 2007
(In percent of GDP, unless otherwise indicated)			
Real GDP growth (in percent)	6.6	7.0	5.2
Inflation (in percent, end of period)	4.9	6.4	7.0
Public sector primary balance	4.1	3.9	4.0
Public sector overall balance	-0.7	-0.6	-0.1
Public sector debt	75	66	62
External current account balance	0.0	-2.4	-2.8
Of which: excluding pulp mills projects	0.0	-1.1	-1.3

Figure 1. Macroeconomic Performance—continues to be strong.



Source: Central Bank of Uruguay; CEPAL, and Fund staff estimates.

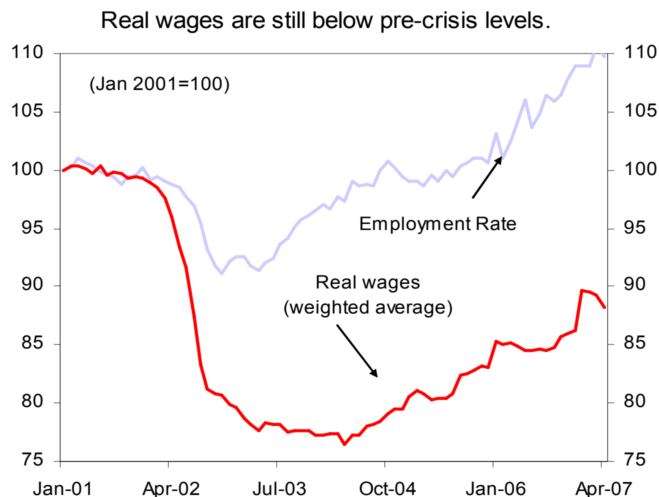
B. Rising Inflation

3. ***At 8.1 percent, inflation is now well above the target range***. The authorities stressed that the rise in inflation is largely due to temporary factors (drought in 2006 has given way to floods in 2007) and likely to decline in the months ahead. Staff noted, however, that underlying inflation has steadily increased—with one measure of core inflation above the target range (Figure 2). The latest survey shows expected inflation near 7 percent by end-2007, and declining to within the target range in 2008.

4. ***Higher core inflation reflects both demand-pull and cost-push factors***:

- ***The authorities emphasized that imported inflation had become a significant factor***. With price increases of tradable goods running well above the inflation target, there was agreement about the need to prevent second round effects.

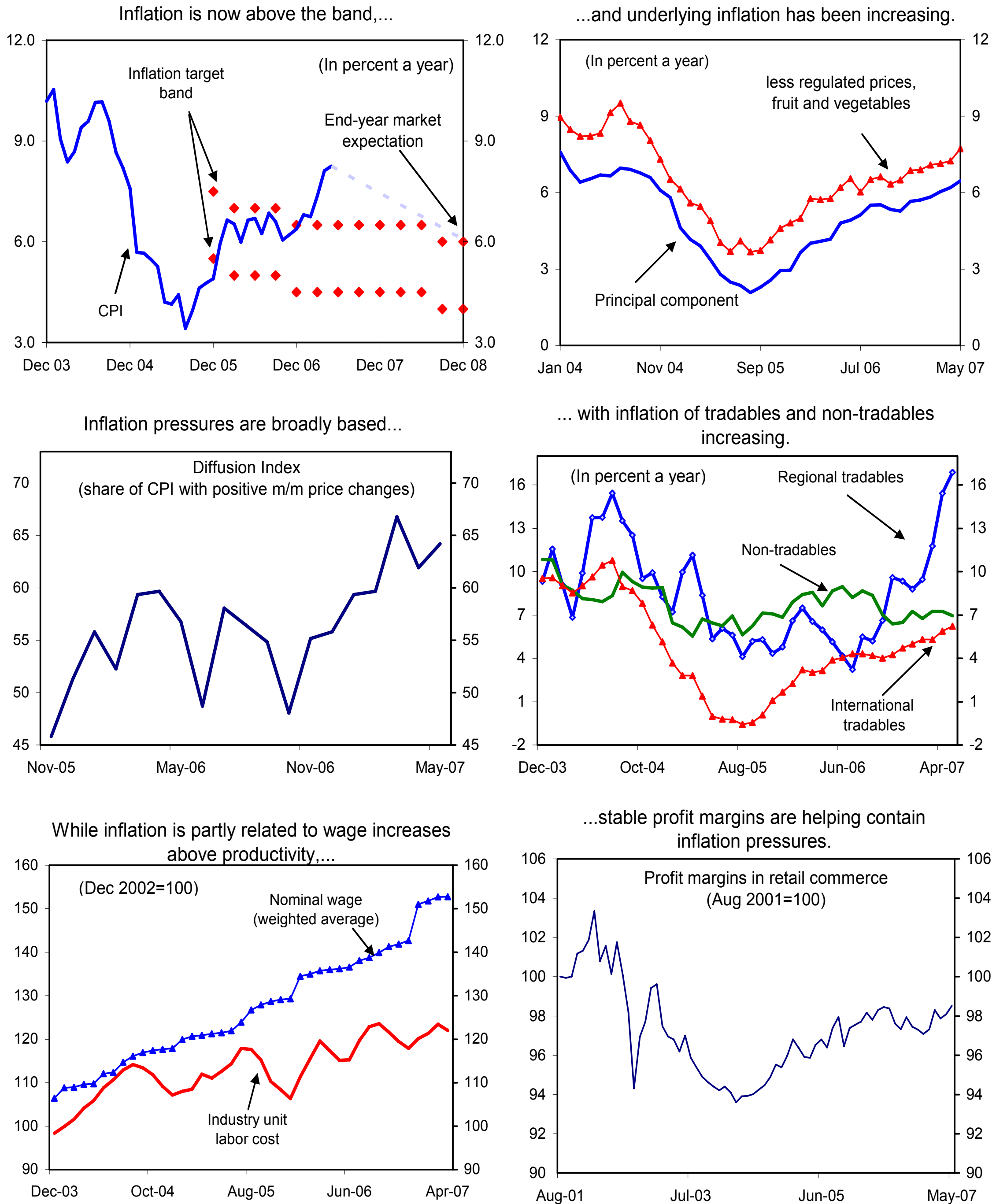
- ***After four years of high growth, capacity is becoming a constraint, in at least some sectors***. According to some measures, output is now above potential (Figure 3). Growth in 2006 reached 7 percent, well above historical averages, with private consumption as the main source of growth. GDP growth during the first quarter and monthly indicators through May have shown few signs of slowing. Still, given the high levels of foreign direct investment, capacity and productivity are likely to expand over the medium term.



- ***Wage pressures have increased as labor market conditions have tightened***. With the unemployment rate at its lowest level in this decade, wage pressures are gradually mounting. Unit labor costs are now growing at a rate above the inflation target. Still, real wages have recovered to only 90 percent of pre-crisis levels.

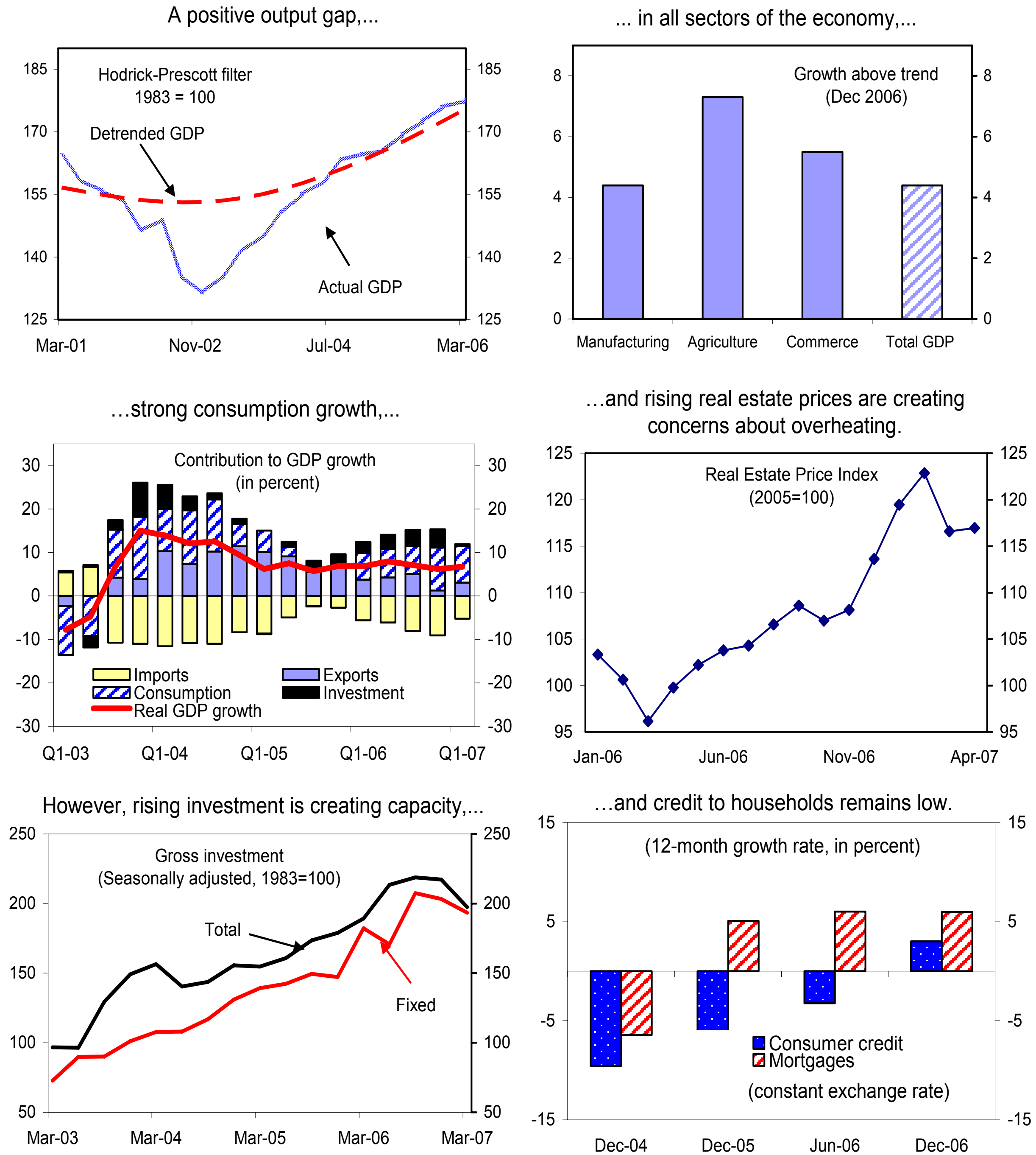
- ***Expansionary monetary and exchange rate policies too have played a role***. In late 2005, with inflation well below the target range and persistent appreciation pressures, the central bank concluded that money growth rates above 25 percent signaled the remonetization of the economy. Negative short-term real interest rates were deemed the result of excess bank liquid reserves (largely held abroad or at the central bank) and weak credit demand. Following large foreign exchange purchases by the central bank, currency appreciation was arrested. However, since these purchases were not sterilized, money growth reached 35 percent by mid-2006. Inflation has increased steadily since then (see Section C below).

Figure 2. Inflation—the rise is broad based.



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

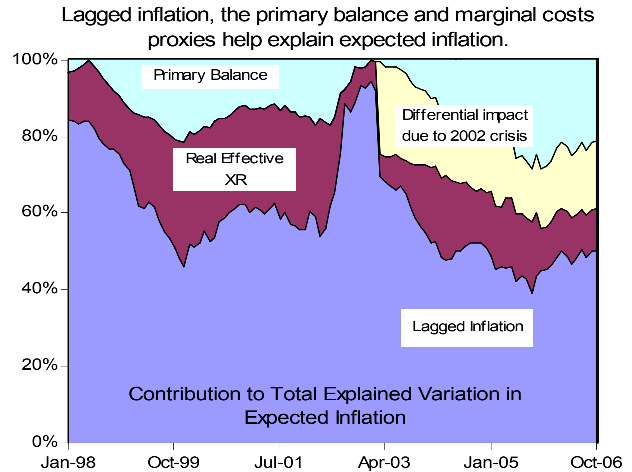
Figure 3. Overheating—the evidence is still mixed.



Source: Central Bank of Uruguay; CINVE; National Institute of Statistics; and Fund staff estimates.

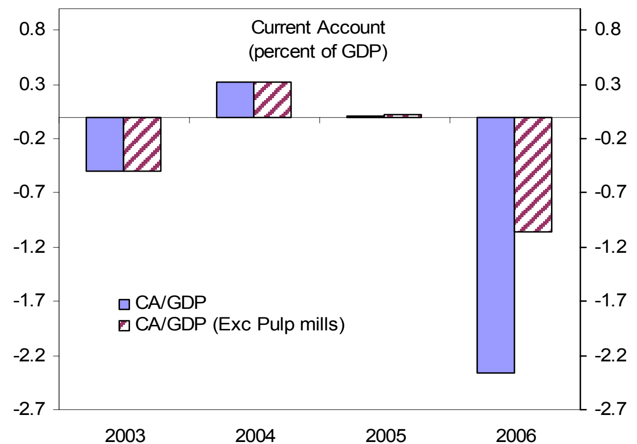
- ***Fiscal policy also contributed to an increase in aggregate demand in 2006, but the fiscal impulse is set to ease in 2007***. Despite substantial fiscal consolidation since the crisis, on a cyclical basis, staff estimates point to a decrease in the primary balance in 2006, implying a fiscal impulse of about 1 percent of GDP. The 2007 primary balance target of 4 percent of GDP, however, implies a lower impulse of 0.3 percent of GDP.

5. ***While inflation inertia has declined since 2002, there are renewed concerns***. As discussed in chapter I of the *Selected Issues* paper, lagged inflation has become less important than forward-looking expectations in explaining inflation, and a higher fiscal primary balance could help lower inflation expectations. Still, the introduction of wage agreements with backward looking elements may raise inflation inertia, while higher than expected inflation during the first half of 2007 may spur higher inflation in the period ahead.



C. Capital Inflows, Monetary Policy, and Competitiveness

6. ***The current account moved into deficit in 2006, reflecting FDI and oil-related imports***. The deterioration is largely explained by vigorous import growth (30 percent in US dollar terms), partly associated with FDI-related imports, high oil prices, and temporary oil needs to deal with a severe drought. Still, despite a slight slowdown, export growth remained robust (17 percent in US dollar terms), supported by higher export prices.

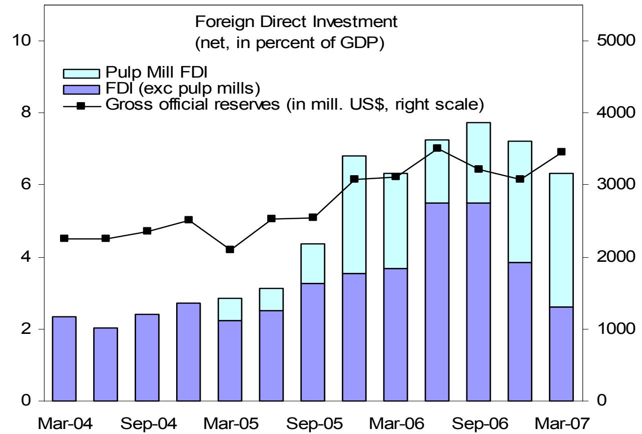


7. ***Capital inflows have allowed a significant increase in reserves, but have complicated macroeconomic management***. Sizable sovereign debt issues were used largely to improve the debt profile, including by repaying all Fund obligations (US$2.4 billion) and, more recently, by placing US$1.2 billion in inflation indexed bonds aimed at gradually reducing dollarization. However, large FDI inflows (7 percent of GDP in 2006) have created appreciation pressures and competitiveness concerns in some sectors. In late 2005 the

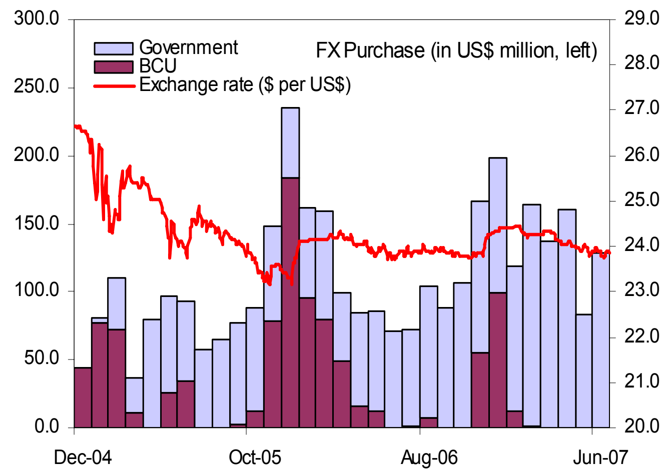
authorities effectively moved from the free float adopted in the aftermath of the 2002 crisis to a managed float. Significant exchange purchases have reduced the appreciation and volatility of the exchange rate. In 2007, foreign exchange purchases have been largely undertaken by the government, partly to meet its foreign currency needs. Net international reserves (excluding private banks' reserves at the central bank and recent prefinancing operations) have risen by US$2½ billion since early 2006 and are approaching adequate levels (see ¶20).

8. ***Despite an announced tightening, monetary conditions have been variable***. In late 2005, the central bank adopted M1 as the intermediate objective of monetary policy, with the associated base money serving as an operational target. While M1 growth slowed somewhat to about 20 percent by end-2006, core inflation increased in early 2007. In response, in March 2007, the authorities announced a shift toward a "contraction" phase, with the 12-month ahead indicative M1 target sharply lowered from 15 percent to 9 percent, i.e., well below nominal GDP growth. Although M1 growth accelerated in May to 26 percent, partly reflecting instability in the money multiplier, base money growth has been contained, at around 15 percent in mid-July. Sterilization operations have helped offset central bank's foreign exchange purchases from the government.

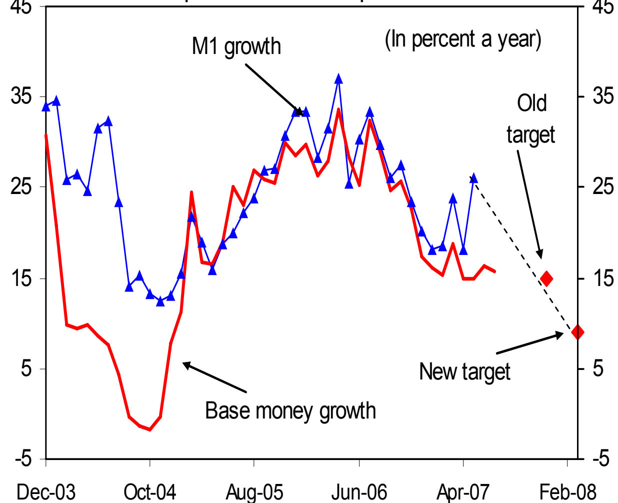
Large FDI inflows led to a steady increase in international reserves.



With large interventions in the foreign exchange market, the nominal exchange rate has remained broadly stable.



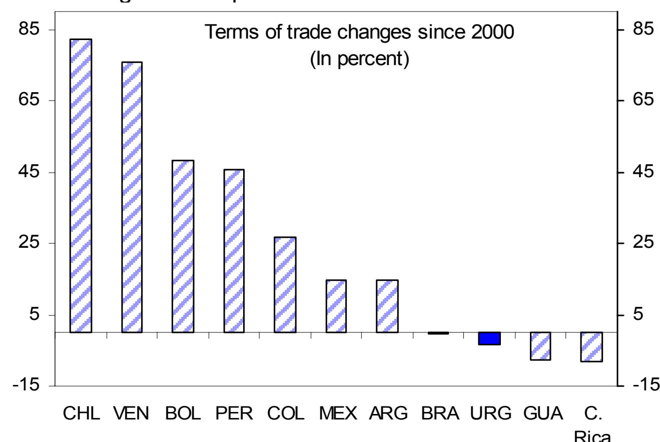
A shift to a contractionary phase was recently announced to help reduce demand preassures.



9. ***The lack of nominal exchange rate flexibility has limited the effectiveness of monetary policy and prompted ambiguity in the policy framework***. Exchange rate rigidity has closed off an important channel from money to prices and has increased market perceptions of an exchange rate ceiling. As discussed in Chapter II of the Selected Issues paper, there is now some ambiguity about the monetary framework, with the central bank appearing to target inflation and an implicit exchange rate (about Ur$ 24 per dollar). In particular, announced targets for inflation and indicative ceilings for M1, combined with intervention in the foreign exchange market partly to resist nominal appreciation, have created ambiguity about the objectives and instruments of monetary policy.

10. ***Uruguay remains competitive***. The external current account (net of FDI related imports) is close to balance; exports are buoyant; and profitability indicators of the tradable sector remain higher than pre-crisis levels. Similarly, despite the rebound during 2004–05, the real effective exchange rate remains below 2001 levels; although the bilateral real exchange rate with Argentina has appreciated to above pre-crisis levels, bilateral rates with other key partners remain favorable. Staff's models suggest at most a mild undervaluation of the real effective exchange rate of around 5–10 percent, despite a deterioration in the terms of trade since 2005 (Figure 4) (the equilibrium real exchange rate was estimated by evaluating the cointegrating relationship between the real exchange rate and economic fundamentals—i.e., productivity differentials, terms of trade, and net foreign assets). While agreeing that Uruguay remains competitive, officials were skeptical about estimates of under or overvaluation.

Uruguay remains competitive, though is one of the few countries in the region that experienced a decline in the terms of trade.



D. Financial Sector Vulnerabilities

11. ***Despite low short-term risks and improved performance indicators, financial vulnerabilities are still important because of high dollarization***. Since the crisis, soundness indicators have strengthened considerably and are now broadly in line with comparator countries; banks are better capitalized, with only 2 percent of non-performing loans. Still,

Financial soundness indicators are now broadly in line with comparator countries

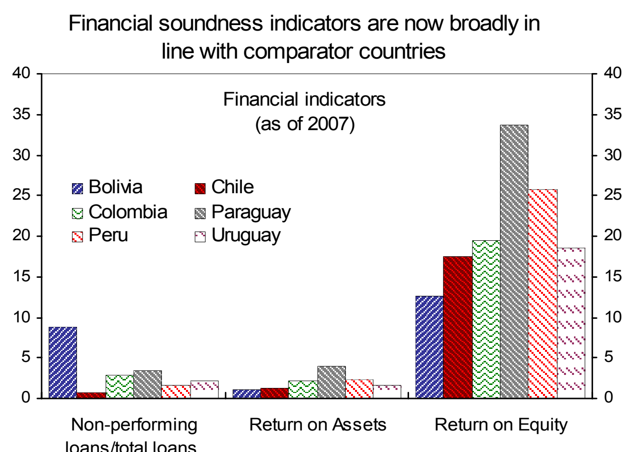
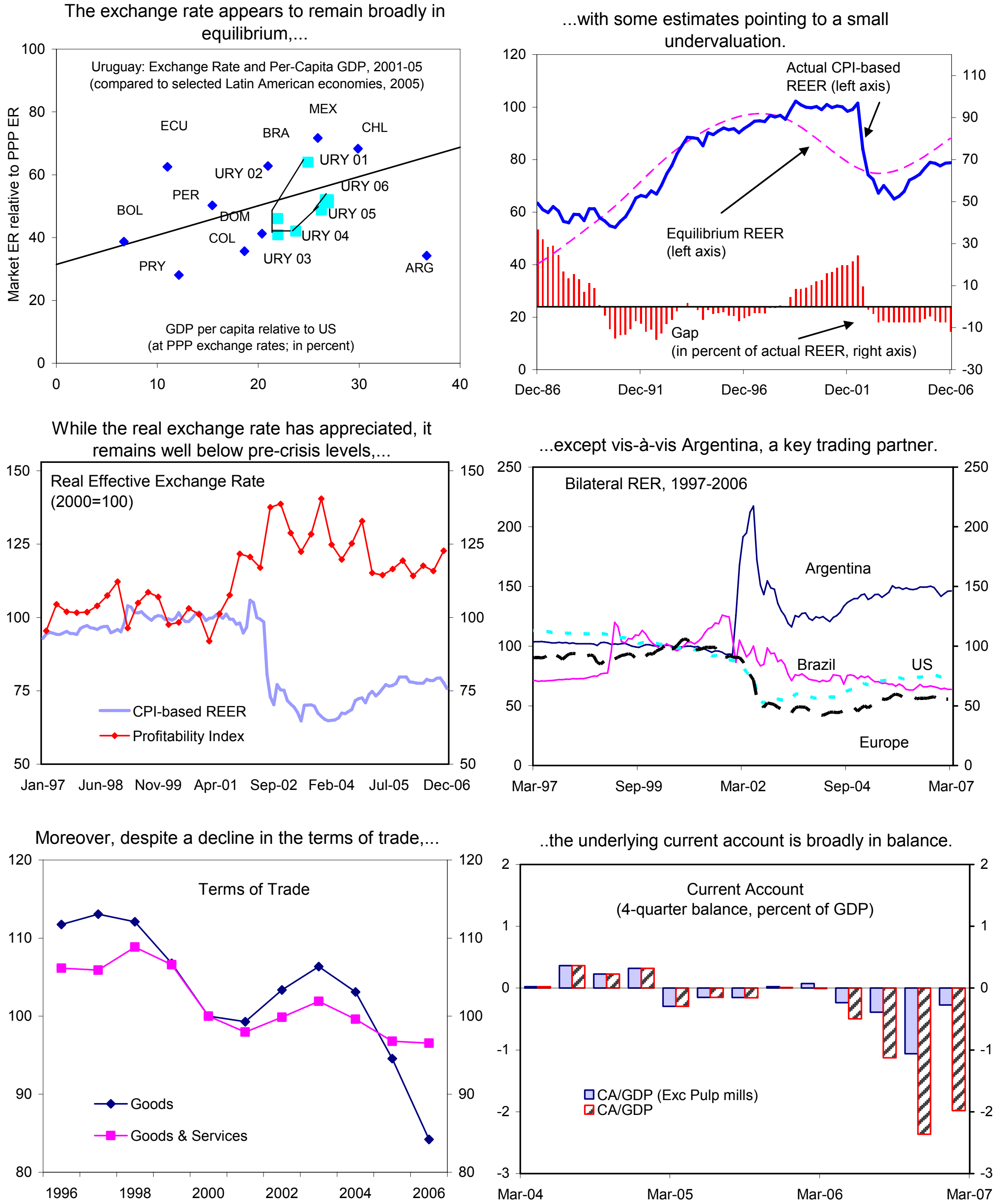


Figure 4. Exchange Rate—despite appreciation, the economy remains competitive.



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

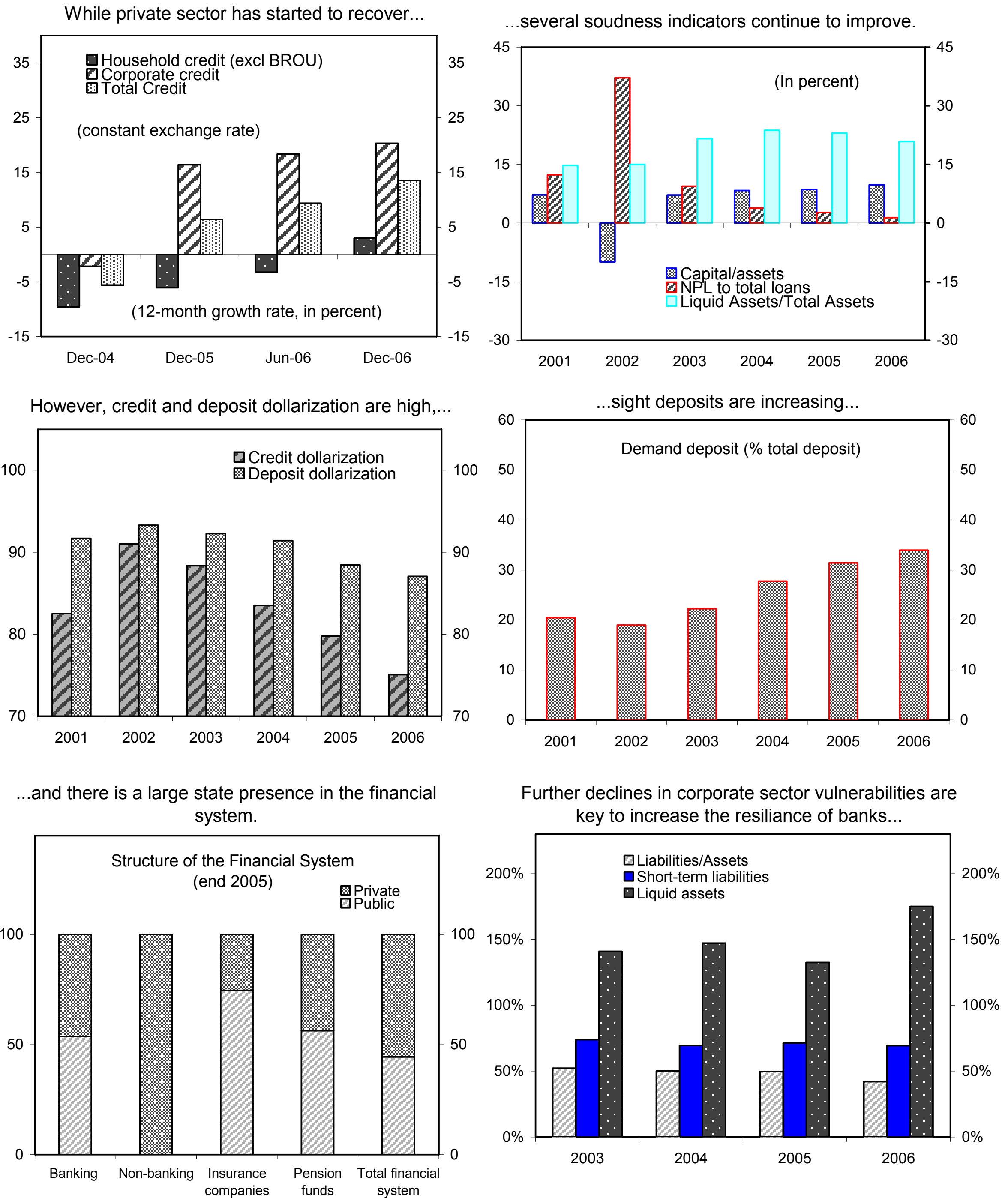
while banks are now profitable, this largely reflects their ability to capture deposits and place them abroad at higher rates, rather than a resumption of credit (Figure 5). Staff and officials agreed that as the economic and credit recovery mature, banks' liquidity buffers against shocks will decline. More importantly, with high demand deposits, over 75 percent of credit denominated in U.S. dollars, and significant currency and maturity mismatches in the corporate sector, the banking system continues to be subject to exchange and credit risk.

12. ***Uruguay also remains exposed to international spillover risks***. Trade has been diversifying away from the region. In addition, non-resident deposits —a key factor triggering the 2002 crisis—have been halved to about 20 percent. At the same time, while country spreads have declined substantially since the crisis, Uruguay has yet to recover the investment grade it had before the crisis. As discussed in chapter III of the *Selected Issues* paper, sovereign spreads behavior is now more closely linked to most Latin American countries, compared with pre-crisis years (Figure 6). Officials broadly agreed with this assessment. Staff also noted that the 2006 FSAP stressed the need to further reducing financial vulnerabilities, including from high dollarization (Figure 7).

Status of FSAP

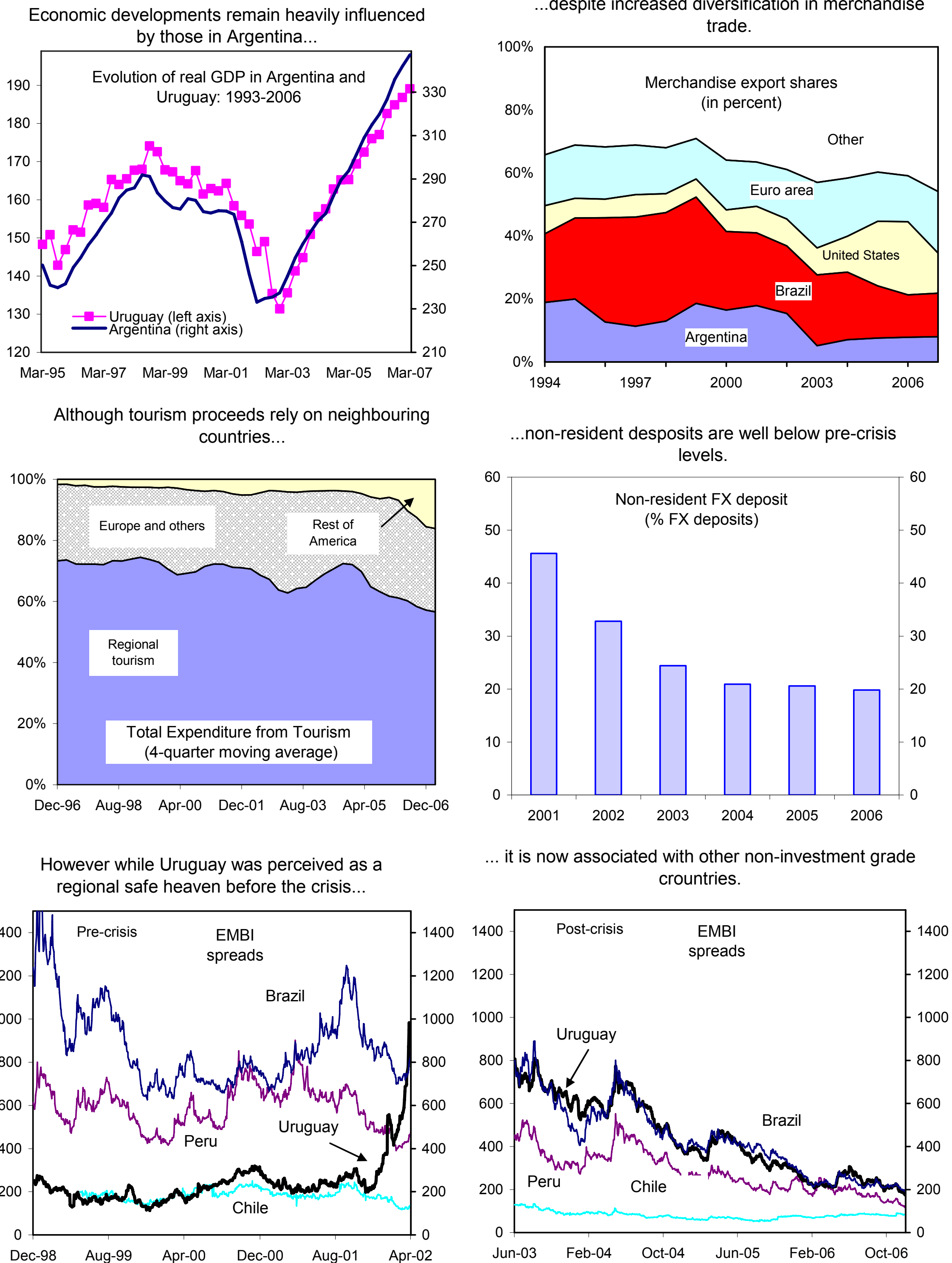
Key Areas	Key Recommendations	Status
Central bank	Strengthen its independence and capitalize the bank	Draft law in congress.
Supervision	Increase resources and training; improve information systems; legal protection to staff.	Draft law in congress. The revised 2008 budget contains increased resources.
Prudential policies	Facilitate usage of credit registry and incorporate BHU loans and small loans of BROU; strengthen credit and debt relief practices of public banks; shorten foreclosure and bankruptcy processes.	Credit registry expected to be operational by end-2007. Credit procedures are being strengthened.
State banks	Restructure and downsize institutions. Require directors and managers to satisfy supervisory fit and proper requirements and to be subject to supervisory corrective actions.	Slow progress is being made in restructuring the housing bank (BHU).
Pension funds	Liberalize rules for investments in nongovernment obligations, including allowing limited, high-quality offshore investments. Eliminate the government-guaranteed minimum return in AFAP Republica.	Pension funds can purchase bonds by multilateral institutions.
Insurance	Ensure that mortgage default insurance prices underlying risks. Contingent liabilities from state insurance company BSE need to be assessed.	The authorities would welcome an external risk assessment at BSE.
Bankruptcy framework and corporate governance	To facilitate efficient reorganization of viable firms and liquidation of nonviable ones. Improve corporate governance and disclosure practices.	Draft law in congress.

Figure 5. The Financial System—has strengthened, but vulnerabilities remain.



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

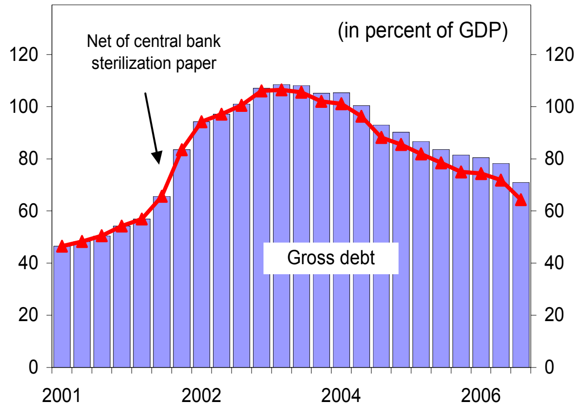
Figure 6. International Linkages—remain significant.



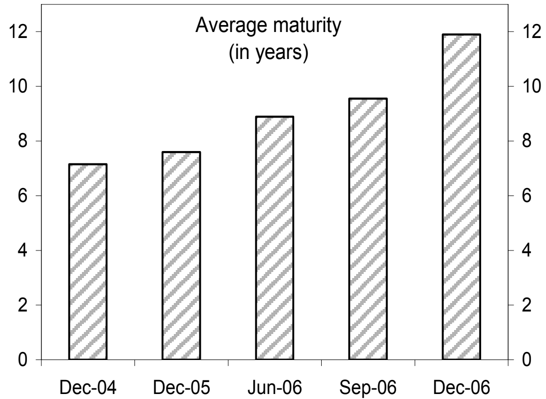
Source: Central Bank of Uruguay; Ministry of Economy and Finance; DOT database and Fund staff estimates.

Figure 7. Vulnerabilities—have declined significantly, but remain important.

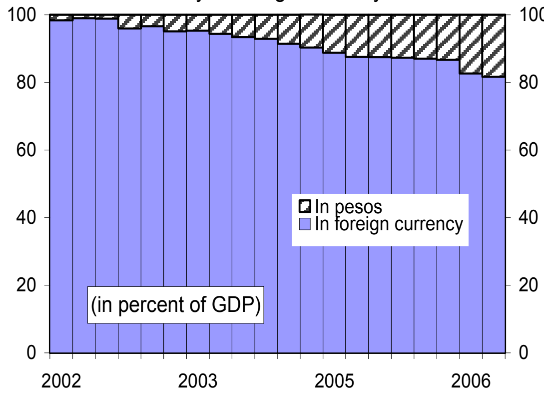
Although it is still higher than before the crisis, public debt has declined significantly,...



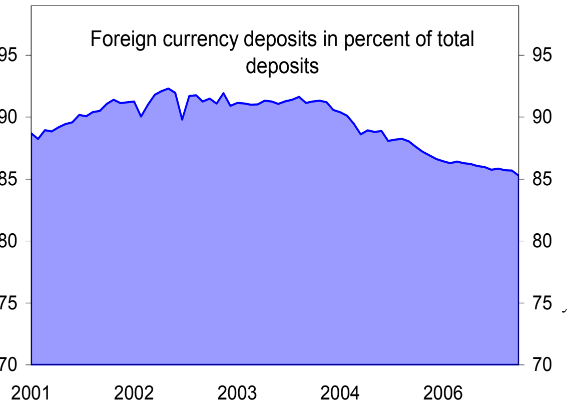
...and its maturity structure has been strengthened.



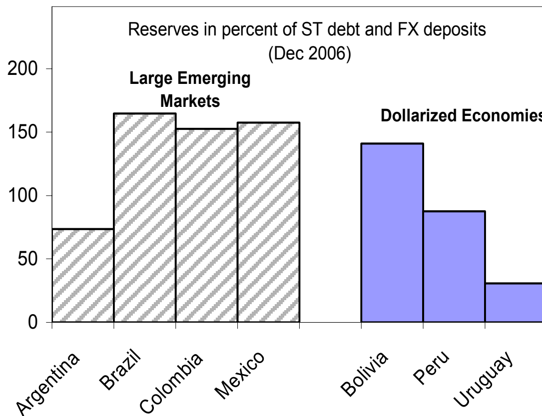
Despite an improvement, debt remains denominated mostly in foreign currency...



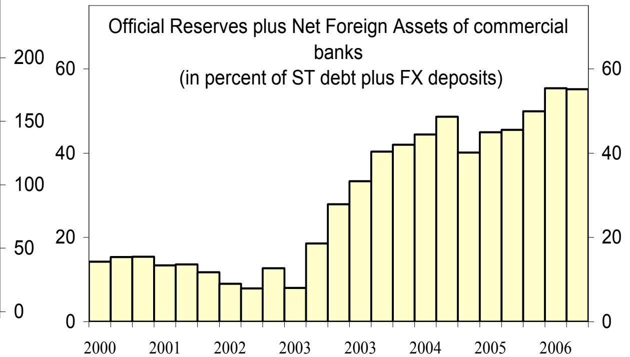
... and financial dollarization also remains high.



While the central bank's reserve coverage is still low compared to other dollarized economies,...



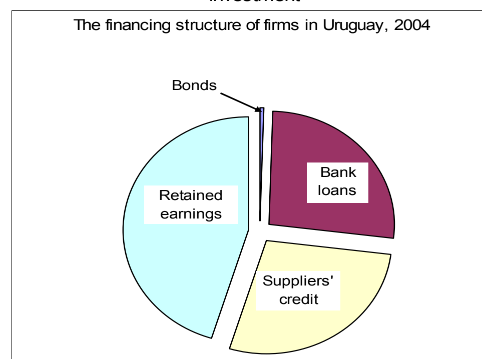
...the foreign exchange liquidity of the financial system is high.



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

13. ***The financial system will face important challenges in the years ahead***. So far, firms have largely relied on excess capacity or financed investment with own funds. However, as the recovery matures, increased financial intermediation will be needed to sustain investment and growth. Thus, it will be important that the banking system be prepared to increase credit without jeopardizing financial stability. As discussed in chapter IV of the *Selected Issues* paper, measures to increase competition, speed up restructuring, and improve efficiency can foster financing deepening. At the same time, as credit demand recovers and the financial system starts playing a more important role in the amplification of shocks, it will be important to further enhance prudential oversight and macro-financial policy coordination.

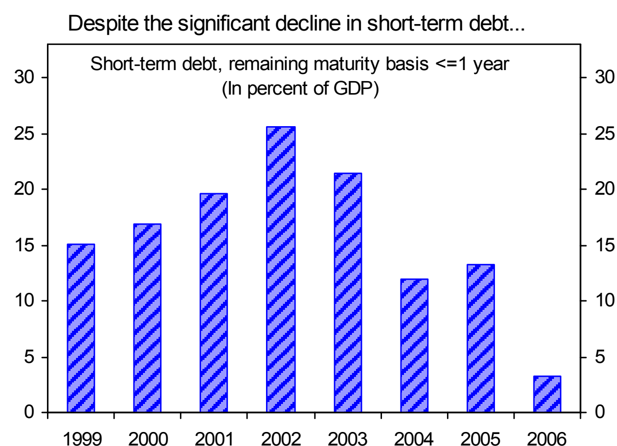
Banks are still to play a more important role in financing investment



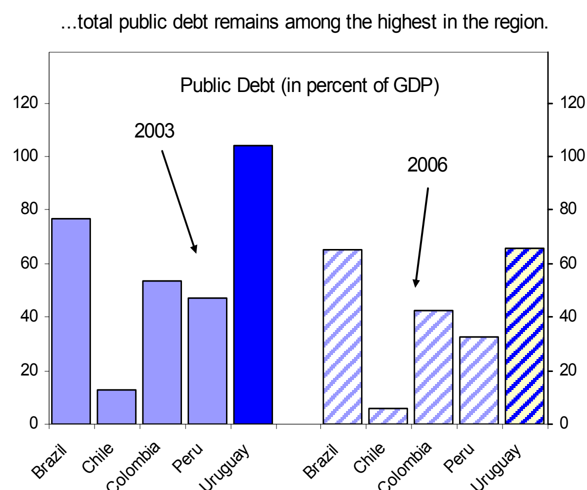
E. Fiscal Adjustment and Debt Sustainability

14. ***The fiscal accounts have improved considerably since 2002, but important structural issues remain to be addressed***. Expenditure reductions shifted a primary deficit into a surplus approaching 4 percent of GDP, and the overall fiscal deficit is now close to zero. However, at 2½ percent of GDP, public investment is significantly lower than in the 1990s. Also, reflecting demographics and social preferences, spending on wages and social security benefits are the highest in the region, representing about 70 percent of total noninterest spending. And, while the recently approved tax reform is expected to improve the efficiency of the system, the tax burden is projected to remain largely unchanged (Figure 8).

Despite the significant decline in short-term debt...



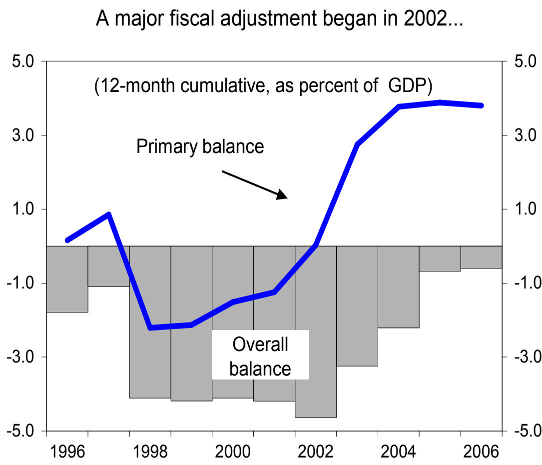
...total public debt remains among the highest in the region.



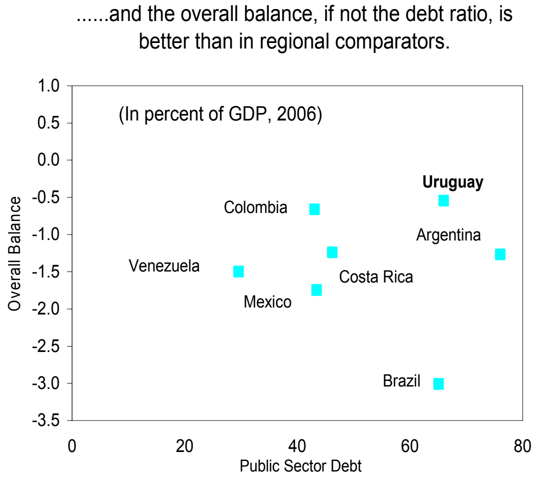
15. ***Debt vulnerabilities are declining, but remain high***. With strong growth, sustained primary surpluses, and real exchange rate appreciation, public debt has declined to 66 percent of GDP, from 110 percent of GDP in 2003. Under current policies, this ratio is projected to drop to 40 percent by 2012, still above pre-crisis levels. Vulnerabilities from

Figure 8. Fiscal Performance—Is strong, but public investment remains low.

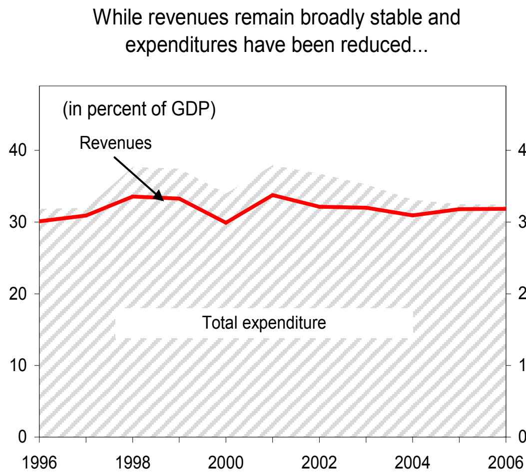
A major fiscal adjustment began in 2002...



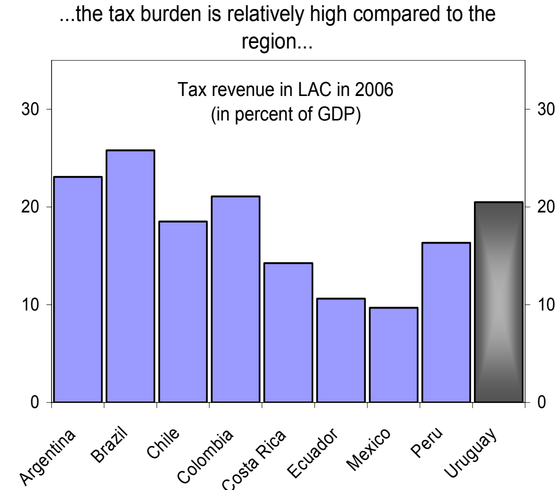
......and the overall balance, if not the debt ratio, is better than in regional comparators.



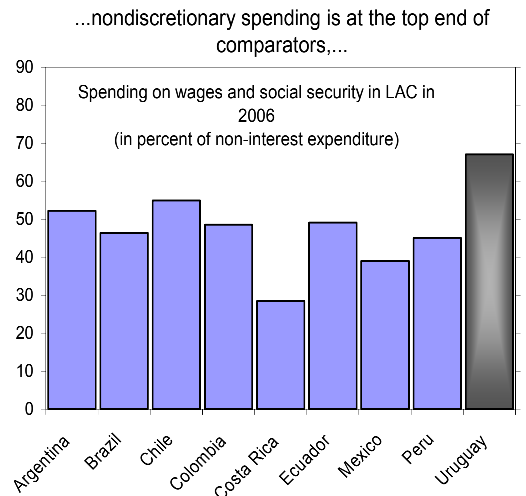
While revenues remain broadly stable and expenditures have been reduced...



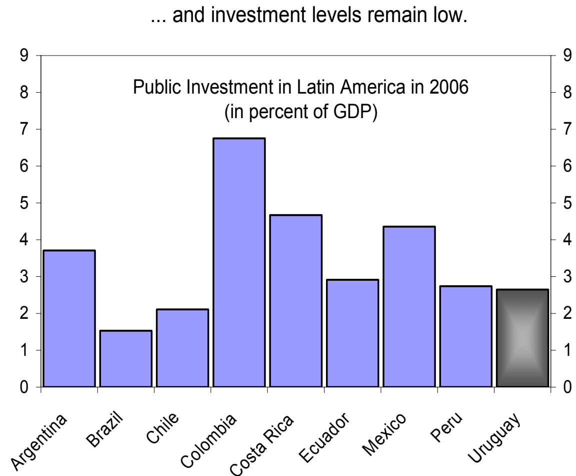
...the tax burden is relatively high compared to the region...



...nondiscretionary spending is at the top end of comparators,...



... and investment levels remain low.



Source: Ministry of Finance; and Fund staff estimates.

rollover and interest risk have also fallen: the government took advantage of strong market access and low spreads to repay short-term, floating interest rate or more expensive debts and raised the average maturity of public debt from about 7 years at end-2001 to almost 12 years in 2006. Nevertheless, despite increased issuance of inflation-indexed bonds, about 70 percent of public debt remains denominated in foreign currency.

II. Policy Issues for Discussions

16. ***Discussions focused on the policy mix to deal with inflation and appreciation pressures and reforms to further reduce vulnerabilities and sustain growth***. Beyond the near term policy challenge of rising inflation and strong capital inflows, the focus was on medium term reforms, including several initiated in recent years: reform of the monetary framework; further strengthening the financial system and its resilience to shocks; sustaining large primary surpluses, while enhancing the quality of fiscal policies; and improving further the business climate. Key measures in these areas, which were part of the recently cancelled SBA and expected to be completed in 2007, are facing further delays.

17. ***In line with the Fund's policy on exceptional access, a report on Uruguay's 2005 SBA has been prepared and discussed with the authorities***. While sharing the thrust of the report regarding the success of the SBA, officials disagreed with the assessment that further progress could have been made in advancing the reform agenda. The authorities argued that these reforms were beyond their control as they required congressional approval and stressed that substantial progress had been achieved on the structural reform agenda."

Pending reforms under the previous Stand-by Arrangement

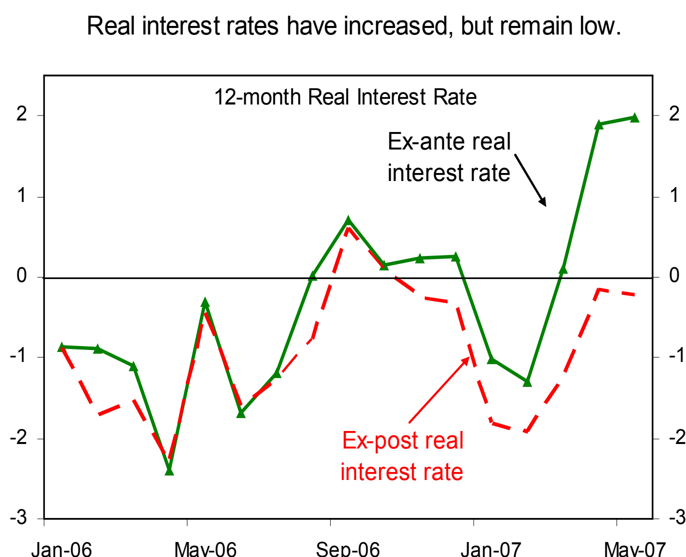
Update on Structural Reforms

Reform	Status as of December 2006	Current Status
	Fiscal reforms	
Tax Reform	Approved by congress in 2006.	Implementation began on July 1, 2007.
Police Pension Fund	Submitted to congress, approval expected in 2007.	Yet to be discussed by congress.
Pension Fund for the Military and Banking Employees	Expected to be submitted to congress in early 2007.	Yet to be submitted. While congress approval could be delayed beyond 2007, adressing the weakness of the banking pension fund is likely to become a priority in 2008.
	Financial sector reforms	
Central Bank	Submitted to congress in late 2005; approval expected in 2007.	Congress approval could be delayed beyond 2007, given widespread opposition to delinking board terms from political cycle.
BHU	Legislation to restrict BHU's activities and creating a new housing agency had been submitted; completion of the restructuring expected in early to mid-2007.	Legislation was approved, but completing the restructuring could be delayed further: a business plan has not been adopted and the transfer of workers from BHU will not be completed in 2007.

A. Dealing with Inflation and Appreciation Pressures

18. ***Staff saw scope for clarifying the objectives and instruments of monetary policy, including foreign exchange intervention***. With the authorities targeting the inflation rate and market perceptions of an exchange rate ceiling (see ¶9), staff observed that the appearance of multiple objectives, and insufficient clarity regarding the relative importance of these objectives, could potentially leave the system without an anchor. While acknowledging concerns about competitiveness, the authorities noted that inflation was the overriding objective of monetary policy. Regarding the effectiveness of monetary policy in a dollarized economy, staff research suggests that new channels of transmission of monetary policy are becoming more important: the exchange rate pass-through has declined below one-half (probably reflecting lower and less volatile inflation since the mid-1990s), thus enhancing the effectiveness of exchange rate as a shock absorber; and, the lending channel, while still low, is increasing as the share of local currency credit grows.

Real interest rates have increased, but remain low.

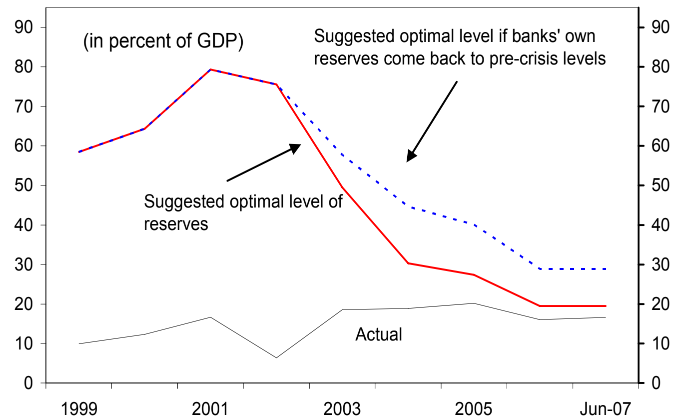


19. ***The authorities view much of the upward pressure on the peso as deriving from temporary FDI (pulp mills) projects***. While they agreed that all channels of monetary policy should be allowed to work, they ruled out a rapid appreciation of the exchange rate noting that this could encourage speculative flows. With inflation expectations for end-2007 above the target range, staff recommended implementing a faster reduction in the growth rate of M1 and to achieve the 9 percent growth rate sooner that currently targeted for June 2008. This should help control inflation and bring expectations to within the 2007 target range. Staff also advised to let interest rates adjust freely and the nominal exchange rate to appreciate in reaction to the monetary tightening. Staff underscored that a small nominal appreciation should not lead to competitiveness concerns, as the ongoing large FDI levels are expected to increase exports and the productivity of the tradable sector.

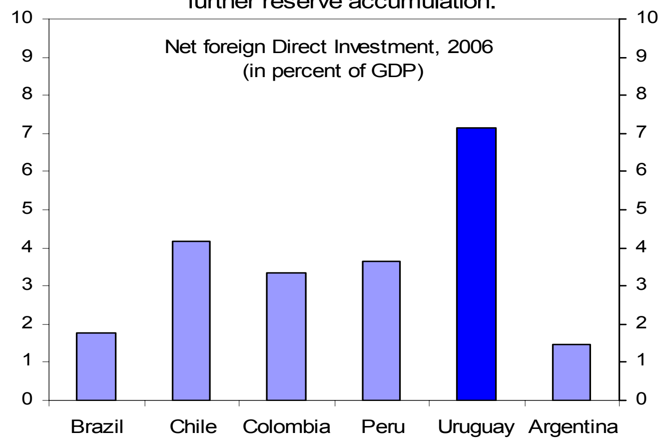
20. ***It was agreed that reserve buildup was desirable, but subordinated to the inflation objective***. As discussed in chapter V of the *Selected Issues* paper, reserve coverage is nearing adequate levels, given the significant increase in reserves of the central bank, the large

liquidity levels held by banks, and the reduction in short term debt and non-resident deposits. Staff's simulations suggest that, while in 2002 the central bank required substantial assistance, a similar shock today could be nearly covered by central bank reserves and banks' own liquidity. However, staff noted that the coverage was still below that of other dollarized economies and, more importantly, the exceptionally high liquidity levels held by banks were likely to decline in the future as lending picked up. At the same time, the currently large levels of foreign direct investment are likely to be temporary. Against this background, there was agreement that that an opportunistic approach to reserve accumulation would be appropriate. Staff emphasized that foreign exchange purchases should be consistent with exchange rate flexibility to avoid deviations from the long-term equilibrium. Officials agreed on the importance of sterilizing these purchases as needed to ensure meeting the monetary targets.

While higher reserve buildup would be desirable, reserve coverage is nearing adequate levels.

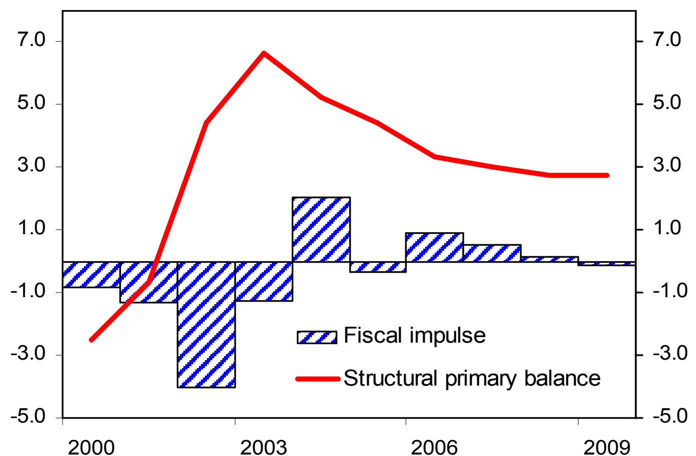


The large levels of FDI are likely to be temporary, justifying further reserve accumulation.



21. ***Staff also recommended that the policy mix should include a tightening of the fiscal stance to help ease the burden on monetary policy***. Analytical work indicates that the primary fiscal balance is important in explaining inflation expectations and that the 4.0 percent of GDP primary surplus target for 2007 still implies a 0.3 percent of GDP positive fiscal impulse, adjusted for the cycle. While noting that fiscal impulse calculations

Reducing the fiscal impulse will also be important.

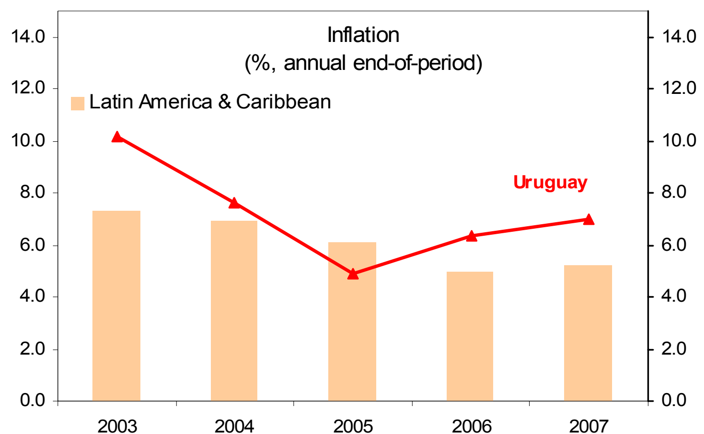


depend on imprecise measures of potential GDP, the authorities agreed that a higher primary balance would help reduce aggregate demand. Staff saw scope for setting a more ambitious target given strong revenue performance in the first semester, but the authorities indicated that uncertainty about the precise effect of the tax reform on revenues, and high spending needs, prevented them from committing, ex-ante, to a higher primary surplus target.

B. Moving to Inflation Targeting

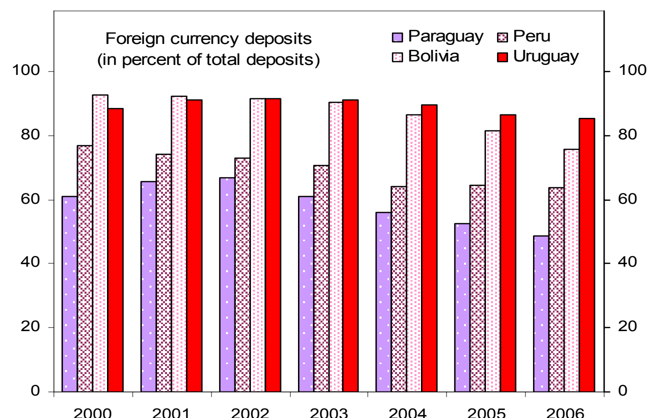
22. ***There was agreement that the adoption of full-fledged inflation targeting should proceed gradually***. Moving toward inflation targeting has been an objective of the authorities for some time, and the case for doing so has strengthened on account of the instability of monetary aggregates and multipliers. Staff encouraged the authorities to build further consensus about price stability as the objective of monetary policy. Also, in line with recent Fund's technical assistance, the mission recommended to: (i) in the near term, improve liquidity forecasting and streamline open market operations; (ii) in an intermediate stage, establish an interest rate corridor and migrate from money base to commercial bank deposits at the central bank as an operational target; and (iii) in a final stage, narrow the interest rate corridor and set a target for the interbank interest rate. The authorities agreed with the thrust of Fund advice, but indicated their intention to further study other alternatives before committing to operational modalities.

With inflation above regional averages, it is key to build further consensus about price stability as the objective of monetary policy.



23. ***Enhancing credibility will be key, given the increased role of expectations in the inflation process***. There was agreement that approval of legislation now in congress to increase the independence of the central bank would be an important step in this direction. Staff stressed that it was also essential to raise operational independence by limiting foreign exchange purchases by the state bank; capitalization of the

Enhancing credibility could be instrumental in reducing dollarization, which is now at the top end of comparators



central bank envisaged in draft law in congress would also be important. Greater monetary credibility, together with continued fiscal prudence and further improvements in the composition of public debt, would help reduce dollarization over the medium-term, further strengthening the effectiveness of monetary policy. There was broad agreement that improving transparency and communications with the markets was important to strengthen the expectation channel of monetary policy. However, some officials argued that ambiguity in the choice of instruments in a small market had benefits since more transparency could lead to collusion against the central bank.

C. Financial System Soundness

24. ***Deepening financial intermediation and reducing vulnerabilities would require action in several areas***. Implementing the key recommendations of the 2006 FSAP will be important, including:

- ***Strengthening state banks and increasing competition***. There was agreement about the need to continue strengthening credit procedures at the state bank. Staff recommended to reduce government guarantees to state-owned institutions, eliminate the privilege of the state bank on payroll deductions, and establish fit-and-proper requirements for directors of state banks. Officials were skeptical that competition would increase as a result of eliminating the monopoly of the state bank over payroll deductions; and noted that implementing fit-and-proper criteria entailed legal challenges, requiring a by-law regulating criteria included in the constitution.

- ***BHU restructuring***. Staff welcomed the establishment of a new agency to execute housing policy and the transfer of all mortgage loans to a new information system. Officials noted that further delays were expected because a new business plan and the transfer of workers from BHU to other parts of the government were yet to be implemented. Staff urged the authorities to swiftly complete BHU restructuring to allow the resumption of sound mortgage lending.

- ***Supervision and regulatory framework***. Staff encouraged the authorities to help ensure early passage of financial sector legislation aimed at increasing the independence of the central bank, provide a bank resolution framework, and enhance the structure of financial sector supervision. Staff also noted that increasing resources and improving information systems would be key for effective supervision and to maintain credit standards as credit picked up. Officials indicated that the revised 2008 budget contained resources for this purpose. Uruguay's regulations on dollar lending and nonresident deposits compare well to other countries, with liquidity requirements differentiated by residency, maturity, and currency; banks are also required to stress test individual loans for a significant depreciation to rate its credit quality. There was agreement on the need to lower the requirements on foreign exchange open positions, and make them fully consistent with recently approved legislation on the required capital for exchange rate risk.

Key Regulations in Selected Latin American Countries

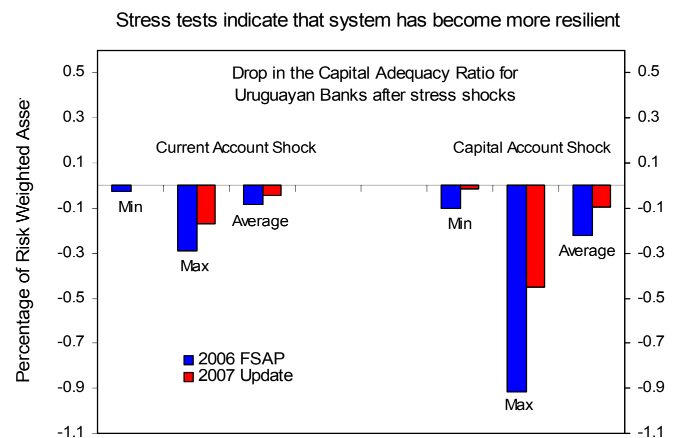
Countries	Risk Practices: Foreign Exchange Rate Risk – Prudential Rules: Limits on FX exposures	Long open position limit (in percent of capital)	Short open position limit (in percent of capital)	Supervisory Guidelines: Specific FX risk management guidelines	Credit Risk: Higher provisions	Higher generic provisions	Liquidity Risk – Liquidity Requirements: Rates for domestic currency (in percent)	Rates for foreign currency (in percent)
Argentina	Y	30	-30	N	N	N	n.a.	n.a.
Bolivia	Y	80	-20	Y	N	N	0 to 10	0 to 10
Brazil	Y	30	-30	Y	N	N	8 to 45	n.a.
Chile	Y	20	-20	N	N	N	n.a.	n.a.
Costa Rica	Y	100	-100	N	N	N	n.a.	n.a.
Peru	Y	100	-2.5	Y	Y	Y	6	6
Uruguay	Y	150	-150	Y	Y	N	19 to 25	19 to 30

Sources: BCU, staff estimates, and J. Cayazzo, et.al. (2006), "Toward and Effective Supervision of Partially Dollarized Banking Systems," IMF Working Paper, WP/06/32.

- ***Developing domestic capital markets***. The authorities were optimistic about prospects for a passage of the bankruptcy law in Congress. They agreed on the importance of improving corporate governance and disclosure practices and gradually developing markets for hedging instruments through the establishment of a reference yield curve for government debt. In this context, the Fund is sponsoring a conference in Montevideo on the development of domestic capital markets in the region.

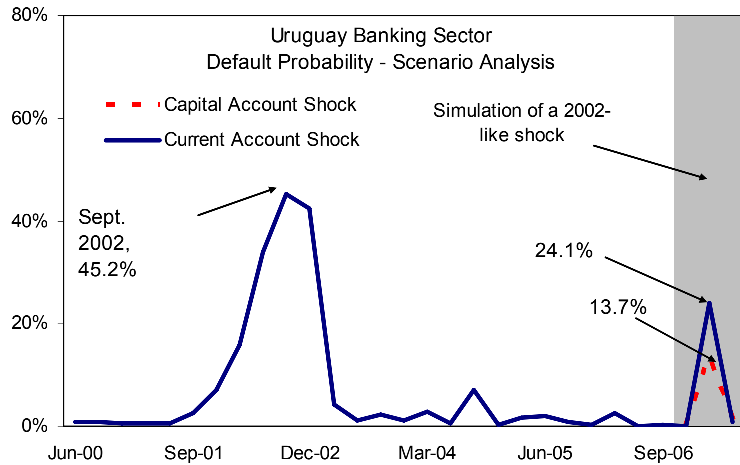
25. ***Updated stress tests show that the system has become more resilient to shocks***. In two extreme scenarios, the impact to the system would be less severe than assessed at the time of the 2006 FSAP. A current account shock, leading to a 4 percent GDP drop and a 5 percent real exchange rate depreciation, would cause, on average, a reduction of 4 percentage points in capital adequacy ratios (CAR), compared to a decline of 8 percentage points calculated in the 2006 FSAP. A severe capital account shock, characterized by a sudden stop, an 8 percent GDP drop and a real exchange rate depreciation of 12 percent, would lower CARs by 10 percentage points, against a fall of 22 percentage points estimated in the FSAP.

Stress tests indicate that system has become more resilient



26. ***A modified contingency claims approach yields similar results***. As discussed in Chapter VI of the *Selected Issues* paper, a simulation of the 2002 crisis suggests that, in the absence of external assistance, banks representing over 90 percent of banking sector's total assets were facing an estimated default probability (EDP) exceeding 25 percent; a similar

The default probability for the banking sector has stabilized since 2002 and remains at lower levels even when facing significant shocks.

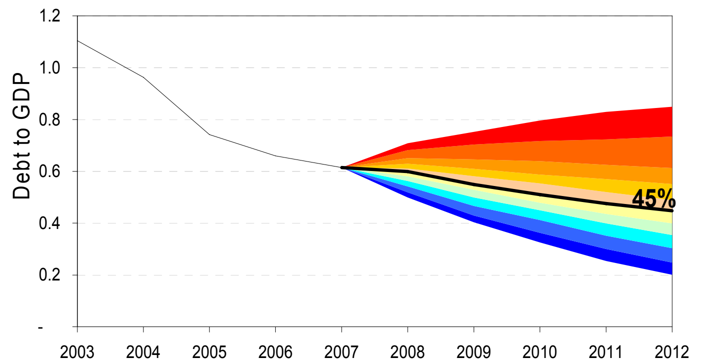


shock today, would yield an EDP exceeding 25 percent for banks representing less than 60 percent of the banking sector. Similarly, under the two extreme FSAP's stress tests, banks would face today, on average, 24 and 14 percent EDP, compared with a model estimate of 45 percent in 2002.

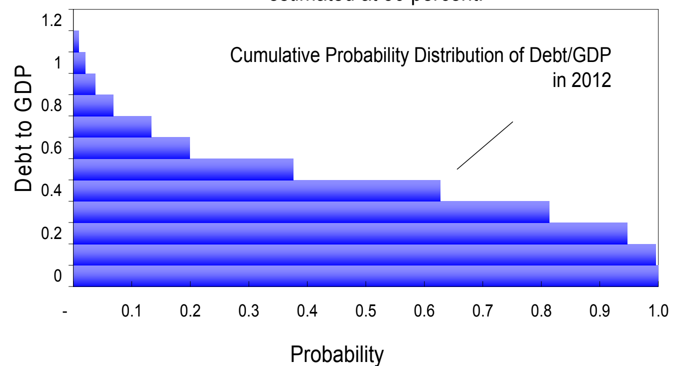
27. ***The authorities stated that the decision to join Fondo Latinoamericano de Reservas (FLAR) was largely made to improve reserve management***. While noting that their membership to FLAR helps reduce risks, officials agreed that regional reserve pooling arrangements are not a substitute of global arrangements, which provide added protection in case of a regional crisis. Indeed, over the last 25 years, Uruguay has experienced two major economic crises, both originating from regional shocks.

D. The Objectives of Fiscal Policy over the Medium Term

Sound fiscal policies have strengthened debt sustainability...



With the probability of Debt-to-GDP surpassing 50 percent in 2012 estimated at 30 percent.



28. ***Debt sustainability analysis argues for continued fiscal discipline and sound debt management***. Traditional (deterministic) debt sustainability analysis indicates that Uruguay's debt will still exceed 40 percent of GDP by 2012. Staff research capturing the stochastic nature of the projections through Monte Carlo simulation, also suggests that, even if fiscal policy remains on track, there would still be a 38 percent probability that debt levels exceed 50 percent of GDP by 2012 (Appendix I). The larger upside risks reflected in the forecast stem from the historically asymmetric impact of shocks on debt levels. These results can be compared with average debt-to-GDP ratio in countries the year before entering the debt crisis of 57 percent (Occasional Paper 255). Despite a

significant decline in debt dollarization in recent years, officials agreed that the process has further to go to reducing Uruguay's exposure to exchange rate movements.

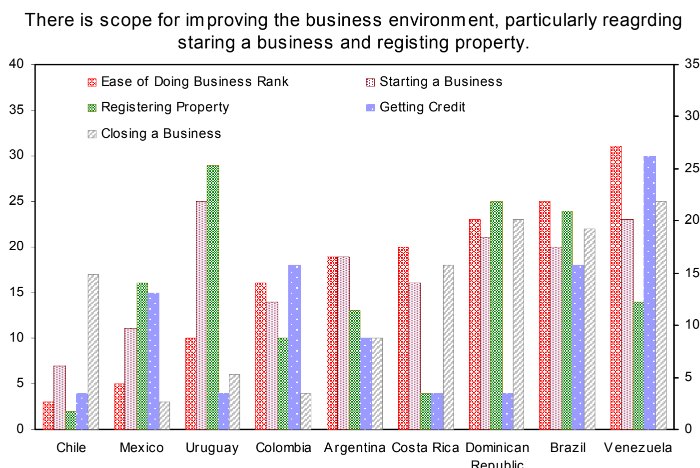
29. ***Staff supported increased spending on projects to catalyze private investment, but urged the authorities to resist pressures to relax the fiscal targets***. Staff recommended maintaining the medium term primary surplus target of 4 percent of GDP in support of debt reduction, while agreeing that a small relaxation may be appropriate to allow for counter-cyclical policy in the event of a slowdown. However, to the extent that inflation concerns persist and the economy remains vigorous, staff advised exceeding the medium-term target. The authorities reaffirmed their commitment to the stance associated with the 4 percent of GDP primary surplus target, but noted their intention to shift the emphasis to the overall balance as the "headline" fiscal objective. The tax reform started to be implemented on July 1 and progress has been made in the area of customs and tax administration reforms. There was agreement that these reforms, together with the implementation of Private-Public Partnerships (PPPs), would help deal with substantial nondiscretionary spending. Staff encouraged the authorities to carefully assess the criterion to undertake PPPs, including contingent liabilities, and to create a general legal and accounting framework for these operations. Further strengthening of public financial management, including commitment controls and audit functions, would also be important.

30. ***Staff recommended to gradually reduce current spending in favor of capital spending over the medium-to long-term***. There was agreement that spending increases, including those related to the new social equity plan, in the revised 2008 budget do not entail significant risks to the medium-term outlook, with targets broadly in line with a 4 percent of GDP surplus in the primary balance. Officials rightly noted that there was little scope for large reductions in current spending, highlighting that their high levels were largely the result of demographic factors and social preferences. Nevertheless, they stressed their plans to press ahead with the reforms of the specialized pension schemes, particularly for banking employees which entail significant fiscal risks beginning in 2009. Staff also pointed to the importance of ensuring that the envisaged reform to the civil service helps increase budget flexibility in the medium-term.

E. Improving the Business Climate

31. ***The frequency of labor conflicts has fallen, but some concerns about the labor climate remain***. A law regulating the resolution of labor conflicts is still to be agreed on. Business associations have resisted a new law on outsourcing that partly makes outsourcing companies liable for labor code violations by subcontractors. There was agreement on the importance of a well functioning and competitive labor market, particularly given Uruguay's high structural rates of unemployment.

32. ***There is scope to reduce bureaucratic impediments to investment***. While Uruguay compares relatively well to other countries in the region in the World Bank's Doing Business Survey, there is room for improvements in several areas (e.g., starting a business and registering property). The new private investment office and the approval of the law on competition are steps in the right direction.



III. Staff Appraisal

33. ***Sound policies and a favorable global environment have contributed to the sharp recovery since the 2002 crisis***. Strong primary fiscal surpluses have helped reduce debt ratios and sound debt management operations have improved the debt structure. Financial sector restructuring has strengthened the resilience of the system to shocks. Prudent monetary policy has been instrumental in reducing inflation to single digits and, with strong foreign direct investment and access to capital markets, reserves have risen significantly.

34. ***Uruguay's near term economic prospects are generally favorable***. Economic growth could reach 5¼ percent in 2007, supported primarily by domestic demand. Higher growth has improved fiscal prospects, with a large primary surplus expected to help trim public debt, and substantial large foreign direct investment should allow for further reserve buildup. However, there is a risk that inflation could exceed the target range (4½–6½).

35. ***The main short-term challenge is to address rising inflation in the wake of vigorous growth and capital inflows***. The central bank has appropriately lowered monetary targets, signaling its commitment to low inflation and should continue implementing a faster reduction in money growth to achieve the end-year targets earlier in the year. Allowing the exchange rate and interest rates to adjust freely in response to this tightening would help increase the effectiveness of monetary policy. Tightening the fiscal stance would help ease the burden on monetary policy.

36. ***The reduction of vulnerabilities in recent years has been a major accomplishment, but challenges remain***. While declining, the public debt ratio is still high and debt is largely denominated in dollars. The financial system too is highly dollarized, with a large share in sight deposits, and currency mismatches in the corporate sector expose banks to exchange rate risk. Given banks' high liquidity levels, central bank reserves appear near adequate levels; still, with banks' liquidity likely to decrease in the future, further reserve buildup is

desirable. Completing reforms initiated in recent years in the monetary framework and public finances would help reduce dollarization, thus increasing Uruguay's resilience to shocks. It is also essential to continue deepening financial sector reforms and implement the recommendations of the 2006 FSAP, including further reforming state banks and strengthening supervision.

37. ***The objectives and instruments of monetary policy should be clarified***. In the long term, the appearance of multiple objectives could potentially leave the system without an anchor. In the near term, the presence of large capital inflows and exchange rate rigidity is reducing the effectiveness of monetary policy. Intervention in the foreign exchange market should avoid hindering exchange rate movements and be subordinated to the inflation objective. The exchange rate level appears broadly appropriate, certainly well within the margins of analytical uncertainty, and the economy remains competitive. The adoption of full-fledged inflation targeting should proceed gradually. Legislation in congress increasing the independence of the central bank should enhance policy credibility of the monetary framework, but it will also be important to capitalize the central bank and limit foreign exchange intervention by the state bank.

38. ***Maintaining high primary fiscal surpluses will be essential to further reduce the debt burden***. Fiscal performance in recent years has been commendable; however, exceeding the medium-term target would be appropriate if inflation concerns persist and debt remains at still high levels. The recent implementation of the tax reform and progress in the area of customs and tax administration reforms is welcomed. The authorities are closely monitoring them to ensure their success. With public investment below regional levels, improving the quality of spending is important. This will require gradually reducing non discretionary spending, including through reforming the banking pension scheme. PPPs are an opportunity for upgrading infrastructure, provided that contingent liabilities are minimized. Reducing debt dollarization is needed to help ensure debt sustainability.

39. ***Further improving the business climate is key***. The creation of a private investment office and implementation of the competition law will help the business environment; approval of the bankruptcy law will be also an important step. It is essential to continue fostering good labor relations, enhance competition in labor markets, and reduce bureaucratic impediments to investment.

40. ***It is proposed that the next Article IV consultation with Uruguay take place on the standard 12-month cycle***.

Table 1. Uruguay: Selected Economic and Social Indicators

Latest information available			
Population (estimate)	3.5	Physicians per 1,000	3.7
		Hospital beds per 1,000	4.4
Life expectancy at birth (years)	75.9		
Crude birth rate (per thousand)	14.4	Access to safe water	
Infant mortality rate (per thousand live births)	12.0	(percent of population)	98.0
Income share held by highest 10 percent of households	33.5	Adult literacy rate	98.0
Income share held by lowest 20 percent of households	4.8	Gross enrollment rate	
Gini coefficient	44.6	Primary education	108.3
Unemployment rate	9.7	Secondary education	101.5
Poverty rate	25.3	Tertiary education	37.7
GDP per capita in 2006 (in US$)	6,007		
Human Development Index Rank	43		

				2006		Proj.					
	2003	2004	2005	Report 07/146	Est.	2007	2008	2009	2010	2011	2012
				(Percent change)							
				I. Output, prices, and employment							
Real GDP	2.2	11.8	6.6	6.5	7.0	5.2	3.8	3.2	3.2	3.2	3.2
Real consumption	1.1	9.5	2.8	5.5	8.6	5.0	4.2	3.1	2.7	2.6	2.3
Real investment	18.0	22.0	12.7	41.0	24.7	16.4	5.1	-5.5	0.5	8.7	8.3
Contributions to real growth (percent) 1/											
Consumption	1.0	8.7	2.5	4.8	7.4	4.3	3.7	2.7	2.4	2.2	2.0
Investment	1.9	2.7	1.7	5.6	3.5	2.7	0.9	-1.0	0.1	1.4	1.4
Net exports	-0.7	0.5	2.4	-3.9	-3.9	-1.8	-0.8	1.5	0.8	-0.5	-0.2
GDP (Ur$ billions)	316	379	407	465	465	523	578	630	679	725	773
GDP (US$ billions)	11.2	13.3	16.7	19.4	19.3	21.9	24.5	26.9	29.1	31.1	33.2
Investment	32.1	25.0	9.0	37.7	41.8	18.4	11.0	4.6	5.2	9.5	10.2
Consumption	20.1	17.2	7.8	12.2	14.0	12.7	10.7	8.2	7.4	6.2	5.7
GDP deflator	18.4	7.5	0.6	6.2	6.8	7.0	6.5	5.5	4.5	3.5	3.3
CPI inflation (average)	19.4	9.2	4.7	6.3	6.4	7.4	6.2	5.0	4.5	3.5	3.3
CPI inflation (eop)	10.2	7.6	4.9	6.0	6.4	7.0	6.0	5.0	4.5	3.5	3.3
Exchange rate change (Ur$/US$)(average)	30.4	1.5	-15.0	...	-1.0	...	...	...	...	...	...
Exchange rate change (Ur$/US$) (eop)	7.3	-9.9	-10.1	...	3.2	...	...	...	...	...	...
Unemployment (in percent)	16.9	13.1	12.1	...	9.8	...	...	...	...	...	...
				II. Monetary indicators							
Base Money (eop)	24.9	11.1	34.1	16.8	13.0	8.0	...	...	...	...	...
M-1	34.6	13.4	29.4	21.0	21.8	11.3	...	...	...	...	...
M-2	17.4	12.8	22.3	17.1	23.3	11.3	...	...	...	...	...
M-3	21.7	-2.0	0.1	11.2	12.6	11.3	...	...	...	...	...
Credit to the private sector (constant exch. rate)	-23.9	-11.2	2.7	5.0	9.1	13.8	...	...	...	...	...
				(Percent of GDP, unless otherwise indicated)							
				III. Public sector operations							
Revenue	32.0	30.9	32.2	31.7	31.8	32.5	32.7	32.9	32.9	32.9	32.9
Non-interest expenditure (incl. discrepancy)	29.3	27.2	28.2	28.0	28.0	28.6	28.8	29.0	29.0	29.0	29.0
Primary balance	2.7	3.9	4.1	3.7	3.9	4.0	4.0	3.9	3.9	3.9	3.9
Interest	6.0	6.0	4.6	4.3	4.4	4.1	4.0	3.8	3.7	3.6	3.5
Overall balance	-3.2	-2.2	-0.7	-0.5	-0.6	-0.1	0.0	0.2	0.2	0.3	0.4
Public sector debt 2/	110	97	75	64	66	62	55	50	46	43	40
Public debt service (as a percent of GDP)	14.1	18.8	15.5	26.6	26.8	7.2	6.2	5.7	6.1	6.4	5.1

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

	2003	2004	2005	2006 Report 07/146	2006 Est.	Proj. 2007	2008	2009	2010	2011	2012
IV. Savings and investment											
Gross domestic investment	12.6	13.1	13.3	16.0	16.5	17.4	17.4	16.8	16.3	16.8	17.3
Gross national savings	12.1	13.4	13.3	13.4	14.1	14.6	14.6	15.0	15.3	15.7	16.4
Foreign savings	0.5	-0.3	0.0	2.6	2.4	2.8	2.8	1.8	1.0	1.0	0.9
V. External indicators											
Merchandise exports, fob (US$ millions)	2,281	3,145	3,758	4,433	4,389	4,861	5,495	6,028	6,514	6,916	7,319
Merchandise imports, fob (US$ millions)	2,098	2,992	3,730	4,894	4,863	5,581	6,267	6,547	6,843	7,240	7,619
Merchandise terms of trade (percentage change)	2.9	-3.1	-9.7	-2.7	-1.5	-0.4	-1.1	-0.6	0.2	0.5	0.2
Current account balance	-0.5	0.3	0.0	-2.6	-2.4	-2.8	-2.8	-1.8	-1.0	-1.0	-0.9
Of which: excluding pulp mills projects	-0.5	0.3	0.0	-1.1	-1.1	-1.3	-1.3	-1.2	-1.0	-1.0	-0.9
Foreign direct investment	3.6	2.4	4.3	6.0	7.1	5.2	4.5	3.3	2.7	2.1	2.1
Overall balance of payments (US$ millions)	1,380	454	951	-689	-337	685	243	231	220	213	202
External debt 3/	98.2	87.4	68.3	53.7	54.7	50.1	45.1	41.7	38.9	36.8	34.5
Of which: external public debt	85.3	76.9	60.8	47.3	48.2	44.5	39.5	36.1	33.3	31.2	28.9
External debt service (percent of exports of goods and services)	52.3	44.8	53.1	89.7	92.5	24.4	20.8	19.1	19.9	20.4	17.5
Gross official reserves (US$ millions) 4/	2,087	2,512	3,438	2,777	3,091	3,776	4,018	4,249	4,470	4,683	4,885
In months of imports of goods and services	6.6	6.5	7.1	5.1	5.6	6.1	6.2	6.2	6.2	6.2	6.2
In percent of short-term debt	131.3	112.4	153.8	221.3	492.1	290.6	297.0	275.7	261.0	262.5	295.1
In percent of short-term debt plus bank non-resident deposits	51.2	55.4	75.8	75.5	101.5	98.9	101.2	99.8	98.7	99.6	104.5
In percent of short-term debt plus FX deposits	20.0	27.7	32.9	28.4	34.1	34.5	34.4	34.5	34.9	35.8	36.5
REER (percentage depreciation -, e.o.p.)	-13.2	8.7	12.4	...	-4.9	...	...	...	...	...	...

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

1/ 2006-09 numbers are large driven by the large scale FDI project in pulp mills.
2/ Debt of the NFPS, net of free reserves of the Central Bank of Uruguay.
3/ Excludes nonresident deposits.
4/ Includes reserve buildup through reserve requirements of resident financial institutions.

Table 2. Uruguay: Summary Accounts of the Banking System

(In millions of U.S. dollars)

	2003	2004	2005	2006	2007
			1. Banco Central del Uruguay		
Net foreign assets	-52	-51	1,307	3,333	4,041
Net international reserves 1/	-321	-164	1,135	3,091	3,776
Gross international reserves	2,087	2,512	3,438	3,091	3,776
Reserve liabilities 1/	-2,407	-2,675	-2,304	0	0
Other net foreign assets	269	113	172	242	265
Net domestic assets	553	775	-253	-2,010	-2,612
Net credit to the public sector	2,464	2,626	1,970	862	177
Net credit to the financial system	-2,091	-1,781	-1,941	-1,937	-1,934
Credit to the private sector	71	62	65	63	71
Securities issued by the BCU	-318	-568	-1,092	-1,447	-1,432
Other	427	437	744	448	505
Peso monetary liabilities	501	724	1,054	1,323	1,429
Memorandum items:					
Monetary base 2/	473	584	857	957	1,033
			2. Public and Private Banks 3/		
Net foreign assets	1,213	1,887	2,030	2,233	2,453
Net domestic assets	5,331	5,090	5,397	5,907	6,709
Net credit to the public sector	219	437	0	25	25
Net credit to the financial system	2,612	2,256	2,602	2,715	3,056
Credit to the private sector	4,726	4,307	4,533	4,933	5,617
Other	-2,226	-1,909	-1,738	-1,766	-1,988
Liabilities to the private sector (residents)	6,544	6,977	7,426	8,140	9,163
Public banks	3,409	3,670	3,842	4,172	4,696
Local currency	394	520	682	847	991
Foreign currency	3,016	3,149	3,160	3,324	3,705
Private banks	3,135	3,307	3,584	3,968	4,467
Local currency	349	405	574	659	779
Foreign currency	2,785	2,902	3,010	3,309	3,688
			3. Banking System		
Net foreign assets	1,161	1,835	3,337	5,566	6,494
Net domestic assets	5,788	5,738	4,952	3,655	3,769
Credit to the public sector	2,684	3,063	1,970	887	202
Credit to the rest of financial system	425	347	470	536	794
Credit to the private sector	4,797	4,369	4,598	4,997	5,688
Other	-2,118	-2,041	-2,086	-2,765	-2,916
Broad money (M3)	6,949	7,573	8,288	9,221	10,263
Memorandum items (in pesos):			(Percentage change)		
Base money (end-of-period)	24.9	11.1	34.1	13.0	8.0
M-1	34.6	13.4	29.4	21.8	11.3
M-2	17.4	12.8	22.3	23.3	11.3
M-3	21.7	-2.0	0.1	12.6	11.3
Credit to private sector (constant exchange rate)	-23.9	-11.2	2.7	9.1	13.8

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

1/ Includes all outstanding liabilities to the IMF, but excludes liabilities to resident financial institutions.

2/ Monetary base excludes from peso monetary liabilities the net government and BPS deposits with BROU, which are subject to 100 percent reserve requirements.

3/ The Banco de la Republica Oriental de Uruguay (BROU), Banco Hipotecario de Uruguay (BHU; mortgage institution), private banks, and cooperatives.

Table 3. Uruguay: Public Sector Operations

			Prel.	2007		Proj. 1/	
	2004	2005	2006	Proj. 1/	Report 07/146	2008	2009
(In millions of current Uruguayan pesos)							
Revenue	117,367	130,824	147,865	170,285	167,413	189,324	207,388
Taxes	83,716	92,280	107,146	118,908	115,872	132,064	143,157
VAT and excise taxes	47,200	53,124	61,574	70,059	67,018	74,611	80,604
On income and profits	18,397	20,148	23,314	26,694	27,837	34,125	37,153
On foreign trade	4,958	5,195	5,995	5,238	5,076	4,627	5,038
On property and other	13,161	13,813	16,264	16,917	15,940	18,702	20,362
Social security contributions	16,657	21,532	25,115	28,035	28,527	31,811	35,894
Nontax revenue	7,117	8,399	9,027	10,554	9,729	10,989	11,965
Current surplus of public enterprises	9,876	8,614	6,577	12,788	13,285	14,460	16,373
Non-interest expenditure	103,082	114,860	130,320	149,701	147,174	166,445	182,744
Current	93,780	105,278	118,008	133,397	131,870	149,169	163,934
Wages	23,409	25,499	28,468	33,172	33,172	36,766	40,302
Goods and services	17,015	19,392	22,548	25,376	24,349	25,100	27,708
Of which : Social emergency plan	0	780	2,508	2,400	1,800	0	0
Social security benefits	47,702	53,057	59,059	66,026	65,526	75,545	83,123
Other	5,654	7,330	7,933	8,824	8,824	11,758	12,802
Capital (Government and enterprises)	9,303	9,582	12,312	16,303	15,303	17,276	18,809
Primary balance (cash basis)	14,284	15,963	17,544	20,585	20,239	22,879	24,645
Primary Balance	14,284	16,563	17,969	21,073	20,728	22,979	24,745
Interest	22,666	18,756	20,564	21,398	21,398	22,919	23,797
Overall balance	-8,382	-2,793	-3,020	-325	-670	60	947

Table 3. Uruguay: Public Sector Operations (continued)

			Prel.	2007		Proj. 1/	
	2004	2005	2006	Proj. 1/	Report 07/146	2008	2009
		(In percent of GDP)					
Revenue	**30.9**	**32.2**	**31.8**	**32.5**	**33.1**	**32.7**	**32.9**
Taxes	22.1	22.7	23.1	22.7	22.9	22.8	22.7
VAT and excise taxes	12.4	13.1	13.2	13.4	13.2	12.9	12.8
On income and profits	4.8	5.0	5.0	5.1	5.5	5.9	5.9
On foreign trade	1.3	1.3	1.3	1.0	1.0	0.8	0.8
On property and other	3.5	3.4	3.5	3.2	3.2	3.2	3.2
Social security contributions	4.4	5.3	5.4	5.4	5.6	5.5	5.7
Nontax revenue	1.9	2.1	1.9	2.0	1.9	1.9	1.9
Current surplus of public enterprises	2.6	2.1	1.4	2.4	2.6	2.5	2.6
Non-interest expenditure	**27.2**	**28.2**	**28.0**	**28.6**	**29.1**	**28.8**	**29.0**
Current	24.7	25.9	25.4	25.5	26.1	25.8	26.0
Wages	6.2	6.3	6.1	6.3	6.6	6.4	6.4
Goods and services	4.5	4.8	4.9	4.9	4.8	4.3	4.4
Of which: Social emergency plan	0.0	0.2	0.5	0.5	0.4	0.0	0.0
Social security benefits	12.6	13.0	12.7	12.6	13.0	13.1	13.2
Other	1.5	1.8	1.7	1.7	1.7	2.0	2.0
Capital (Government and enterprises)	2.5	2.4	2.6	3.2	3.0	3.0	3.0
Primary balance (cash basis)	3.8	3.9	3.8	3.9	4.0	4.0	3.9
Primary balance	**3.9**	**4.1**	**3.9**	**4.0**	**4.1**	**4.0**	**3.9**
Interest	6.0	4.6	4.4	4.1	4.4	4.0	3.8
Overall balance 2/	**-2.2**	**-0.7**	**-0.6**	**-0.1**	**-0.4**	**0.0**	**0.2**
Memorandum items							
Stock of floating debt 3/	0.8	0.6	0.4	0.3	0.3	0.3	0.2
Change in floating debt	-0.2	-0.1	-0.1	-0.1	-0.1	0.0	0.0
GDP (billions of pesos)	379	407	465	523	506	578	630

Sources: Ministry of Finance; and Fund staff estimates.

1/ Based in part on assumptions provided by the authorities.
2/ Up to 2006 on a cash basis. Starting in 2007, on a modified cash basis, which includes variations of the stock of floating debt.
3/ Starting in 2004 the definition includes an expanded government concept, forestry subsidies, and membership fees of international organizations.

Table 4. Uruguay: Balance of Payments
(In millions of U.S. dollars, unless otherwise stated)

	2003	2004	2005	Prel. 2006	Projections 2007	2008	2009	2010	2011	2012
				1. Balance of Payments						
Current account	**-56**	**43**	**2**	**-457**	**-609**	**-687**	**-478**	**-293**	**-310**	**-298**
Trade balance	183	153	28	-474	-720	-772	-519	-329	-323	-300
Exports, f.o.b.	2,281	3,145	3,758	4,389	4,861	5,495	6,028	6,514	6,916	7,319
Imports, f.o.b.	2,098	2,992	3,730	4,863	5,581	6,267	6,547	6,843	7,240	7,619
Services	167	365	409	361	384	348	373	398	429	465
Exports, f.o.b.	803	1,151	1,335	1,284	1,424	1,506	1,613	1,719	1,833	1,954
Imports, f.o.b.	636	786	926	923	1,040	1,157	1,240	1,321	1,404	1,490
Income (net)	-489	-588	-585	-470	-373	-364	-434	-463	-516	-564
Transfers (net)	83	113	149	126	100	101	102	101	100	102
Financial and capital account	**1,039**	**67**	**1,016**	**202**	**1,294**	**929**	**777**	**713**	**647**	**606**
Foreign direct investment	401	315	715	1,377	1,127	1,109	895	780	655	708
Portfolio investment	-541	-422	766	1,810	171	-164	-114	-39	-24	-105
Government securities	-5	240	566	1,830	421	28	-12	15	-10	-99
Issues	613	504	1,094	2,391	680	111	46	155	266	-31
Amortization	618	263	528	562	259	83	58	140	276	68
Banks	-537	-663	200	-20	-250	-192	-102	-54	-14	-6
Other capital flows (net)	1,179	174	-466	-2,985	-4	-16	-4	-27	15	3
Loans	375	-133	-198	-2,922	-4	-16	-4	-27	15	3
Deposits, net	267	180	-428	3	0	0	0	0	0	0
Other flows, net	537	128	161	-66	0	0	0	0	0	0
Errors and omissions	397	345	-66	-83	0	0	0	0	0	0
Overall balance	1,380	454	951	-337	685	243	231	220	213	202
Reserve assets (- increase)	**-1,380**	**-454**	**-951**	**337**	**-685**	**-243**	**-231**	**-220**	**-213**	**-202**
				2. Reserve Adequacy and External Indicators						
Gross official reserves (stock)	**2,087**	**2,512**	**3,438**	**3,091**	**3,776**	**4,018**	**4,249**	**4,470**	**4,683**	**4,885**
In months of next year's imports of goods and services	6.6	6.5	7.1	5.6	6.1	6.2	6.2	6.2	6.2	6.2
In percent of next year's short-term debt excl. nonres. deposits	131.3	112.4	153.8	492.1	290.6	297.0	275.7	261.0	262.5	295.1
In percent of next year's short-term debt incl. nonres. deposits	51.2	55.4	75.8	101.5	98.9	101.2	99.8	98.7	99.6	104.5
Net international reserves (stock)	**-763**	**-2,218**	**-1,166**	**916**	**1,601**	**1,844**	**2,075**	**2,295**	**2,508**	**2,711**
				(As percent of GDP)						
Exports	20.3	23.7	22.5	22.7	22.2	22.4	22.4	22.4	22.3	22.1
Imports	18.7	22.6	22.3	25.2	25.5	25.5	24.4	23.6	23.3	23.0
Current account	-0.5	0.3	0.0	-2.4	-2.8	-2.8	-1.8	-1.0	-1.0	-0.9
Underlying current account 1/	-0.5	0.3	0.0	-1.1	-1.3	-1.3	-1.2	-1.0	-1.0	-0.9
Financial and capital account	9.3	0.5	6.1	1.0	5.9	3.8	2.9	2.5	2.1	1.8
Of which: foreign direct investment (net)	3.6	2.4	4.3	7.1	5.2	4.5	3.3	2.7	2.1	2.1
Of which: government securities (net)	0.0	1.8	3.4	9.5	1.9	0.1	0.0	0.1	0.0	-0.3
Of which: IMF (net)	6.0	0.8	-1.1	-12.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance	12.3	3.4	5.7	-1.7	3.1	1.0	0.9	0.8	0.7	0.6
Changes in GIR	-12.3	-3.4	-5.7	1.7	-3.1	-1.0	-0.9	-0.8	-0.7	-0.6
External debt	98.2	87.4	68.3	54.7	50.1	45.1	41.7	38.9	36.8	34.5
Short-term debt (residual maturity)	21.4	12.0	13.4	3.3	5.9	5.5	5.7	5.9	5.7	5.0
External public debt	85.3	76.9	60.8	48.2	44.5	39.5	36.1	33.3	31.2	28.9
External debt + NR deposits	118.1	106.1	82.0	67.2	61.6	55.8	51.8	48.6	46.2	43.6
				(As percent of annual exports of goods and services)						
Total external debt	357.1	269.9	224.2	186.1	174.2	158.4	146.6	137.3	130.6	123.4
Total external debt (including nonresidential deposits)	429.3	327.8	269.3	228.7	214.2	195.8	182.1	171.6	163.9	156.0
Debt service	52.3	44.8	53.1	92.5	24.4	20.8	19.1	19.9	20.4	17.5
Of which: interest payments	19.2	16.7	16.6	15.8	11.8	10.4	9.9	9.7	9.5	9.2
				(Annual percent changes)						
Exports	18.7	37.9	19.5	16.8	10.8	13.0	9.7	8.1	6.2	5.8
Imports	12.0	42.6	24.7	30.4	14.8	12.3	4.5	4.5	5.8	5.2
Export prices in US$ (year-on-year percent change) 1/	7.4	6.4	5.1	6.7	3.4	1.3	-0.2	0.2	0.8	0.8
Import prices in US$ (year-on-year percent change) 1/	5.1	9.1	12.2	8.2	3.5	2.0	0.0	-0.3	0.1	0.3
Terms of trade 1/	2.2	-2.4	-6.3	-1.4	-0.1	-0.7	-0.1	0.5	0.7	0.5
Export volume 1/	9.4	28.7	16.2	8.9	7.3	7.0	6.8	6.4	6.2	5.8
Import volume 1/	6.2	29.1	9.4	13.6	9.7	7.8	7.0	6.8	6.2	5.3

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

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

Table 5. Uruguay: Vulnerability Indicators

	2003	2004	2005	2006	2007
	(Percent change, unless otherwise indicated)				
Financial sector indicators					
Broad money	21.7	-2.0	0.1	12.6	11.3
Credit to the private sector (const. exch. rate)	-23.9	-11.2	2.7	9.1	13.8
Share of nonperforming loans in total loans (in percent) 1/	14.3	4.7	3.6	1.9	2.1
Provisions to nonperforming loans (in percent) 1/	91.4	106.8	118.8	218.6	296.2
Capital to asset ratio (in percent) 1/	7.2	8.3	8.6	9.8	10.2
Return on assets (in percent) 1/	-1.1	-0.1	0.7	1.2	1.7
Interbank interest rates (percent, end-of-period) 1/	2.5	1.3	1.0	3.0	2.8
FX deposits held by residents (in percent of total deposits)	88.8	87.0	83.7	82.3	81.4
FX loans to residents (in percent of total loans)	76.8	73.4	70.0	66.0	62.3
Public debt indicators					
Public sector gross debt (PSGD, in percent of GDP)	110.4	96.3	74.1	66.0	61.7
Of which: Exposed to rollover risk (in percent of total PSGD)	12.1	13.5	16.0	5.1	6.8
Exposed to exchange rate risk (in percent of total PSGD)	86.4	85.9	80.3	71.2	69.3
Exposed to interest rate risk (in percent of total PSGD)	45.5	44.6	40.0	19.0	18.4
External indicators					
Merchandise exports	18.7	37.9	19.5	16.8	10.8
Merchandise imports	12.0	42.6	24.7	30.4	14.8
Merchandise terms of trade	2.9	-3.1	-9.7	-1.5	-0.4
REER appreciation (+)	-13.2	8.7	12.4	-4.9	...
	(Percent of GDP, unless otherwise indicated)				
Current account balance	-0.5	0.3	0.0	-2.4	-2.8
Capital and financial account balance	9.3	0.5	6.1	1.0	5.9
Of which: Net foreign direct investment	3.6	2.4	4.3	7.1	5.2
Government securities	0.0	1.8	3.4	9.5	1.9
Other net inflows	5.7	-3.7	-1.6	-15.6	-1.2
Total gross external debt (ED) in percent of GDP	98.2	87.4	68.3	54.7	50.1
Of which: Short-term ED (original maturity, in percent of total ED)	6.7	7.6	6.4	8.0	8.0
ED to foreign official sector (in percent of total ED)	51.1	50.7	48.4	25.4	24.5
External interest payments (in percent of exports of GNFS)	19.2	16.7	16.6	15.8	11.8
External amortization payments (in percent of exports of GNFS)	33.1	28.2	36.4	76.7	12.6
	(U.S. million, unless otherwise indicated)				
Central Bank reserve liabilities 2/	2,407	2,675	2,304	0	0
Gross official reserves	2,087	2,512	3,438	3,091	3,776
In months of imports GNFS	6.6	6.5	7.1	5.6	6.1
In percent of short-term external debt excl. nonres FX deposits	131.3	112.4	153.8	492.1	290.6
In percent of short-term external debt plus bank NR deposits	51.2	55.4	75.8	101.5	98.9
In percent of short-term debt plus FX deposits	20.0	27.7	32.9	34.1	34.5
In percent of broad money	30.0	33.2	45.0	34.6	44.8
In percent of base money	341.1	329.9	301.3	190.3	241.5
Banking system foreign assets as percent of short-term external debt plus all FX deposits 3/ 4/	57.0	65.8	71.4	80.4	71.9
Financial market indicators					
Foreign currency debt rating (Moody's) 1/	B3	B3	B3	B1	B1
Foreign currency debt rating (S&P) 1/	B	B	B	B+	B+
EMBI secondary market spread (bps, end of period) 1/	388	462	298	185	141
Exchange rate (per U.S. dollar, period average)	28.2	28.6	24.3	24.4	...
Exchange rate (per U.S. dollar, end-of-period)	29.2	26.3	23.7	24.4	...

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

1/ Excludes BHU. End-May 2007 figures.
2/ Includes all use of Fund credit.
3/ By remaining maturity.
4/ Excludes nonreserve assets from BCU.

Table 6. Uruguay: Financial Indicators

	2001	2002	2003	2004	2005	2006	2007
				I. Soundness Indicators 1/			
Capital adequacy indicators							
Capital/assets	7.2	-10.0	7.2	8.3	8.6	9.8	10.2
Tier 1 capital/risk-adjusted assets (percent) 2/	8.5	-11.7	9.2	10.9	11.2	12.3	18.8
Asset quality indicators							
NPL to total loans (net of provisions)	11.5	33.9	14.3	4.7	3.6	1.9	2.1
Loan provisions to nonperforming loans (percent)	61.9	58.3	91.4	106.8	118.8	218.6	296.2
Credit growth (net of provisions, percent)	0.0	6.9	-0.2	-9.8	3.3	9.1	2.3
Of which : consumer lending	...	...	...	...	...	...	...
Sectoral distribution of loans to total loans (percent)							
Public sector	6.5	9.6	10.0	9.7	8.3	6.2	7.4
Credit to the private sector	93.5	90.4	90.0	90.3	91.7	93.8	92.6
Residents	72.6	77.8	85.5	86.0	86.4	89.2	88.6
Nonresidents	20.9	12.6	4.6	4.3	5.2	4.6	3.9
Profitability indicators							
Return to Assets	0.0	-25.3	-1.1	-0.1	0.7	1.2	1.7
Public banks	0.2	-4.2	0.1	0.5	0.6	1.6	2.0
Private banks	-0.2	-42.6	-2.0	-0.2	1.0	1.0	1.8
ROE	-0.1	-70.0	-15.3	-0.9	7.6	12.7	18.6
Financial margin to gross income	37.3	12.5	27.3	31.6	28.7	31.7	38.3
Noninterest expenses to gross income	33.0	31.7	28.9	32.7	33.1	31.0	33.8
Personnel expenses to noninterest expenses	52.4	41.1	46.9	48.3	46.6	50.2	48.3
Spread between lending and deposit rates (domestic currency, percent)	27.0	55.8	29.3	17.5	27.3	25.8	22.3
Spread between lending and deposit rates (foreign currency, percent)	6.3	7.6	7.9	6.3	5.6	5.6	5.6
Liquidity indicators							
Liquid assets to total assets (percent)	25.1	23.8	35.2	45.1	45.3	43.8	42.6
Liquid assets to total deposits (percent)	35.1	34.4	47.8	60.0	64.4	61.6	60.7
Foreign currency assets to foreign currency deposits (percent)	35.7	34.0	46.7	59.3	62.9	60.1	60.9
Domestic currency assets to domestic currency deposits (percent)	27.9	41.5	62.9	67.8	76.1	71.1	59.4
Net loans to the private sector/total deposits (percent)	92.8	76.6	83.8	83.8	32.5	33.1	32.9
Foreign currency loans to foreign currency deposits (percent)	91.4	76.2	85.3	85.4	28.8	29.1	28.8
Domestic currency loans to domestic currency deposits (percent)	106.8	81.4	68.6	70.1	50.4	56.3	55.4
Sight deposits to total deposits	30.1	53.3	50.1	59.4	64.1	67.0	69.5
Credit to deposit ratio	58.8	62.8	38.8	36.0	35.6	36.9	38.6
Exposure to FX risk							
Net open position in foreign exchange to capital	44.7	...	59.9	67.9	54.2	46.3	44.6
Foreign currency denominated loans to total loans	86.3	92.0	87.4	82.7	79.8	75.4	73.0
Foreign currency denominated liabilities to total liabilities	90.7	92.5	90.5	88.2	83.3	82.1	81.3
				II. Structure of the Financial System 3/			
Assets	...	...	...	...	16,669	16,194	16,921
Banks	...	...	...	...	13,139	14,059	14,778
Private commercial	...	...	...	...	6,282	7,015	7,308
State-owned	...	...	...	...	6,857	7,044	7,470
Cooperatives	...	...	...	...	24	26	28
Securities companies	...	...	...	...	157	142	156
Foreign financial institutions	...	...	...	...	3,177	1,732	1,697
Other credit institutions	...	...	...	...	172	235	262

Sources: Banco Central del Uruguay; and International Monetary Fund.

1/ Includes private and public banks (BROU) and cooperatives.
2/ Data for 2006 and 2007 are calculated with new weights for risk weighted assets.
3/ In millions of U.S. dollars.

APPENDIX I. DEBT SUSTAINABILITY

1. ***The authorities have made substantive changes in the debt profile in recent years***. The net present value of public debt declined and its structure improved after the 2003 debt exchange. Further fundamental improvements have taken place since then. Vigorous growth, the strengthened fiscal position, and currency appreciation have lowered the debt-to-GDP ratio from above 100 to below 65 percent.

Gross financing needs have fallen in the medium term

Gross Financing Needs

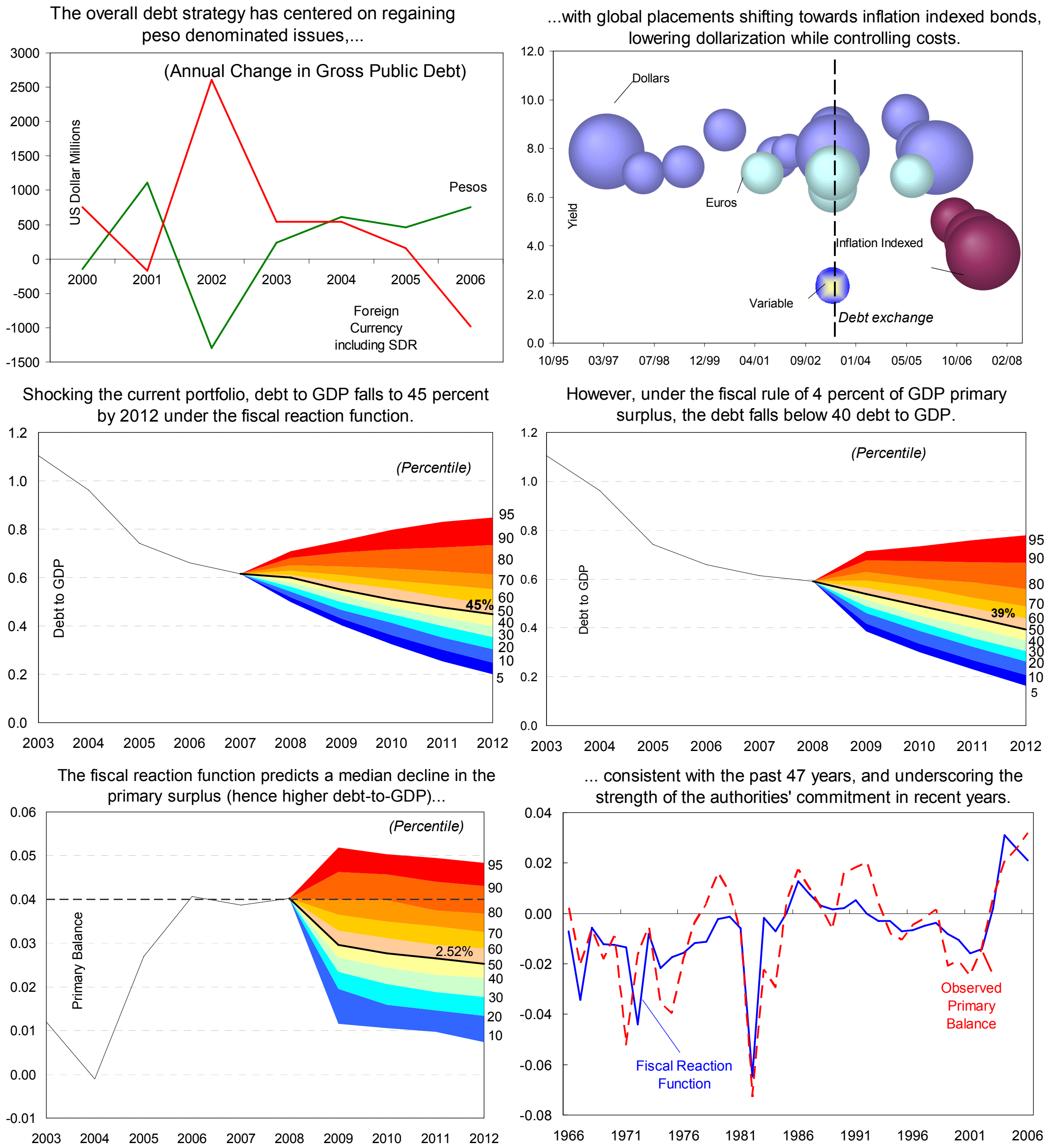
	2004	2005	2006	2007	2008	2009	2010
	(In percent of GDP)						
Current	13.8	11.7	22.8	3.10	2.26	1.97	2.37
Report 05/109	...	...	...	10.2	7	6.5	6.7

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.

2. ***Recent efforts in the markets have succeeded in lowering gross financing requirements over the medium term***. The authorities have taken advantage of strong market access and sharply lower spreads and have improved the debt profile by using long-term bond issues to repay short-term, floating rate or more expensive debts. This includes the full repayment of all remaining Fund obligations (SDR 726 million) in November 2006. Also, the government increased issuance of inflation-indexed bonds (including two combined placements in 2007 exceeding US$1.2 billion) and swapped US$1.1 billion in amortization payments due mostly in 2011 and 2015 into longer maturity bonds (Figure 1). As a result, the average maturity of public debt has risen from about 7 years at end-2004 to nearly 12 years. Consequently, gross financing requirements have fallen in the medium term, from 10 percent forecasted for 2007 a year ago to just over 3 percent.

3. ***The strengthening of the portfolio has significantly reduced the debt vulnerability as measured in dynamic simulations***. Staff sought to capture inherent uncertainty contained in debt forecasts by modeling 1,000 potential five-year economic scenarios through Monte Carlo simulation. The debt forecast results from the authorities' reaction to each economic scenario. The economic scenarios are simulated using a vector autoregression of economic fundamentals from approximately the past ten years, excluding the crisis period surrounding 2002. The crisis period is excluded since policy responses to such scenario can not be sensibly modeled by a parsimonious fiscal reaction function. Instead, the fiscal reaction function is estimated over almost fifty years of recorded data of the Uruguayan primary balance, debt, and other economic aggregates. This function is intended to systematically

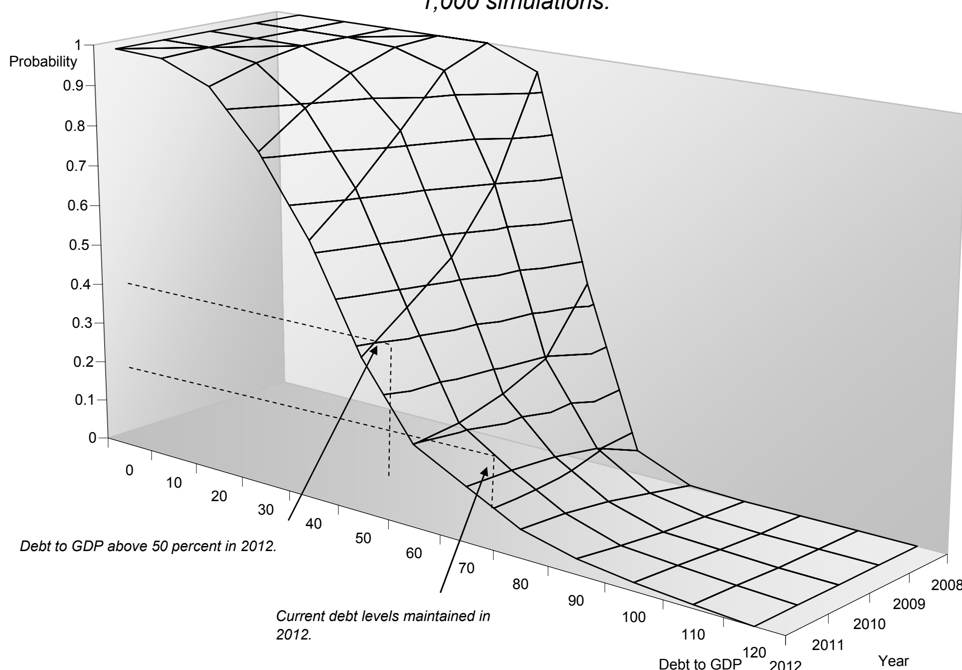
Appendix I Figure 1. Uruguay: Dynamic Debt Analysis



produce a fiscal response to the 1,000 simulated scenarios.[1] The results suggest a median debt path declining to approximately 46 percent, with significant upside risk. The probability of exceeding 65 percent of GDP in the last year of the forecast is below 18 percent, while the probability of the debt declining to below 40 percent is approximately 37 percent.

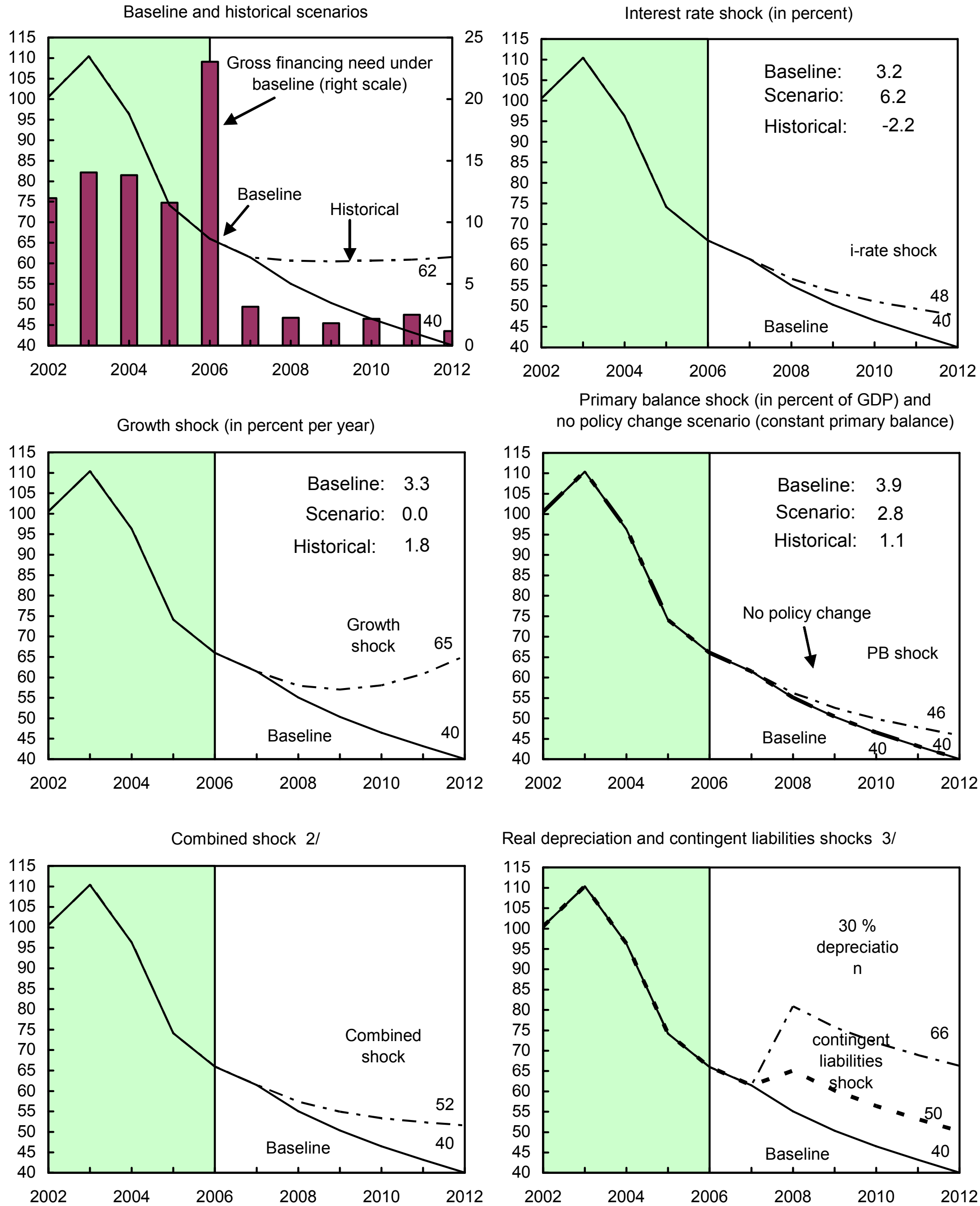
4. ***Staff estimates that the current implicit fiscal rule of keeping a primary balance of 4 percent of GDP will ensure greater stability for Uruguay***. The fiscal reaction function was compared to a fiscal rule of maintaining a 4 percent of GDP primary surplus, which yields a debt ratio declining to just below 40 percent of GDP by the last year of the forecast. This is consistent with the deterministic approach to debt sustainability (Figure 2), which also highlights the exposure to exchange rate risks and lower GDP growth.

The probability of observing a debt to GDP ratio above 50 percent in 2012 is less than 40 percent in 1,000 simulations.



[1] Staff estimated the fiscal reaction using: $pb_t = \alpha_0 + \alpha_1 D_{t-1} + \alpha_2 \Delta REER_t + \alpha_3 Ygap_t + \varepsilon_t$; pb_t is the primary balance in year *t*, D_{t-1} represents lagged US dollar external debt, $\Delta REER_t$ is an index that captures the devaluation divided by the depreciation, and $Ygap_t$ represents the output gap (estimated via Hodrick-Prescott). The function is estimated using data from 1965 to 2006, and tests reject potential endogeneity in the output gap, staff nevertheless instruments it using external factors and lagged values. Various robustness tests indicated that the function fit the data well, including tests for non-linearity in debt levels, oil prices, regional and trading partners, among others.

Appendix I. Figure 2. Uruguay: Public Debt Sustainability: Bound Tests 1/
(In percent of GDP)



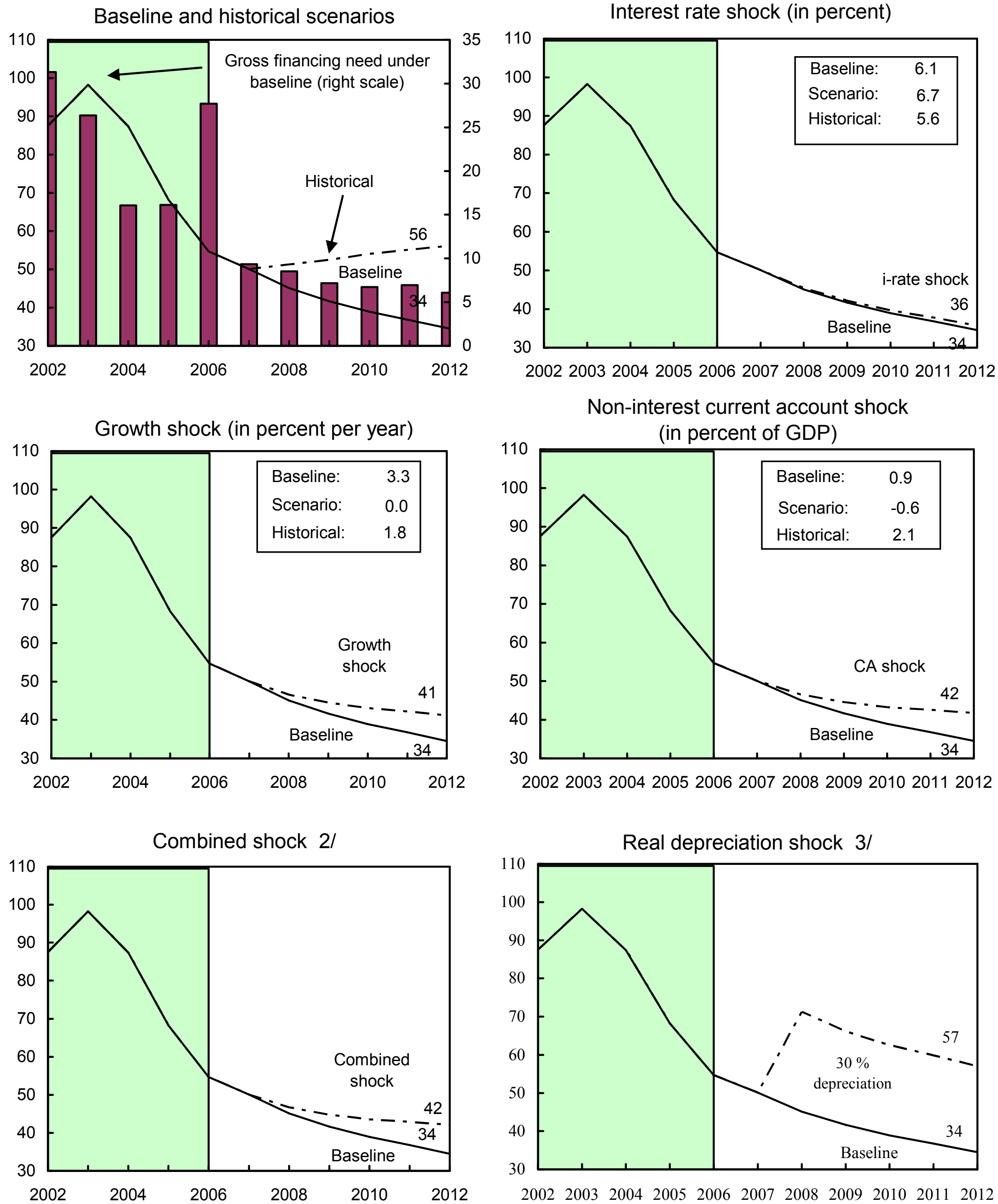
Sources: International Monetary Fund, Country desk data, and staff estimates.

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 2007, with real depreciation defin
ed as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Appendix I. Figure 3. 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 2008.

Appendix I. Table 1. Uruguay: Public Sector Debt Sustainability Framework, 2001-2011

(In percent of GDP, unless otherwise indicated)

	Actual			Projections						
	2004	2005	2006	2007	2008	2009	2010	2011	2012	Debt-stabilizing primary balance 1/
Baseline: Public sector debt 2/	97	75	66	**62**	**55**	**50**	**47**	**43**	**40**	**0.7**
Of which : foreign-currency denominated	83	63	53	44	38	34	30	27	25	
Change in public sector debt	-14.1	-22.2	-8.1	-4.5	-6.4	-4.7	-3.8	-3.3	-3.1	
Identified debt-creating flows (4+7+12)	-15.1	-18.9	-10.7	-7.2	-5.9	-4.6	-3.8	-3.3	-3.1	
Primary deficit	-3.8	-3.9	-3.8	-3.9	-4.0	-3.9	-3.9	-3.9	-3.9	
Revenue and grants	30.1	30.6	31.8	32.5	32.7	32.9	32.9	32.9	32.9	
Primary (noninterest) expenditure	26.3	26.7	28.0	28.6	28.8	29.0	29.0	29.0	29.0	
Automatic debt dynamics 3/	-11.3	-15.0	-6.9	-3.3	-1.9	-0.7	0.1	0.7	0.8	
Contribution from interest rate/growth differential 4/	-12.6	-2.8	-4.2	-3.3	-1.9	-0.7	0.1	0.7	0.8	
Of which contribution from real interest rate	-1.7	3.1	0.5	-0.2	0.2	0.9	1.6	2.1	2.1	
Of which contribution from real GDP growth	-10.9	-5.8	-4.6	-3.0	-2.1	-1.6	-1.5	-1.4	-1.3	
Contribution from exchange rate depreciation 5/	1.3	-12.2	-2.7	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	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	
Recognition of implicit or contingent liabilities	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	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 6/	1.0	-3.3	2.5	2.7	-0.5	-0.1	0.0	-0.1	0.0	
Public sector debt-to-revenue ratio 2/	320.3	242.3	207.5	188.9	168.2	152.9	141.2	131.2	121.7	
Gross financing need 7/	13.8	11.6	23.0	3.2	2.3	1.8	2.2	2.5	1.2	
in billions of U.S. dollars	1.8	2.0	4.4	0.7	0.6	0.5	0.6	0.8	0.4	
Debt service	...	15.5	26.8	7.2	6.2	5.7	6.1	6.4	5.1	
Scenario with key variables at their historical averages 8/				**61.5**	**60.7**	**60.5**	**60.7**	**61.0**	**61.5**	**1.7**
Scenario with no policy change (constant primary balance) in 2005-2010				**61.5**	**55.1**	**50.4**	**46.5**	**43.2**	**40.0**	**0.7**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline										
Real GDP growth (in percent)	11.8	6.6	7.1	5.2	3.8	3.2	3.2	3.2	3.2	
Average nominal interest rate on public debt (in percent) 9/	6.5	5.2	6.7	7.0	7.1	7.5	8.0	8.3	8.6	
Average real interest rate (nominal rate minus change in GDP deflator, in pe	-1.0	3.6	1.1	0.0	0.6	2.0	3.5	4.8	5.3	
Nominal appreciation (increase in US dollar value of local currency, in percer	-1.5	17.6	4.8	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	7.5	1.7	5.6	7.0	6.5	5.5	4.5	3.5	3.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.5	8.2	12.4	7.4	4.4	4.1	3.2	3.2	3.2	
Primary deficit	-3.8	-3.9	-3.8	-3.9	-4.0	-3.9	-3.9	-3.9	-3.9	

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 - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of denominated debt; and e = 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 3/ as r - p (1+g) and the real growth contribution as -g.

5/ The exchange rate contribution is derived from the numerator in footnote 3/ as ae(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 and primary balance in percent of GDP.

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

Appendix I. Table 2. Uruguay: External Debt Sustainability Framework, 2002-2012

(In percent of GDP, unless otherwise indicated)

	Actual				Est.	Projections						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	87.5	98.2	87.4	68.3	54.7	**50.1**	**45.1**	**41.7**	**38.9**	**36.8**	**34.5**	**-2.2**
Change in external debt	39.4	10.7	-10.8	-19.1	-13.6	-4.6	-5.0	-3.4	-2.7	-2.2	-2.3	
Identified external debt-creating flows (4+8+9)	21.1	3.8	-17.9	-22.3	-13.9	-4.9	-3.4	-2.9	-2.9	-2.3	-2.3	
Current account deficit, excluding interest payments	-7.8	-2.6	-5.4	-4.6	-1.7	-0.1	0.3	-0.6	-1.4	-1.3	-1.3	
Deficit in balance of goods and services	-1.7	-3.1	-3.9	-2.6	0.6	1.5	1.7	0.5	-0.2	-0.3	-0.5	
Exports	22.3	27.5	32.4	30.5	29.4	28.8	28.5	28.4	28.3	28.2	27.9	
Imports	20.6	24.4	28.5	27.8	30.0	30.3	30.2	29.0	28.1	27.8	27.5	
Net non-debt creating capital inflows (negative)	-1.5	-3.6	-2.4	-4.3	-7.1	-5.2	-4.5	-3.3	-2.7	-2.1	-2.1	
A1. Key variables are at their historical averages in 2007-11 3/	30.4	9.9	-10.1	-13.4	-5.0	0.4	0.8	1.1	1.1	1.1	1.1	
Contribution from nominal interest rate	4.6	3.1	5.1	4.6	4.1	2.9	2.5	2.4	2.4	2.3	2.2	
Contribution from real GDP growth	8.2	-2.1	-9.8	-4.6	-4.1	-2.5	-1.7	-1.3	-1.2	-1.2	-1.1	
Contribution from price and exchange rate changes 2/	17.6	8.9	-5.4	-13.5	-5.0	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	18.2	6.9	7.1	3.2	0.3	0.3	-1.6	-0.6	0.2	0.1	0.1	
External debt-to-exports ratio (in percent)	392.8	357.1	269.9	224.2	186.1	174.2	158.4	146.6	137.3	130.6	123.4	
Gross external financing need (in billions of US dollars) 4/	3.8	3.0	2.1	2.7	5.4	2.0	2.1	1.9	2.0	2.2	2.0	
B5. One time 30 percent nominal depreciation in 2007	31.3	26.4	16.1	16.1	27.7	9.4	8.5	7.2	6.7	7.0	6.1	
Scenario with key variables at their historical averages 5/						**50.1**	**51.3**	**52.5**	**54.1**	**55.1**	**56.2**	**1.1**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	-11.0	2.2	11.8	6.6	7.0	5.2	3.8	3.2	3.2	3.2	3.2	
GDP deflator in US dollars (change in percent)	-26.8	-9.2	5.8	18.2	7.9	7.6	8.3	6.0	4.7	3.7	3.5	
Nominal external interest rate (in percent)	6.2	3.2	6.1	6.7	7.0	6.0	5.7	5.8	6.1	6.3	6.4	
Growth of exports (US dollar terms, in percent)	-17.8	14.5	39.3	18.6	11.4	10.8	11.4	9.1	7.8	6.3	6.0	
Growth of imports (US dollar terms, in percent)	-33.1	9.7	38.2	23.2	24.3	14.4	12.1	4.9	4.8	5.9	5.4	
Current account balance, excluding interest payments	7.8	2.6	5.4	4.6	1.7	0.1	-0.3	0.6	1.4	1.3	1.3	
Net non-debt creating capital inflows	1.5	3.6	2.4	4.3	7.1	5.2	4.5	3.3	2.7	2.1	2.1	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 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.

Appendix I. Table 3. Uruguay: Debt Profile

				Projections					
	2004	2005	2006	2007	2008	2009	2010	2011	2012
(In millions of U.S. dollars)									
Debt Stocks 1/	12,855	12,570	12,793	13,487	13,518	13,499	13,465	13,368	13,226
Domestic Currency 2/	1,306	507	116	116	110	104	97	88	84
Inflation Linked 3/	899	1,262	2,406	3,774	4,040	4,279	4,523	4,747	4,939
External Currency	10,650	10,800	10,271	9,597	9,368	9,116	8,845	8,533	8,204
Interest		771	855	896	973	1,013	1,081	1,123	1,152
Domestic Currency		...	...	20	5	5	5	5	5
Inflation Indexed		...	...	157	301	306	317	323	326
External Currency		...	...	720	667	702	758	795	822
Amortization	1,711	1,859	2,663	677	556	530	689	869	535
Domestic Currency		...	...	8	6	6	7	9	5
Inflation Indexed		...	...	0	0	0	0	0	0
External Currency		...	...	669	550	524	681	860	530
Gross Borrowing	2,504	1,940	4,443	1,200	549	486	627	771	383
Domestic Currency		...	...	0	0	0	0	0	0
Inflation Indexed		...	...	1,200	40	37	51	66	35
External Currency		...	...	0	510	448	576	705	348
(In Uruguayan Pesos)									
Debt Stocks 1/	363,077	304,776	306,793	321,607	318,488	317,106	315,906	313,392	309,856
Domestic Currency 2/	37,339	12,335	2,794	2,743	2,596	2,463	2,294	2,085	1,973
Inflation Linked 3/	21,229	29,827	56,835	89,164	95,449	101,102	106,854	112,156	116,676
External Currency	304,509	262,614	247,164	229,700	220,443	213,540	206,758	199,151	191,207
Interest	22,666	18,756	20,564	21,398	22,919	23,797	25,339	26,306	26,963
Domestic Currency	...	...	...	476	116	121	122	119	112
Inflation Indexed	...	...	...	3,698	7,103	7,221	7,486	7,622	7,694
External Currency	...	...	...	17,224	15,701	16,456	17,730	18,565	19,157
Amortization	48,923	45,210	64,070	16,193	13,093	12,407	16,099	20,282	12,460
Domestic Currency	...	...	...	179	147	133	169	209	112
Inflation Indexed	...	...	...	0	0	0	0	0	0
External Currency	...	...	...	16,014	12,946	12,274	15,930	20,073	12,349
Gross Borrowing	52,351	47,178	106,904	28,722	12,925	11,375	14,650	17,992	8,927
Domestic Currency	...	...	...	0	0	0	0	0	0
Inflation Indexed	...	...	...	28,722	932	873	1,189	1,543	807
External Currency	...	...	...	0	11,993	10,502	13,461	16,449	8,120
(In percent of GDP)									
Debt Stocks 1/	96.9	75.2	66.2	61.7	55.2	50.4	46.5	43.2	40.1
Domestic Currency 2/	9.8	3.0	0.6	0.5	0.5	0.5	0.4	0.4	0.4
Inflation Linked 3/	6.8	7.5	12.5	17.3	16.5	16.0	15.7	15.4	15.0
External Currency	80.3	64.6	53.2	43.9	38.1	33.9	30.4	27.5	24.7
Interest	6.0	4.6	4.4	4.1	4.0	3.8	3.7	3.6	3.5
Domestic Currency	...	...	...	0.1	0.0	0.0	0.0	0.0	0.0
Inflation Indexed	...	...	...	0.7	1.2	1.1	1.1	1.0	1.0
External Currency	...	...	...	3.3	2.7	2.6	2.6	2.6	2.5
Amortization	12.9	11.1	13.8	3.1	2.3	2.0	2.4	2.8	1.6
Domestic Currency	...	...	...	0.0	0.0	0.0	0.0	0.0	0.0
Inflation Indexed	...	...	...	0.0	0.0	0.0	0.0	0.0	0.0
External Currency	...	...	...	3.1	2.2	1.9	2.3	2.8	1.6
Gross Borrowing	13.8	11.6	23.0	5.5	2.2	1.8	2.2	2.5	1.2
Domestic Currency	...	...	...	0.0	0.0	0.0	0.0	0.0	0.0
Inflation Indexed	...	...	...	5.5	0.2	0.1	0.2	0.2	0.1
External Currency	...	...	...	0.0	2.1	1.7	2.0	2.3	1.1
Debt Stocks 1/									
Domestic Currency 2/	10.2	4.0	0.9	0.9	1.0	1.0	0.9	0.9	0.9
Inflation Linked 3/	7.0	10.0	18.8	28.0	30.0	31.8	33.7	35.6	37.4
External Currency	82.9	85.9	80.3	71.2	69.0	67.3	65.4	63.5	61.7
Memorandum:									
GDP	379,353	406,705	464,802	523,200	578,381	629,719	679,114	725,375	773,290
Free Reserves	467	1,374	916	1,601	1,794	1,975	2,145	2,308	2,461

Sources: Uruguayan authorities; and IMF Staff estimates.
1/ Debt by currency denomination. External currency debt is net of free reserves of the Central Bank of Uruguay.
2/ Domestic currency debt excludes inflation index bonds.
3/ Assumes no further issues of inflation indexed debt in 2007.

Appendix II. Summary of Annexes

The full annexes to this report can be viewed in CyberDocs on the Fund's intranet and on the secure extranet for Executive Directors and member officials.

Fund Relations

On June 8, 2005, a three-year SBA was approved under the exceptional access procedures (SDR 766.3 million, 250 percent of quota). Uruguay repurchased all remaining Fund obligations (SDR 726.7 million, 237 percent of quota) on November 30, 2006, and cancelled the arrangement on December 27, 2006. A safeguard assessment was completed in September 2005. In April, 2006, Uruguay's *defacto* exchange rate regime was reclassified from an independent float to a managed float with no predetermined path for the exchange rate. The 2006 Article IV consultation was concluded by the Executive Board on June 28, 2006 (Country Report No. 06/425).

Relations with the World Bank Group[1]

The current investment portfolio comprises six projects totaling US$181 million in commitments, with an undisbursed amount of US$141 million as of May 17, 2007. The performance of the investment portfolio improved significantly in CY04 and CY05, with disbursements for investment operations aggregating to US$43.8 million and US$58.6 million respectively. Disbursements from the investment portfolio in CY06 were US$42.1 million, with a decrease with respect to previous years as a consequence of the renewal of the portfolio and slow start-up of new operations. On November 21, 2006, the Board of Executive Directors of the WB Group approved a loan of US$170 million by the IFC, and a guarantee of US$350 million by MIGA, to the Finnish company Botnia for the construction of a wood pulp plant in Fray Bentos.

Relations with the Inter-American Development Bank[2]

As of May 24, 2007 the Bank's current portfolio in Uruguay includes loans for the financing of 18 investment projects; and two policy based operations, for the social sectors and for improvements in competitiveness. The lending portfolio, which is largely aligned to the administration's priorities and consistent with the Bank's country strategy, amounts to US$1,017.5 million, of which US$604.8 million are pending disbursement. Portfolio performance in the recent past 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. In line with the strengthening of the fiscal accounts, the pace of project implementation in 2006 increased markedly.

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[1] Adopted from text prepared by World Bank staff in June 2007.

[2] Adopted from text prepared by IDB staff in June, 2007.

INTERNATIONAL MONETARY FUND

URUGUAY

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by Prepared by the Western Hemisphere Department

July 31, 2007

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Annex I. Fund Relations
(As of May 31, 2007)

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

II. **General Resources Account:**

	SDR Million	Percent Quota
Quota	306.50	100.00
Fund holdings of currency	306.51	100.00
Reserve Position	0.00	0.00
Holdings Exchange Rate		

III. **SDR Department:**

	SDR Million	Percent Allocation
Net cumulative allocation	49.98	100.00
Holdings	0.68	1.36

IV. **Outstanding Purchases and Loans:** None

V. **Latest Financial Arrangements:**

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Jun 08, 2005	Dec 27, 2006	766.25	263.59
Stand-By	Apr 01, 2002	Mar 31, 2005	1,988.50	1,988.50
Of which SRF	Jun 25, 2002	Aug 08, 2002	128.70	128.70
Stand-By	May 31, 2000	Mar 31, 2002	150.00	150.00

VI. **Projected Payments to Fund**
(SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2007	2008	2009	2010	2011
Principal					
Charges/Interest	1.07	2.12	2.12	2.12	2.12
Total	1.07	2.12	2.12	2.12	2.12

VII. ***Safeguards Assessment***. The authorities are in the process of addressing all safeguards concerns raised in the safeguards assessment completed in September 2005, and have already implemented many of the recommendations proposed by staff. Uruguay's total obligations to the Fund are now included in the BCU's financial statements and 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$). Uruguay has followed an independently floating exchange rate regime since July 29, 2002. In April 2006, Uruguay's de facto exchange rate regime was reclassified from an independent float to a managed float with no predetermined path for the exchange rate. On May 31, 2007, buying and selling interbank rates for the U.S. dollar, the intervention currency, were Ur$ 23,97 and Ur$24.02, respectively. Uruguay's exchange system is free of restrictions on payments and transfers for current international transactions. The exchange restriction associated with the reprogramming of time deposits at BROU and BHU during the 2002 crisis was removed ahead of schedule in April 2005.

IX. ***Article IV Consultation***. The 2006 Article IV consultation was concluded by the Executive Board on June 28 (Country Report No. 06/79). Uruguay is on the standard consultation cycle governed by the provisions approved by the Executive Board on July 15, 2002.

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

XI. ***FSAP participation and ROSCs***. The Financial Sector Stability Assessment (FSSA) was considered by the Executive Board on June 28, 2006 (Country Report No. 06/187). 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. The ROSC on Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) was published on December 2006 (Country Report No. 06/435)

XII. ***Technical Assistance***. Technical assistance on tax, customs, and social security administration was provided by FAD in February 2007, March 2006, June 2005, and July 2003, on tax policy in October 2005 and May 2003, and on public financial management in March 2005 and July 2006. 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. Further, MFD has also provided technical assistance to strengthen the formulation and conduct of monetary and exchange rate policies, including in July 2006 and May 2007. In February 2007, LEG provided technical assistance to develop a framework to elaborate and implement a national AML/CFT strategy consistent with the recommendations of the Fund's 2005 AML/CFT assessment report.

XIII. ***Resident Representative***. Mr. Gaston Gelos. Starting late August, the Resident Representative will cover Uruguay from the Buenos Aires' office.

ANNEX II. RELATIONS WITH THE WORLD BANK GROUP
(As of May 21, 2007)

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 outlined 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.

The previous 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.

Because of the 2003 referendum on petroleum and the 2004 constitutional amendment on water, SAL II was restructured. In January 2007, a second tranche of US$40 million was released and the third tranche was cancelled. 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 were cancelled at the Government's request. The social reform agenda continues to be supported by a series of DPLs. The first DPL (DPL1), approved by the Board of Executive Directors together with the CAS on June 9, 2005, in an amount of US$75 million, supported reform progress in social policies as well as important measures taken by the new Government with respect to health, education and social protection. The DPL1 has been fully disbursed. A subsequent DPL, the First Programmatic Reform Implementation Development Policy Loan in the amount of US$100 million, will be considered by the Board of Directors on May 30, 2007. This operation will support the Government's reform program in the areas of tax reform, business climate and capital markets development, and in improving the social protection

system. On May 30, 2007 an Institution Building Technical Assistance Project in the amount of US$15 million will also be presented to the Board for consideration. In addition, the second phase of an APL for OSE Modernization and Rehabilitation Systems (US$50 million) will also be presented for approval before the end of the fiscal year.

Four investment operations have been approved since the beginning of the new CAS period. These include two investment operations for Integrated Natural Resources and Transport Infrastructure and Rural Access, in the amount of US$30 million and US$70 million respectively, which were approved by the Board on June 9, 2005 together with the CAS**.** In addition, in December 2006, the Board approved a Supplemental Financing for the Foot and Mouth Disease Project in the amount of US$6.5 million. Another investment loan in support of the Promoting Innovation to Enhance Competitiveness Project was approved on May 1, 2007 in the amount of US$26 million.

The current investment portfolio comprises six projects totaling US$181 million in commitments, with an undisbursed amount of US$141 million as of May 17, 2007. The performance of the investment portfolio improved significantly in CY04 and CY05, with disbursements for investment operations aggregating to US$43.8 million and US$58.6 million respectively. This was a reflection of the substantially improved economic situation, as well closer portfolio monitoring, with portfolio performance reviews being conducted every six months. Disbursements from the investment portfolio in CY06 were US$42.1 million, with a decrease with respect to previous years as a consequence of the renewal of the portfolio and slow start-up of new operations.

On November 21, 2006, the Board of Executive Directors of the WB Group approved a loan of US$170 million by the IFC, and a guarantee of US$350 million by MIGA, to the Finnish company Botnia for the construction of a wood pulp plant in Fray Bentos.

Financial Relations with the World Bank Group
(In millions of U.S. dollars)

I. IBRD Operations (as of May 21, 2007)

	Commitments (Net of Cancellations)	Disbursed	Undisbursed
Foot & Mouth Disease (Add. Financing)	7	0	7
Public Services Modernization	6	2	4
Basic Education III	42	20	22
Transport Infrastr. Maint. & Rural Access	70	14	56
Integrated Nat. Resources & Biodiv. Mgnt.	30	2	28
Innovation to Enhance Competitiveness	26	0	26
Total	**181**	**39**	**141**

II. IFC Operations (as of April 30, 2007)

	Loans	Equity	Quasi	Participation
Committed	115.1	0.0	8.3	100.0
Outstanding	59.8	0.0	8.3	63.8

III. IBRD Loan Transactions (calendar year)

	2002	2003	2004	2005	2006	2007[1]
Disbursements	234	97	144	134	42	171
Debt service payments	75	78	80	104	205	61
Net Disbursements	158	19	64	30	-163	110

[1] As of May 21 2007.

ANNEX III. RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(As of May 24, 2007)

The Inter-American Development Board of Executive Directors approved a new Country Strategy for Uruguay on March 15, 2006. The Bank's Country Strategy supports the Government's policy, which seeks to consolidate growth and improve the population's social welfare. In support of this longer-term goal, the Strategy focuses 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 implementation of the Bank's strategy proposes a likely lending scenario of about US$1.2 million for the five-year period 2005–09, which together with a normal execution of the loan portfolio, mainly investment projects, will allow for the net lending flows to remain relatively neutral. This program includes lending to support the Government in the key policy areas of competitiveness, the social sectors and poverty reduction, and public sector management. To this end, within the area of competitiveness, a loan for a program to support the productivity and development of new livestock products, for US$15.8 million, was approved in July 2005; an investment project to improve cluster competitiveness for US$9 million was approved in July 2006; and a two-year programmatic loan to improve competitiveness for a total of US$150 million—for US$75 million each—is under preparation, with the first loan approved in January 2007 and expected approval of the second loan in early 2008. In the social sector area, a sector loan, for US$250 million, was approved in August 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; and a loan for sanitation, for US$118.6 million, was approved in January 2006, to improve the standard of living of the population in Montevideo by increasing the coverage of sanitation service and reducing pollution in the bay. Within the public sector management area, a loan to support the public debt management unit for US$2.45 million was approved in November 2005; and a three-year programmatic loan to support improvements in tax administration and public sector management is being prepared. The first loan for US$50 million was approved in October 2006; a second loan for an estimated US$150 million is likely to be approved in end-2007 while the amount for 2008 is to be determined. The lending program also includes investment projects with new operations planned in the area of microfinance, to support transport infrastructure, and social programs such as a neighborhood improvement programs.

As of May 24, 2007 the Bank's current portfolio in Uruguay includes loans for the financing of 18 investment projects; and two policy based operations, for the social sectors and for improvements in competitiveness. The lending portfolio, which is largely aligned to the

administration's priorities and consistent with the Bank's Country Strategy, amounts to US$1,017.5 million, of which US$604.8 million are pending disbursement. Portfolio performance in the recent past 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. In line with the strengthening of the fiscal accounts, the pace of project implementation in 2006 increased markedly. A challenge ahead in terms of portfolio management, for both the Bank and the authorities, will be to ensure that the projects maintain the pace of project execution in 2007–08 while setting the stage for a normal implementation of the new projects within the context of the budgetary allocations approved in the five-year Budget Law, in the Budget Review Law for 2005 as well as in the Budget Review Law for 2006, currently under discussion by Congress. As part of their debt management strategy, the authorities paid in February 2006, US$100 million due and in March, and pre paid the remaining US$300 million due in August 2006 and 2007, corresponding to the Social Protection and Sustainability Program, which was approved in August 2002.

FINANCIAL RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(In millions of U.S. dollars)

Total outstanding loans: US$1,868.7[1]

Loan transactions:

	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007[2]**
Disbursements	162.9	214.2	558.6	367.2	53.1	242.3	114.8	492.5
Amortization	59.4	60.7	73.1	103.7	113.3	220.0	519.6	138.1
Net Loan Flows	**103.5**	**153.5**	**485.5**	**263.6**	**-60.2**	**22.3**	**-404.8**	**354.4**

Source: Inter-American Development Bank.

[1] As of April 30, 2007.
[2] IDB staff projection.

Annex IV. Uruguay: Statistical Issues

Uruguay's economic and financial database is generally adequate for the assessment and monitoring of macroeconomic policies. Uruguay subscribed to the SDDS in February 2004, and meets the SDDS specifications. However, Uruguay uses the flexibility option for timeliness of central and general government operations, and the analytical accounts of the banking sector.

Real sector statistics

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

Both the consumer and wholesale price indices are reported on a regular and timely basis for publication in the *IFS*. The consumer price index has a base period of March 1997 = 100, and the base of the wholesale price index has been updated to 2001. Coverage of the CPI is limited to the capital city. The authorities do not provide trade price and volume indices for publication in the *International Financial Statistics (IFS)*.

Government finance statistics

Official data on the central administration, the state enterprises and the social security system are complete and current, but there are problems with the timeliness of the data on local governments. There are also problems with the timeliness of financing and debt data reported for inclusion in the Fund's statistical publications. Information on a monthly and quarterly basis for financing and debt data respectively, are disseminated on the BCU website from 1999 onwards for the central government and total public sector. The information reported for publication in the *Government Finance Statistics Yearbook* covers transactions on revenue and expense for the consolidated central government, and the general government's operations on financial assets and liabilities, both in terms of flows (financing) and stocks (debt). However, data on revenue and expense for local governments have not been reported since 1994.

Monetary and financial statistics

Monetary and financial statistics are prepared in accordance with the IMF's *Monetary and Financial Statistics Manual (2000).* Authorities have yet to report monetary data using the standardized reporting forms (SRF). In April 2003, an STA mission visited Montevideo to assist the authorities in the adequate recording of the loans funded from the Fund for the Stabilization of the Banking System (FSBS) in the Central Bank's balance sheet. The mission's recommendations have been implemented and were reflected in the *IFS* June 2003 issue.

External sector statistics

Balance of payments statements are compiled and published on a quarterly basis. Data are compiled following the recommendations of the fifth edition of the *Balance of Payments Manual (BPM5)*. Uruguay compiles and reports to STA quarterly data on balance of payments and annual data on the international investment position (IIP) for publication in the *IFS* and the *Balance of Payments Statistics Yearbook*. The new surveys would also allow for improved coverage of the private sector in the IIP.

Uruguay started disseminating the international reserves and foreign currency liquidity data template on the Fund's external website in 2005 The BCU also disseminates quarterly external debt statistics on its website, although not in the format envisaged by the SDDS.

URUGUAY: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of July 19, 2007)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	May 2007	6/15/07	M	M	M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2007	7/2/07	M	M	M
Reserve/Base Money	Apr. 2007	6/6/07	M	M	M
Broad Money	Mar. 2007	6/6/07	M	M	M
Central Bank Balance Sheet	Apr. 2007	6/6/07	M	M	M
Consolidated Balance Sheet of the Banking System	Mar. 2007	6/6/07	M	M	M
Interest Rates[2]	Apr. 2007	6/6/07	M	M	M
Consumer Price Index	Jun. 2007	7/13/07	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Mar. 2005	6/30/2005	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Dec. 2006	4/2/07	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar. 2005	6/30/2005	Q	Q	Q
External Current Account Balance	Q4/06	April 2007	Q	Q	M
Exports and Imports of Goods and Services	Q4/06	April 2007	Q	Q	M
GDP/GNP	2006	April 2007	A	A	M
Gross External Debt	Q4/05	March 2006	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

Statement by the Staff Representative on Uruguay

August 29, 2007

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

1. ***Twelve-month inflation at end-July was 8.0 percent, only marginally lower than in May and June***. Thus, the risks of exceeding the authorities' target range by end-2007 (4½–6½ percent) have increased. The latest survey shows expected inflation for end-2007 near 7½ percent, but still declining toward the target range in 2008.

2. ***The recent financial turmoil had only moderate impact in Uruguay***. The exchange rate did not come under pressure and sovereign spreads widened only marginally (reaching 238 basis points in mid August, compared to 213 at end July).

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 07/111
FOR IMMEDIATE RELEASE
September 10, 2007

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2007 Article IV Consultation with Uruguay

On August 29, 2007 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Uruguay.[1]

Background

The Uruguayan economy continues to expand after the profound crisis experienced in 2002, poverty rates have declined considerably, and unemployment is at its lowest level in a decade. Growth has exceeded expectations supported by strong macroeconomic policies and renewed market confidence, and economic vulnerabilities have been sharply reduced. Nevertheless, a recent increase of inflation and the ongoing implementation of the structural reform agenda remain key challenges.

Real GDP grew by 7 percent in 2006, continuing the strong performance following the crisis in 2002. The growth momentum remains solid this year, led by foreign investment and consumption, and supported by an accommodative monetary policy stance. Inflation has increased, fueled by pass-through from oil and other commodity prices and strong domestic activity. Twelve-month inflation through July 2007 was 8 percent, above the upper limit of the central bank's target range (6.5 percent).

Fiscal performance has also been strong, with primary balances averaging near 4 percent of GDP since 2004. Higher revenue collection and declining debt service going forward should

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

make room for priority social and capital expenditures while maintaining primary balances consistent with the five-year budget approved in December 2005. To this end, it will be important to continue to press ahead with the ongoing tax administration and customs reforms, and to monitor carefully the implementation of the landmark tax reform which became effective in July 2007. The public debt has declined from 110 percent of GDP in 2003 to a projected 62 percent of GDP by end 2007, with peso-denominated, inflation-indexed notes now representing approximately 30 percent of the outstanding public debt stock.

Uruguay's external sector remains strong, with buoyant exports and import growth driven by large foreign direct investment projects. Measures of exchange rate competitiveness indicate that the peso is broadly in line with fundamentals, while appreciation pressures may increase as high capital inflows persist. Sovereign spreads are below pre-crisis levels, and the central bank has accumulated US$3.6 billion in reserves to date, the equivalent of six months of imports or three times short-term debt, with financing needs remaining moderate in the next few years.

Financial indicators have improved considerably, although vulnerabilities persist due mainly to dollarization. Short-term debt has been sharply reduced through debt management operations. Financial system soundness indicators have also improved, showing a well-capitalized banking system, low non-performing-loan ratios, high liquidity levels, and improved profitability. In addition, nonresident deposits—a key vulnerability at the time of the crisis—are much lower than in 2002, and stress tests confirm the increased resilience of the financial system. State-dominance in the financial system remains large, and Uruguay remains one of the most dollarized economies in the world (70 percent of public debt and over 80 percent of total liabilities are denominated in dollars). Spillovers from regional shocks also remain a concern, particularly in an environment of increasing financial risk.

Strong economic performance and policy reforms have sharply reduced vulnerabilities and near-term risks since the 2002 crisis. Nevertheless, important structural reforms to the state housing bank, the central bank, and state pension funds included in the agenda remain unfinished. Also, the likelihood of less favorable global conditions has increased with the rapidly changing liquidity environment, although the recent financial turmoil had only a moderate impact on Uruguay.

Executive Board Assessment

Executive Directors commended the authorities for their sound policies and progress on structural reforms which, together with favorable external conditions, have led to a vigorous economic recovery since the 2002 crisis and greatly reduced economic vulnerabilities. Sound debt management has improved the debt structure, the financial sector has been strengthened, and international reserves have increased significantly. While prospects are favorable, inflation has risen above the target range and, together with the steadfast implementation of ongoing structural reforms, is among the key challenges facing policymakers.

The central bank has acted appropriately to address rising inflation by substantially lowering its monetary targets. Directors looked forward to continuing efforts to bring inflation and expectations within the target range, including by allowing interest rates to adjust freely to the monetary tightening. Directors generally saw scope for clarifying the objectives and instruments of monetary policy, including foreign exchange intervention, to help enhance the effectiveness of monetary policy in the face of large capital inflows. Directors recognized that with high financial dollarization and banks' liquidity likely to decline in the future, some additional reserve buildup would be helpful. At the same time, most Directors considered that purchases in the foreign exchange market should not hinder exchange rate movements and should be subordinated to the inflation objective by allowing the currency to adjust more freely in response to shocks. Directors agreed that the adoption of inflation targeting should proceed gradually, in particular given the still high dollarization. Steps to further enhance the credibility of the monetary framework should include capitalizing the central bank and strengthening its autonomy. Directors welcomed the authorities' assurances that inflation is the overriding objective of monetary policy.

Directors welcomed the significant increase in the banking system's resilience to shocks. To address the remaining challenges, they stressed the importance of deepening financial sector reforms and implementing the recommendations of the 2006 Financial Sector Assessment Program. These include further strengthening state banks and banking supervision, and completing the restructuring of the housing bank (BHU) to allow the resumption of sound mortgage lending. Swift approval of the financial sector law will be key to enhancing central bank independence and strengthening the supervisory and resolution frameworks. Several Directors welcomed the authorities' decision to join the Latin American Reserve Fund (FLAR).

Fiscal performance in recent years has been commendable. Directors underscored that it will be essential to maintain large primary surpluses to further reduce the public debt ratio, which is still at a high level. A number of Directors suggested that exceeding the medium-term targets to help ease the burden on monetary policy would be appropriate if inflation concerns persist. Directors also looked forward to continuing efforts to reduce debt dollarization in order to further reduce vulnerabilities.

Directors welcomed the recent implementation of the tax reform and progress in the area of customs and tax administration. Freeing up resources for public investment, among the lowest in the region, will require gradually reducing nondiscretionary spending. To this end, Directors encouraged the authorities to press ahead with the reform of specialized pension funds. They supported the authorities' interest in public-private partnerships (PPPs) as a vehicle for upgrading infrastructure, while emphasizing the importance of carefully assessing the criterion to undertake PPPs, minimizing contingent liabilities, and strengthening the legal and accounting framework for these operations.

Directors praised the authorities' commitment to further improve the business climate. The creation of a private investment office, the passage of the competition law, and the expected approval of the bankruptcy law, are important steps to further enhance the business

environment. A few Directors also noted the need to enhance competition in labor markets and reduce bureaucratic impediments to investment.

Directors welcomed the opportunity to review Uruguay's experience under the 2005–06 Stand-By Arrangement. They noted that the arrangement was highly successful in helping strengthen the economy, thereby paving the way for Uruguay's exit from Fund financial support. Directors supported the key messages of the ex post evaluation report, highlighting the important role that the authorities' steadfast pursuit of prudent macroeconomic policies and strong ownership had played in contributing to the program's success. Directors endorsed the report's conclusion that a further reduction of Uruguay's vulnerabilities, building on the significant progress already made, will hinge on the implementation of pending structural reforms to strengthen macroeconomic and financial stability and maintain high growth over the medium term. They welcomed the authorities' commitment in this regard, including to ensure the sustainability of structural reforms.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Uruguay: Selected Economic Indicators

	2001	2002	2003	2004	2005	Prel. 2006	Proj. 2007
(Annual percentage changes, unless otherwise indicated)							
Real GDP	-3.4	-11.0	2.2	11.8	6.6	7.0	5.2
Contributions to growth							
Domestic demand (percent)	-3.6	-20.2	2.9	11.3	4.2	10.9	7.0
Foreign balance (percent)	0.3	9.1	-0.7	0.5	2.4	-3.9	-1.8
Exports of GNFS (percent)	-3.2	-3.8	1.5	10.9	6.8	3.5	3.3
Imports of GNFS (percent)	3.5	12.9	-2.2	-10.4	-4.5	-7.3	-5.1
Prices							
Consumer price index (period average)	4.4	14.0	19.4	9.2	4.7	6.4	7.4
Consumer price index (eop)	3.6	25.9	10.2	7.6	4.9	6.4	7.0
Terms of trade	-0.4	3.5	2.2	-2.4	-6.3	-1.4	-0.1
(In percent of GDP)							
Public sector finances							
Total revenues	33.8	32.1	32.0	30.9	32.2	31.8	32.5
Expenditure (incl. discrepancy)	37.9	36.8	35.3	33.2	32.8	32.4	32.7
Primary balance	-1.2	0.0	2.7	3.9	4.1	3.9	4.0
Overall balance	-4.2	-4.6	-3.2	-2.2	-0.7	-0.6	-0.1
Public sector debt 1/	43.0	96.0	110.0	97.0	75.0	66.0	62.0
Outstanding external debt	48.1	87.5	98.2	87.4	68.3	54.7	50.1
Of which: Public external debt	31.4	68.9	85.3	76.9	60.8	48.2	44.5
(Annual percentage change)							
Money and credit							
Base money (eop)	-2.2	22.1	24.9	11.1	34.1	13.0	8.0
M1	-2.8	1.7	34.6	13.4	29.4	21.8	11.3
M3	19.6	15.8	21.7	-2.0	0.1	12.6	11.3
Credit to the private sector (constant exchange rate)	-3.8	-17.6	-23.9	-11.2	2.7	9.1	13.8
Gross official reserves (US$ million) 2/	3,099	772	2,087	2,512	3,438	3,091	3,776
In percent of short-term debt	100.4	32.3	131.3	112.4	153.8	492.1	290.6
In percent of short-term debt and FX deposits	42.4	7.0	20.0	27.7	32.9	34.1	34.5
(In percent of GDP, unless otherwise indicated)							
Balance of payments							
Current account	-2.9	3.2	-0.5	0.3	0.0	-2.4	-2.8
Merchandise exports, f.o.b.	11.5	15.9	20.3	23.7	22.5	22.7	22.2
Merchandise imports, f.o.b.	15.7	15.5	18.7	22.6	22.3	25.2	25.5
Services, income, and transfers (net)	1.3	2.8	-2.1	-0.8	-0.2	0.1	0.5
Capital and financial account	4.3	-18.5	9.3	0.5	6.1	1.0	5.9
Foreign direct investment	1.7	1.5	3.6	2.4	4.3	7.1	5.2
Overall balance of payments (US$ millions)	302	-2,328	1,380	454	951	-337	685
Debt service ratio (in percent of exports of goods & services)	43.6	55.0	52.3	44.8	53.1	92.5	24.4

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

1/ Debt of the NFPS, net of free reserves of the Central Bank of Uruguay.

2/ Includes reserve buildup through reserve requirements of resident financial institutions.

Statement by Hector Torres, Alternate Executive Director for Uruguay and David Vogel, Advisor to Executive Director
August 29, 2007

Recent Developments

Uruguay's economy continues to show a satisfactory performance. Clearly, the Uruguayan authorities' policies and reforms have led to positive and synergetic results. Among others, economic activity continues to increase robustly; unemployment is currently below 9 percent (the lowest rate in more than a decade); real wages have increased significantly - although they have not yet fully recovered to pre-crisis levels; the poverty rate is five percentage points lower than it was two and a half years ago; inflation -although it has increased in recent months due to some temporary factors and a high imported inflation- is under control; investment relative to GDP is at an inedited high level for the country; exports exhibit record levels and are highly diversified; the average maturity of debt (currently at 14 years) has risen significantly; interest payments represent around 4.1 percent of GDP (6 percent in 2004); the overall fiscal balance will be close to the equilibrium at the end of 2007, which is absolutely unprecedented in Uruguay; the debt-to-GDP ratio will finish this year somewhat higher than 60 percent (approximately 40 percentage points below the ratio in 2004); and international reserves have increased substantially.

The Authorities' Unalterable Ownership

After many years, this Article IV Consultation is no longer in the context of an IMF supported program. Regarding the developments of the last program, the Ex Post Evaluation points out the critical contribution of the Stand-By Arrangement, and Uruguay's efforts and achievements made so far.

In 2004, Uruguay's debt to the Fund was very high (SDR 1,728 million, representing 564 percent of Uruguay's quota or 20 percent of the country's GDP). Hence, one of our authorities' most immediate actions was to reach a new arrangement with the Fund in order to significantly mitigate financial pressures over the short-term.

The Board approval of the Stand-By Arrangement in June 2005 was key for Uruguay to regain access to international financial markets, in a process which has obviously been fed by the confidence instilled by the authorities' policies and reinforced by the creation of a Debt Management Unit at the Ministry of Finance - one of the program's conditionalities. The Debt Unit's professional work contributed to reducing Uruguay's debt cost, lengthening its maturity,

and improving its currency structure (although much remains to be done in this area, the current structure -71 percent in external currency and 29 percent in domestic currency and inflation linked- is substantially different from the one observed in 2004 - 83 percent and 17 percent respectively).

After a significant change in the financial situation, at the end of 2006, and in the context of the program's fifth and sixth reviews, the government formalized the cancellation of the Stand-By Arrangement and the early repayment of the outstanding debt to the Fund. The latter allowed the country to fulfill its commitment of establishing a well-articulated exit strategy from the Fund's financial support. It is worth noting that all along the Stand-By Arrangement and - perhaps more telling- even after the early cancellation in December 2006, our authorities have demonstrated their strong ownership of the program - Uruguay's program. The fact that Uruguay has no outstanding obligations with the Fund has not meant any change in the envisaged reforms or targets, but simply a rescheduling of certain reforms in order to better fit the program with financial, social, and political aspects.

Key Aspects of the Reform Agenda

During recent years, the Fund has increasingly taken political economy considerations into account in its analysis and reports. These considerations are particularly important when a country, like Uruguay, has to face delicate equilibriums among substantial social, economic, and financial needs, some of which may -at least in the short term- imply trade-off situations.

As usual, trade-off situations bring out different preferences, conflicts, and collateral effects that require in-depth analysis and discussions, which should obviously be handled with **due respect to democratic process**. It is worth underscoring that Uruguay enjoys a well-established democratic system and, of course, this requires investing time in building up consensus before making decisions.[1]

Decisions always involve time considerations. In this regard, the Uruguayan authorities have put special emphasis on the **sustainability** of reforms. As depicted by the cited phrase (footnote 1), bringing people around takes more time than establishing a reform by decree, but it is worth the trouble as reforms are long-lasting only when society understands the need for them. Furthermore, it is worth recalling that **citizen's involvement** in public discussions and decisions is often associated with less corruption. Moreover, our authorities have kept in mind the importance that each reform **provides proper incentives and habits as well as promoting better institutions** as the pillars on which Uruguay's social and economic developments should be based.

In this kind of ambitious reform agenda, it is impossible to undertake all reforms at the same time. Establishing priorities is critical to the reform agenda and, in this regard, an adequate assessment of the **macro criticality** of each reform has been key in the reform process.

Years of Reforms

Having underscored the key aspects of the reform agenda, we turn now to specific comments on some of the most significant achievements.

Reinforcing financial institutions**:** Just days after the current administration took place, the authorities had to face the insolvency of a cooperative bank (Cofac). The government resisted pressures to bail out depositors. Far from that, the government introduced a limited deposit insurance scheme and established a clear precedent that no public money would be used to bail out private creditors. Furthermore, the government successfully privatized the Nuevo Banco Comercial (NBC), which was acquired by a partnership of foreign financial institutions. The Government also improved the supervision and prudential policies of the financial sector so as to reduce vulnerabilities, for instance, by creating incentives to lessen the still high dollarization in the financial system. Admittedly, BHU's reform is not yet completed but the Government is relentlessly working on it. In fact, the legal framework for BHU's reform has already been approved and it is at the implementation stage.

Diversifying trade and investment**:** Uruguay's Congress has approved an Investment Treaty with the United States. This agreement was complemented early this year by the signing of a Trade and Investment Framework Agreement (TIFA), which sets a blueprint to enhance economic relations between Uruguay and the United States. Beyond this, Uruguay's government is also making progress in diversifying its trading partners, so as to avoid too much concentration of trade within our region.

Establishing and reforming key offices**:** In addition to the Debt Management Unit which was established at the Ministry of Finance, a new Private Investment Office was created and the Tax Agency (DGI) has been decisively transformed, thus enhancing transparency and accountability while reducing incentives to evasion and rent-seeking activities. Following the same objective, the customs agency and the social security bank (BPS) are undergoing a vital transformation.

The tax reform as the centerpiece of the authorities' reform agenda**:** It is interesting to recall that in order to invite Uruguayan citizens to participate in this reform, a draft version of the tax bill was first posted on the Ministry's website. Later on, a refined version was subject to in-depth discussions in Congress. Throughout the whole process, our authorities have clearly underscored that, whereas they would not compromise with pressure groups, they were open to introducing improvements aimed at strengthening the reform's objectives (efficiency, equity, and coherence with the government's aim of promoting investment).

Improving the business climate**:** A law aimed at promoting and defending competence was recently issued and a bankruptcy bill is currently under Congress' consideration. The

Uruguayan authorities have also made it clear that it is absolutely crucial to further increase social inclusiveness to promote stability in a global sense.

***Looking forward*:** Our authorities have underlined that until the end of this year, they will focus on the approval of the financial sector laws and the reform of the police pension fund.

Fiscal Issues

Fiscal policies have successfully contributed to the authorities' envisaged targets: ensuring fiscal sustainability (as noted, overall fiscal balance and public debt relative to GDP show substantial improvements); mitigating poverty conditions (although growth is a pre-condition to reducing poverty, the social deterioration coming from the 2002 crisis required active policies - namely the Social Emergency Plan); revamping public infrastructure (the limited resources led to foster a modality of Private-Public Partnership, which will be carried out in a transparent manner and following the best international practices in this area); and significantly increasing and better targeting social expenditures (which was undertaken without putting fiscal prudence at risk).

Precisely, during recent discussions on the budget in Congress, Uruguay's Minister of Finance stressed that effective social policies require prudential fiscal management. The government has discussed at length with Congress on the budget composition, which shows a clear interest in improving social expenditure without compromising Uruguay's financial program in any way.

Monetary and Exchange Rate Policies

Some factors have posed substantial challenges for the monetary policy. First, the inflation "imported" through the booming of commodity prices and particularly with recent increases affecting Uruguay's agricultural exports, which weigh heavily in its CPI as they constitute the staple food of its population. Secondly, the increase in international oil prices which also has a direct impact on Uruguay's CPI as there is a full pass-through into domestic fuel prices. Finally, the country was hit by climate vagaries as during the past year a drought was followed by a flood and a severe cold. Fortunately, the tax reform (which involves a reduction of VAT rates and the elimination of certain other indirect taxes that were largely inefficient and distortive - i.e., Cofis or *Impuesto de Contribución para el Financiamiento de la Seguridad Social*) has helped to partially offset the above-referred pressures.

Another challenge to Uruguay's monetary policy comes from large capital inflows, which tend to generate some difficulties related to volatility and eventual distortions of the competitiveness in the short term. The Central Bank grasped the opportunity to make opportunistic foreign currency purchases that helped both to increase international reserves (Chapter V of the Selected Issues Paper underscores that "reserves are nearing optimal prudential levels, although

further accumulation is desirable going forward") and smooth volatility and reduce the distortions on the exchange rate. Having said this, it is important to remark that the authorities fully agree with the staff's comments (Chapter II of the Selected Issue Paper) that "the exchange rate should be allowed to float more freely in response to normal shocks". Whereas it is not yet clear whether Uruguay will continue to enjoy such strong capital inflows, our authorities prefer to smooth some volatility associated with short-term capital inflows which, by their nature, are quite unpredictable.

In conclusion, the BCU's target-range is expected to decrease in the future (4-6 percent in 2008) and, as usual, the authorities will continue to face the mentioned challenges with a combination of fiscal and monetary instruments, which, if necessary, could be pragmatically tuned-up to meet the inflation target. Our Central Bank authorities are strongly committed to continue improving the functioning of the financial and monetary systems, whereas giving clear signals that keeping inflation at check is the overriding objective of monetary policy.

Market Access and Sovereign Spreads

As noted above, Uruguay has taken advantage of the global financial conditions and regained important and relatively inexpensive access to the international financial markets. This has been possible thanks to the authorities' prudent policies and their outstanding debt strategy.[2] Chapter III of the Selected Issues Paper deserves an in-depth analysis. This study notes that since the loss of investment grade, Uruguay's spreads are mostly associated with those of other emerging market economies - particularly neighboring countries. Evidently, almost every country in the world is affected by deeper links to the global financial markets established by a high integration and more sophisticated products. Uruguay is no exception; however, the specificities of its case are made apparent by noting that whereas during 2004 and 2005 the average of EMBI global bond spreads for emerging markets were noticeably lower than Uruguay's, the current situation is showing a positive change for the country in absolute and relative terms.

It is also interesting to underline that during the period of market turbulences in recent weeks, Uruguay's rating was upgraded, which is an arms-length recognition to the authorities' fiscal policies and debt strategy, firmly settled on Uruguay's long and unalterable tradition of honoring its debts, as was fully recognized by many outstanding international policymakers during a recent conference on Uruguay's 2002 crisis and its aftermath.[3]

Conclusion

The authorities are satisfied with the positive results achieved so far, as well as the encouraging prospects based on sound policies and the reform advances undertaken in two and a half years. However, this is not bringing complacency but rather reinforcing their determination to continue making progress to fully implement the government's policies and reform agenda,

setting the basis for Uruguay's sustainable growth and human development.

Finally, this Article IV consultation ratifies once again the excellent relation between Uruguay and the IMF. Our authorities very much value the candid and fruitful discussions on different issues, even in those where both sides had different approaches.

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[1] A good illustration of the these kinds of considerations is provided by the former Chilean Minister of Finance Alejandro Foxley (cited by Allan Drazen in Political Economy in Macroeconomics, Princeton University Press, 2000), underscoring that "economists must not only know their economic models, but also understand politics, interests, conflicts, passions -the essence of collective life. For a brief period of time you could make changes by decree; but to let them persist, you have to build coalitions and bring people around."

[2] For instance, Euromoney awarded Uruguay as the best borrower among emerging countries in 2007.

[3] Uruguay: The 2002 Crisis and its Aftermath. Montevideo, May 29, 2007.