DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

SM/07/280
Correction 2

January 25, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Uruguay—Staff Report for the 2007 Article IV Consultation**

The attached corrections to SM/07/280 (8/1/07) have been provided by the staff:

Mischaracterization of the Views of the Authorities

Page 18, para. 17, lines 18–19: for "The authorities argued that these reforms were beyond their control as they required congressional approval; they disagreed that delays in implementing these reforms were a "disappointment"
read: "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."

Page 21, para. 21, lines 3–5: for "but the authorities indicated that uncertainty about the effect of the tax reform on revenues, and high spending needs and pressures, prevented them from committing, ex-ante, to a higher primary surplus target,"
read "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."

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 10, para. 9, lines 7–9: for "combined with intervention in the foreign exchange market to resist nominal appreciation,"
read "combined with intervention in the foreign exchange market partly to resist nominal appreciation,"

Page 24, “Uruguay Banking Sector” graph: replaced to add shading.

Page 27, para. 36, lines 2–5: for “It is also essential to continue deepening financial sector reforms and implement the recommendations of the 2006 FSAP, including reforming state banks and strengthening supervision.”
read “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. ”

Questions may be referred to Mr. Piñón (ext. 37400), Mr. López-Mejía (ext. 34334), and Mr. Romeu (ext. 37695) in WHD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

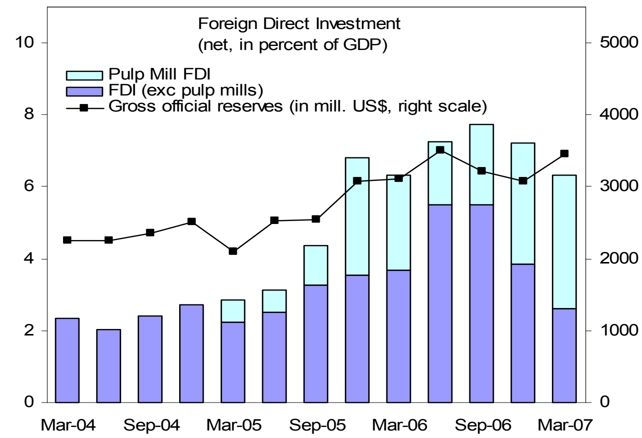
Att: (5)

Other Distribution:
Department Heads

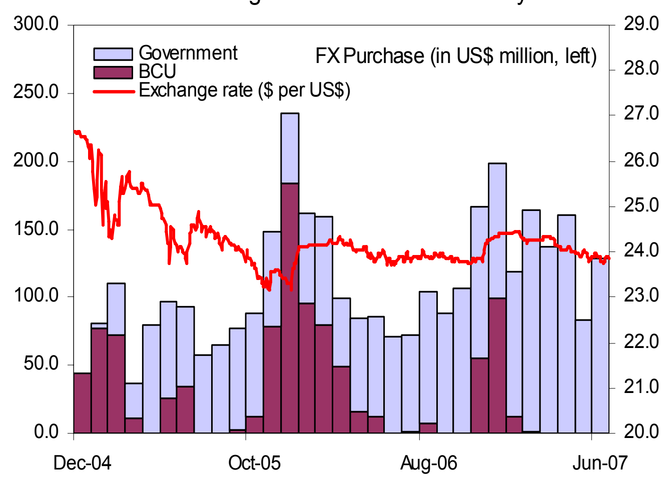
authorities effectively moved from the free float adopted in the aftermath of the 2002 crisis to a managed float. Significant exchange purchases have reduced the appreciation and volatility of the exchange rate. In 2007, foreign exchange purchases have been largely undertaken by the government, partly 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.

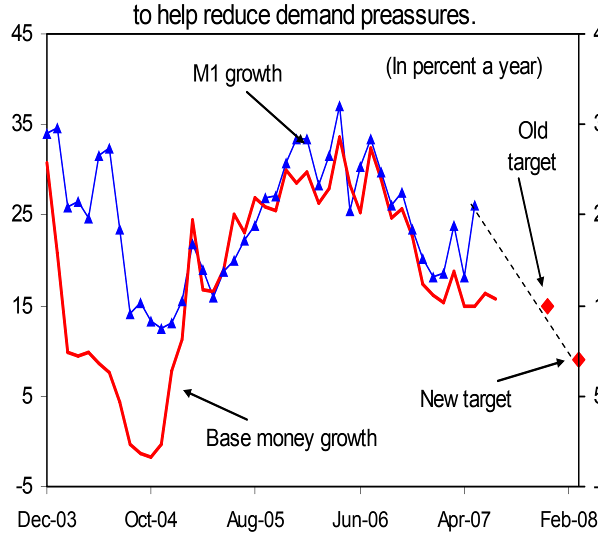
Large FDI inflows led to a steady increase in international reserves.



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



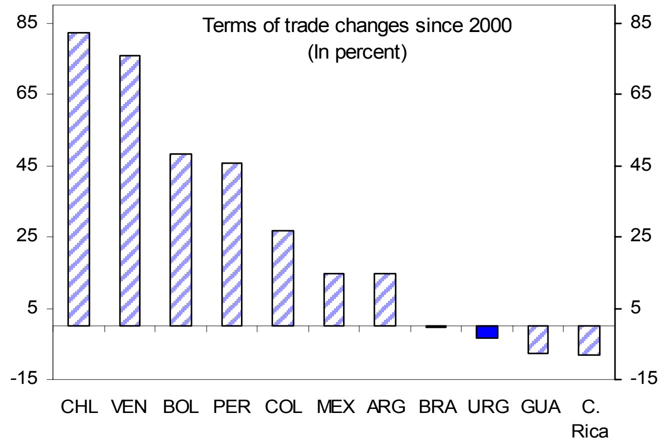
A shift to a contractionary phase was recently announced to help reduce demand preassures.



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

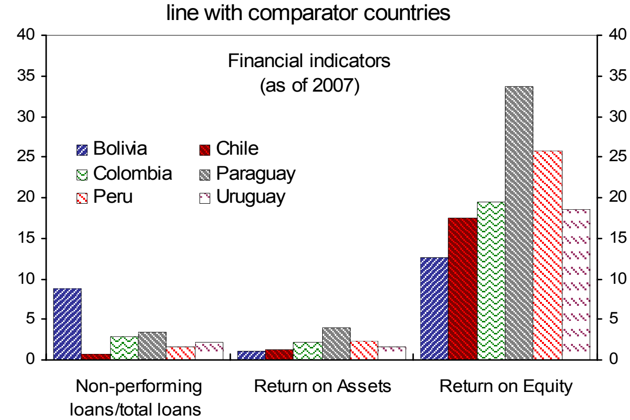
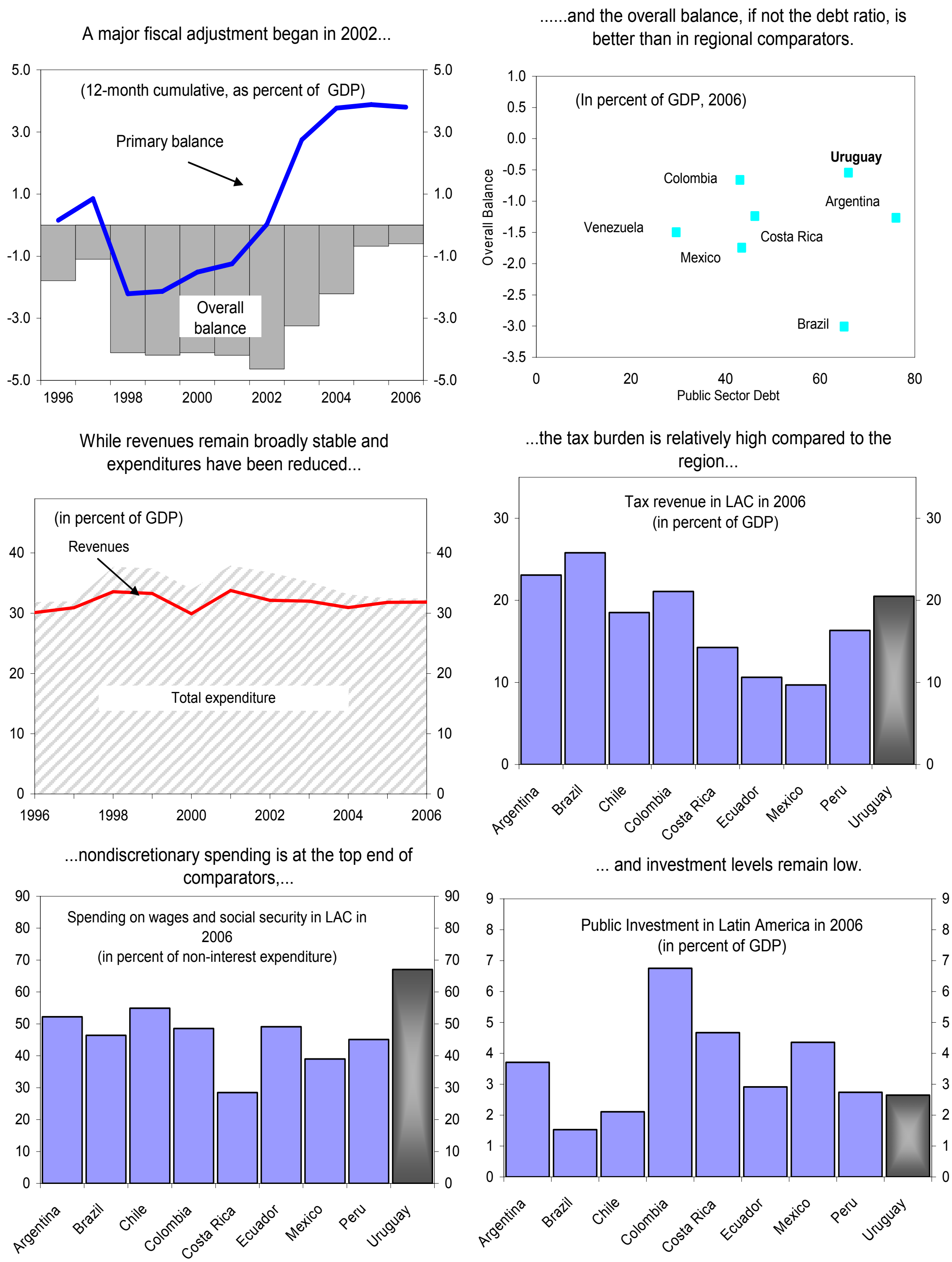


Figure 8. Fiscal Performance—Is strong, but public investment remains low.



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.~~; they disagreed that delays in implementing these reforms were a "disappointment.~~"

Pending reforms under the previous Stand-by Arrangement

Update on Structural Reforms

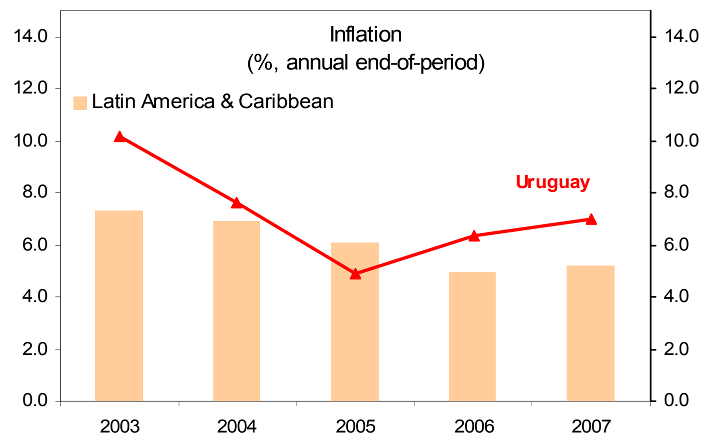
Reform	Status as of December 2006	Current Status
	Fiscal reforms	
Tax Reform	Approved by congress in 2006.	Implementation began on July 1, 2007.
Police Pension Fund	Submitted to congress, approval expected in 2007.	Yet to be discussed by congress.
Pension Fund for the Military and Banking Employees	Expected 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.

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~~ and pressures~~, prevented them from committing, ex-ante, to a higher primary surplus target.

B. Moving to Inflation Targeting

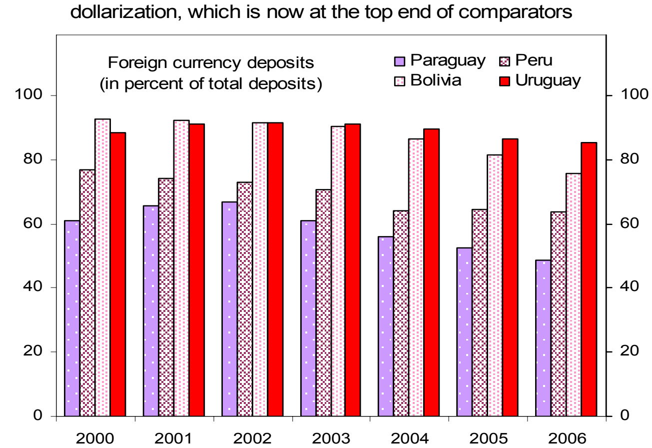
22. ***There was agreement that the adoption of full-fledged inflation targeting should proceed gradually***. Moving toward inflation targeting has been an objective of the authorities for some time, and the case for doing so has strengthened on account of the instability of monetary aggregates and multipliers. 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

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



state bank; capitalization of the 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

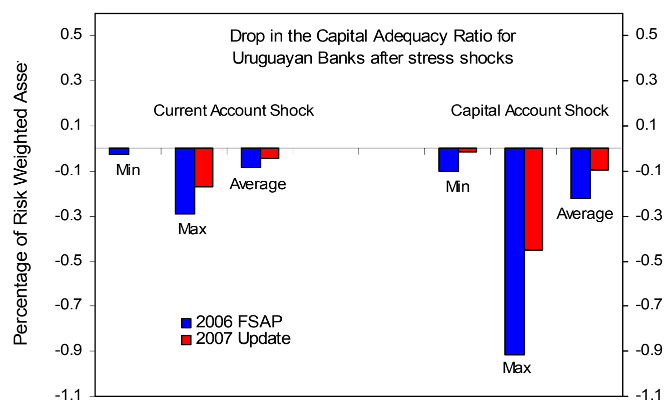
Countries	Risk Practices: Foreign Exchange Rate Risk: Prudential Rules: Limits on FX exposures	Long open position limit (in percent of capital)	Short open position limit (in percent of capital)	Supervisory Guidelines: Specific FX risk management guidelines	Credit Risk: Higher provisions	Higher generic 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.

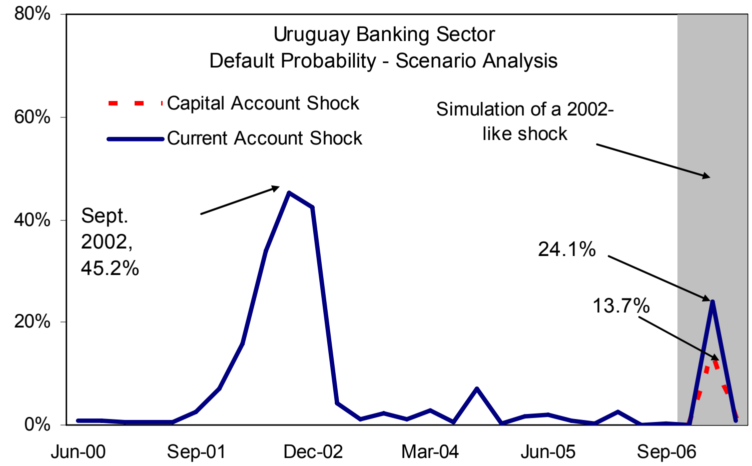
Stress tests indicate that system has become more resilient



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

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.

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

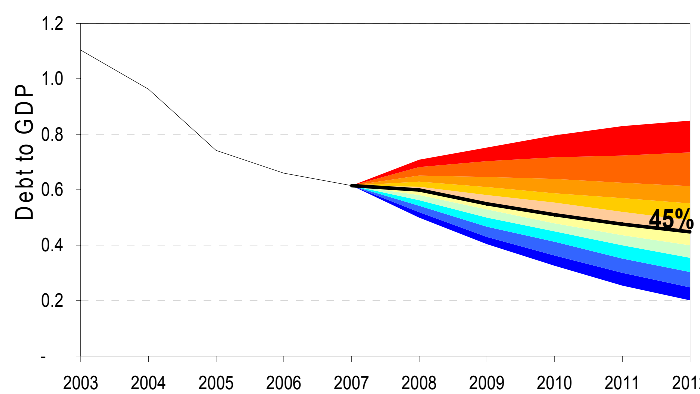


27. ***The authorities stated that the decision to join Fondo Latinoamericano de Reservas (FLAR) was largely made to improve reserve management***. While noting that their membership to FLAR helps reduce risks, officials agreed that regional reserve pooling arrangements are not a substitute of global 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.

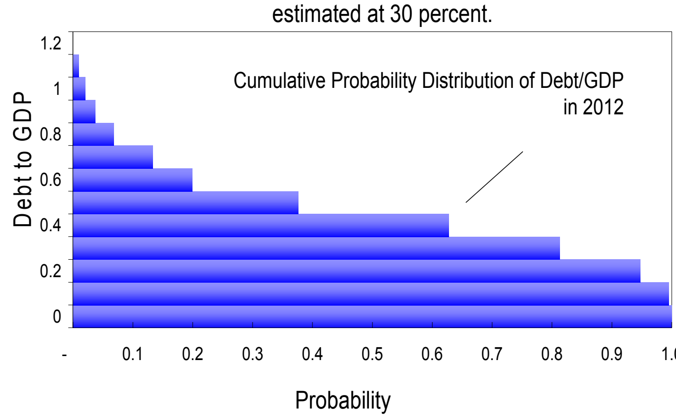
D. The Objectives of Fiscal Policy over the Medium Term

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

Sound fiscal policies have strengthened debt sustainability...



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



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	EBS/06/166	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