FINANCIAL STABILIZATION PROGRAMS REPORT

BRIDGE LOAN TO URUGUAY FROM THE EXCHANGE STABILIZATION FUND

A Report to Congress

in accordance with

Section 1704 of the International Financial Institutions Act,

as added by

section 612 of the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1999.

U.S. Department of the Treasury
September 2002

ESF Report to Congress - Uruguay

1. *Condition of the Uruguayan Economy* – Uruguay has historically been a center of economic stability and market-oriented reform in the Southern Cone region. The country experienced robust growth during much of the last decade due to sound management and appropriate economic policies. Substantial trade liberalization, financial sector reform, prudent fiscal management, and strong demand from Brazil and Argentina helped Uruguay grow 4.4% per year from 1990-94 and by 5.1% from 1996-98. This growth, underscored by a dramatic reduction in the overall deficit and inflation, helped Uruguay earn investment grade status on its sovereign debt in 1997.

   However, economic growth has been weak during the last four years as conditions in Uruguay's close neighbor, Argentina, deteriorated. In the last year, Uruguay has faced acute financial pressures, due largely to the dramatic deterioration in Argentina at the end of 2001. The impact of lower growth on tax revenues led to an increase in the debt stock. The Uruguayan authorities have taken substantial measures to address the effects of these pressures, accelerating their reform agenda, including a streamlining of the financial sector.

   The financial sector in Uruguay is open to foreign participation and is underpinned by a generally strong supervisory and regulatory framework. For several years, the government has been undertaking financial sector reforms to address outstanding vulnerabilities by enforcing greater disclosure of financial statements, broader compliance with the Basle Core Principles, and greater sanctioning power for the oversight arm of the Central Bank.

   Despite these reforms, the extraordinary demand to withdraw dollar deposits resulting from the freeze on deposits in Argentina in late-2001 put immediate and substantial pressure on the financial system. In response, the Uruguayan authorities acted quickly to restore confidence, closing insolvent banks, solidifying the regulatory framework, and backing bank deposits needed for economic transactions. In June 2002, the Uruguayan Central Bank floated the peso as part of a phased shift to greater exchange rate flexibility that began the previous year. Authorities will take steps to close insolvent, private domestic banks and to restructure public banks. To reinforce confidence in the banking system, the central bank will further strengthen its supervisory capacity.

   ESF financing in the form of a short term four-day bridge loan was specifically to be used to ensure the availability of funds to back transactional deposits of Uruguayan banks. This loan supported in a timely manner the restoration of confidence in the financial sector.

2. *Degree of Implementation of financial restructuring and corporate governance reform measures required by IMF* – Since early 2001, Uruguay has performed consistently under IMF programs with respect to financial restructuring and corporate governance targets. Furthermore, throughout the recent recession and financial sector deterioration, the GOU has assiduously respected the commercial nature of bank lending, limited intervention to prudential supervision, and maintained open financial markets.

The following chart illustrates progress made by Uruguay in implementing corporate governance and financial sector reforms:

Corporate Governance and Financial Sector Reform Progress
Before end-March 2001
Publish quarterly reports for public sector financial and non-financial enterprises
Complete independent external audit of three public banks
Complete independent external audit of six public utilities
Before end-June 2001
Submit law to Congress to reform five special pension funds
Publish annual reports of all three public banks and six public utilities
Before end-September 2001
Submit law to Congress to reform the special pension fund for university professionals
The BCU will issue a regulation requiring all banks to obtain and publish a corporate credit rating
Before end-July 2002
Presentation to Congress of restructuring plan of one public bank

3. *Description of implementation of reform measures required by the IMF to deregulate and privatize economic activity, undertake trade liberalization, and open up restricted areas of the economy to foreign investment and competition.*

   Privatization and Foreign Investment - State owned enterprises represent a relatively minor share of Uruguayan GDP (roughly 2% of GDP). Nonetheless, authorities did commit in the context of recent official sector support to end private sector monopolies in key sectors by allowing for both domestic and foreign competition. In the current program, the GOU commits to presenting legislation to Congress to foster competition in both the telecommunications and oil sectors by end-2002.

   Trade Liberalization – Uruguay continues to operate a generally open trade regime (see below). There have been no specific requirements in IMF programs in the trade area.

4. *Description of the trade policies of the countries including any unfair trade practices or adverse effects of the trade policies on the United States* - Uruguay is a member of the World Trade Organization (WTO) and is a founding member of MERCOSUR, the Southern Cone Common Market (also composed of Brazil, Argentina and Paraguay, with Chile and Bolivia as Associate Members). Since 1995, no tariffs have been paid on goods traded between MERCOSUR countries. The same year, a common external tariff went into effect on imports from non-member countries, with most rates ranging between 0 and 20 percent. In 1997, the maximum common effective tariff was raised to 23 percent, and in July 2002, stood at 21.5 percent. In addition to tariff rates, a (refundable) value-added tax of 28 percent is applied over customs' valuations plus import surcharges. Import duties on non-MERCOSUR goods range from zero to 21.5 percent. Uruguay has maintained a long-lasting tradition of imposing no restrictions on the purchase of foreign currency or the remittance of profits abroad. Foreign exchange can be freely obtained.

   U.S. trade with Uruguay is small and consistently in surplus for the U.S. Uruguay's exports to the U.S. represent less than 10% of Uruguay's trade with the world. U.S. exports to Uruguay represent only 0.06% of U.S. trade with the world. The full year trade data for 2001

shows U.S. exports to Uruguay of $414 million. 2001 US imports from Uruguay were $228 million. The key framework for US-Uruguay trade relations going forward is likely to be the Joint Commission of Trade and Investment (JCTI), which President Bush agreed to establish with President Batlle in February of 2002.

5. *Description of the extent to which the financial stabilization programs have resulted in appropriate burden sharing among private sector creditors, including rescheduling of outstanding loans by lengthening maturities, agreements on debt reduction, and the extension of new credit* – Historically, the Uruguayan government has maintained good relations with its private creditors, reinforced by sound economic management. Its strong fiscal position and timely servicing of external obligations contributed to an investment grade rating on the government's obligations that lasted until the recent crisis. The strengthened reform measures undertaken under Uruguay's program with the IMF have been directed to restore this confidence and thereby reduce capital account pressures while strengthening the foundations for sustainable growth going forward.

6. *A description of the extent to which the economic adjustment policies of the IMF and the policies of the government of the country adequately balance the need for financial stabilization, economic growth, environmental protection, social stability, and equity for all elements of society*. The GOU has actively sought to minimize the impact on the most vulnerable portions of the population of the recent recession and the current crisis. In the current period, the GOU has emphasized the importance of mitigating the adverse effects of the crisis on the poor, including through 1) lowering the wage and pension tax for lower-income pensioners; 2) shielding budget expenditures on key social programs, including early child development and rural housing; and 3) maintaining the current system of unemployment benefits. In support of the IMF stabilization package, the IDB approved a $500 million emergency loan that will be disbursed in two equal tranches to support spending on priority social programs. The goal of the financing is to mitigate the harmful effects of the economic crisis on low-income groups while at the same time preventing a reversal of ongoing modernization efforts in the social sectors. The emergency loan is conditioned on the government protecting budgetary expenditure in the period 2002-2003 for priority social programs in education, health, and social security. The World Bank also recently approved $300m in programs as part of a broader $550m Country Assistance Strategy that includes support for fiscal and social policy reforms, including measures to ensure that social protection programs are focused on helping the country's poorest families and children. Recent enactment by the GOU of the General Environmental Protection Act likewise illustrates the high priority that Government authorities place on environmental issues and reflects a growing public awareness of and support for these issues.

7. *Whether International Monetary Fund involvement in labor market flexibility measures has had a negative effect on core worker rights, particularly the rights of free association and collective bargaining. Include a description of any pattern of abuses of core worker rights –*

   - Uruguay is one of 80 states to have ratified all eight of the International Labor Organization's fundamental conventions. In total, Uruguay has ratified 102 ILO conventions.

- The PIT-CNT (central labor collective) is very active politically and has the full backing of the leftist political coalition party, Encuentro Progresista-Frente Amplio.

- In prior years, the international financial institutions have had extensive discussions with Uruguayan authorities on labor issues. In order to address the dampening effect high labor costs have on employment generation, Fund staff, with the support of the United States, have urged the government to reduce its tax on hiring new employees in order to lower costs for employers and spur job creation.

8. *The amount, rate of interest, and disbursement and repayment schedules of any funds disbursed from the stabilization fund in the form of loans, credits, guarantees, or swaps in support of the financial stabilization programs* – The ESF entered into a swap agreement with Uruguay, effective Sunday, August 4, 2002, to provide short-term bridge financing until the disbursement of credits to Uruguay from the IMF, the World Bank, and the Inter-American Development Bank. The rate of interest was 1.689%, based on the costs of funds to the U.S. Treasury. On Monday, August 5, Uruguay drew $1,466,000,000 from the ESF and on Friday, August 9, completed repayment to the ESF of the $1,466,000,000, plus $271,350.58 in interest.

9. *The amount, rate of interest, and disbursement and repayment schedules of any funds disbursed by the IMF to the countries in support of the financial stabilization programs* – On August 8, the IMF approved a SDR 376 million ($494 million) augmentation on its current Stand-By Arrangement (SBA) to Uruguay and accelerated disbursement of SDR 227 million ($298 million) in funds previously committed. This allowed Uruguay to immediately draw down SDR 603 million ($793 million) and help settle its obligations to the ESF under the swap agreement. The August augmentation and re-phasing of IMF disbursements come in addition to a 24 month SBA of SDR 594.1 million ($781 million), approved in March 2002, and a subsequent augmentation of SDR 1.16 billion ($1.5 billion), approved in June. The total size of Uruguay's IMF financial package currently amounts to SDR 2.13 billion ($2.8 billion). Of this amount, SDR 128.7 million ($169.8 million) was disbursed under the Fund's Special Reserve Facility (SRF).

   Since March, Uruguay has drawn SDR 1.1 billion ($1.5 billion) from the IMF. Uruguay's remaining drawings are scheduled for disbursement in 7 installments over the course of the coming year and a half. Pending successful completion of performance reviews, disbursements in the amount of SDR 145 million (about $191 million) will be made available, respectively, in October and December 2002, February, May, August and November 2003, and February 2004, at which time Uruguay will have completely drawn down all of its current IMF financial packages.

   Principal repayments on existing and prospective drawings of Uruguay's SBA are scheduled on an expectations basis[1] to be made as follows: SDR 51 million in 2002, SDR 264 million

[1] Countries are expected to make repayments prior to final obligation dates under the "Expectations Schedule." The IMF Executive Board can extend repayment dates up to the final "Obligations schedule" upon request by the debtor

in 2003, SDR 94 million in 2004, SDR 321 million in 2005, SDR 894 million in 2006 and SDR 859 million in 2007.[2] Currently, 95% of Uruguay's outstanding obligations to the Fund are provided under Stand-By Arrangements. Members are *expected* to repay loans from this facility 2¼ to 4 years from the date of drawing and are obliged to do so 3¼ to 5 years from the date of drawing. Under the SRF, the member is *expected* to repay 1–1 ½ years after the date of drawing but must do so not later than 2–2 ½ years. Uruguay's repayment schedule can be referenced online through the IMF website at www.imf.org.

Use of the SBA carries a surcharge of 100 basis points above the basic rate of charge for credit exceeding 200 percent of a member's quota, and 200 basis points for credit exceeding 300 percent of quota. Since Uruguay's combined credit outstanding is in excess of 300% of quota, it pays a surcharge of 300 bps on top of the basic interest rate (determined weekly based on a weighted average of representative interest rates on short-term debt in the money markets of major IMF creditor countries). For the 5% of Uruguay's outstanding obligations financed through the SRF, credits are subject to surcharges of 300 basis points above the basic rate of charge during the first year from the date of drawing, with these surcharges rising by 50 basis points at the end of that first year and every six months thereafter until they reach 500 basis points.

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country if its external payments position is not strong enough to meet the expectations without undue hardship or risk.